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Sixteenth Edition

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**F. Ladson Boyle
Jonathan G. Blattmachr**

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Preface to the Sixteenth Edition

The Fifteenth Edition represented the collaborative efforts of Jonathan and Lad to present a revised and comprehensive examination of how estates and trusts are income taxed.

This Sixteenth Edition includes a new chapter 4 that discusses the 3.8% Medicare Tax under section 1411 on net invest income and how it applies to estates and trusts. This chapter explores the statute and the proposed regulations issued by the Treasury Department. Future supplements to this Sixteenth Edition will incorporate changes made by anticipated final regulations for section 1411. The addition of the new chapter 4 resulted in the renumbering of chapters 4–9 of the Fifteenth Edition as chapters 5–10 in the Sixteenth Edition.

In addition, the Sixteenth Edition updates all of the material from the Fifteenth Edition for changes made by Congress, the courts, and the Treasury Department through August 1, 2013.

We hope that you will find our book useful and informative when issues arise that concern how an estate or trust is income taxed. Enjoy!

JONATHAN G. BLATTMACHR
F. LADSON BOYLE

AUGUST 2013

Chapter 1

Types of Trusts

Income taxation of estates and trusts is governed by provisions contained in subchapter J¹ of chapter 1 of the Internal Revenue Code² that were originally enacted as a part of the general adoption of the Internal Revenue Code of 1954.³ Important amendments to subchapter J were made by the Tax Reform Act of 1969,⁴ primarily in the so-called throwback rules, in the rules for split-interest charitable trusts, and the taxation of income for the benefit of a grantor's spouse. Significant changes were also made by the Tax Reform Act of 1976,⁵ again especially in the throwback rules.⁶ Additional amendments were made by the Revenue Act of 1978;⁷ the Tax Reform Act of 1984;⁸ the Tax Reform Act of 1986;⁹ and the Revenue

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1. I.R.C. §§ 641–692.
 2. EDITORIAL NOTE. The “Code” referred to in this book is the Internal Revenue Code of 1986 as amended. It is cited in the footnotes as “I.R.C.” Citations of the preceding Internal Revenue Code of 1939 appear as “I.R.C. ____ (1939).”
 3. Before extensive changes to income tax rules governing estates and trusts were made in 1954, the relevant sections in the 1939 Code were 161 to 172. See Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 COLUM. L. REV. 1237 (1954).
 4. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.
 5. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.
 6. See generally Cornfeld, *New Laws on Accumulation Trusts Require Practitioners to Take Prompt Action*, 45 J. TAX’N 331 (1976); Howe, *Transaction of Trusts and Beneficiaries Changed by Provisions of Tax Reform Act of 1976*, 17 TAX’N FOR ACCT. 346 (1976); Johnston & Garrett, *Sweeping Changes in Rules of Accumulation Trusts Partially Unscramble Tax Computations*, 4 EST. PLAN. 142 (1977).
 7. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.
 8. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.
 9. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

Reconciliation Act of 1993.¹⁰ The Small Business Job Protection Act of 1996¹¹ made significant changes to rules governing foreign grantor trusts and domestic grantor trusts with foreign grantors or substantial owners. Additional important changes were made to several areas of the income taxation of estates, trusts, and beneficiaries by the Taxpayer Relief Act of 1997.¹²

Trusts and estates can be divided into five general categories:

- (1) "Ordinary trusts," consisting of valid, domestic trusts that do not fall into either the second, third, fourth, or fifth categories. Generally, decedents' estates are treated in the same manner as ordinary trusts.¹³ The provisions of subchapter J, relating generally to trusts and estates in this category, are sections 641–68.¹⁴ Ordinary trusts and estates are discussed in greater detail in chapter 3.
- (2) "Grantor trusts," are trusts in which the grantor retains sufficient dominion and control or beneficial interest to treat the corpus or the income as still belonging to the grantor for income tax purposes.¹⁵ Under these rules, dominion and

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10. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416. *See generally* Early, *Living With the New Fiduciary Income Tax Rates Under RRA '93*, 21 EST. PLAN. 3 (Jan.–Feb. 1994).
 11. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.
 12. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.
 13. Differences exist between estates and trusts, however. For example, an estate is entitled to a personal exemption of \$600, while a trust is entitled to a personal exemption of either \$100 or \$300. *See* I.R.C. § 642(b).
 14. In *United States v. Cooke*, 228 F.2d 667 (9th Cir. 1955), *aff'g* 115 F. Supp. 830 (D. Haw. 1953), a legal life estate was held not taxable as a trust; thus, the holder of the life estate was not a fiduciary and did not have to report a capital gain. However, the case has been distinguished and is of doubtful value. *United States v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960); *see also* *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972) (guardianship); *Hirschmann v. United States*, 309 F.2d 104 (2d Cir. 1962), *aff'g* 202 F. Supp. 722 (S.D.N.Y. 1962); *Weil v. United States*, 180 F. Supp. 407 (Ct. Cl.), *cert. denied*, 364 U.S. 822 (1960); Rev. Rul. 61-102, 1961-1 C.B. 245; Rev. Rul. 59-154, 1959-1 C.B. 160 (requiring trust treatment of power in trust although legal title was in the beneficiaries); *cf.* *Sher, Recent IRS Successes Taxing Life Tenant on Sale of Principal Residence Are Questionable*, 17 J. TAX'N 30 (1962); *see also* *Morgan v. United States*, 94-1 T.C. ¶ 50,146 (N.D. Fla. 1994) (CCH) (discussion of consequences of sale of life estate and sale of remainder, suggesting apportionment of capital gain based on actuarial interests of each if all interests sold).
 15. I.R.C. §§ 671–79.

Types of Trusts

control or beneficial interest in a person other than the grantor may result in that person being treated as the owner as well.¹⁶ Grantor trusts are discussed in greater detail in chapter 5.

- (3) "Foreign trusts," are trusts that do not meet the definition of a domestic trust and receive special treatment.¹⁷ New foreign trust rules were enacted in 1976,¹⁸ including a new code section for foreign trusts with U.S. beneficiaries.¹⁹ Legislation in 1996 added to the adverse treatment of foreign trusts under U.S. law and eliminated grantor trust status for many trusts, whether domestic (U.S.) or foreign, with foreign grantors.²⁰ The 1996 legislation also expanded the reporting requirements for foreign trusts if there is a U.S. grantor or a distribution is made to a U.S. person. Foreign trusts are discussed in greater detail in chapter 6.
- (4) Trusts that own stock of S corporations are subject to extensive and complex rules governing when a trust or estate may own S corporation stock without voiding the S election. The taxation of these types of trusts may fall under ordinary trust rules, grantor trust rules, or special rules that apply to Electing Small Business Trusts.²¹ Chapter 8 provides an expansive overview of the tax rules applicable to trusts and estates that own stock of an S corporation.
- (5) "Special trusts," are trusts used in particularized situations, such as pension trusts,²² common trust funds,²³ alimony trusts,²⁴ trusts taxable as corporations,²⁵ and Alaska Native

16. I.R.C. § 678.

17. See I.R.C. § 7701(a)(31)(A). Legislation in 1996 provides a trust will be considered domestic (U.S.) if (i) a court in the United States is able to exercise primary supervision over the administration of the estate or trust, and (ii) one or more U.S. fiduciaries have the authority to control all substantial decisions of the trust. I.R.C. § 7701(a)(31)(B). See section 6:3.

18. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

19. I.R.C. § 679 enacted by Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, § 1013(a).

20. Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755, § 1093.

21. See section 8:7.

22. I.R.C. § 401.

23. I.R.C. § 584.

24. I.R.C. § 682. The tax treatment of alimony trusts was modified by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

25. Treas. Reg. § 301.7701-4(b). See also section 6:3.

Settlement Trusts.²⁶ Also included in this category are split-interest charitable trusts—charitable lead and remainder annuity trusts, charitable lead and remainder unitrusts, and pooled income funds—with simplified treatment for non-charitable current beneficiaries.²⁷ Special trusts, including charitable trusts, are discussed in greater detail in chapter 7.²⁸

When a decedent dies, income attributable to the decedent's efforts (services income) does not necessarily end and income generated by the decedent's property continues. In general, only the income received before a decedent dies is reported on the decedent's final return. Similarly, income generated by the decedent's property and received before death is reported on the decedent's final return. In addition, when a decedent dies with a right to either type of income, special

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26. I.R.C. § 646. Alaska Native Settlement Trusts are not discussed in this book. Priv. Ltr. Rul. 200733013 discusses the legislative history of I.R.C. § 646 and the issues and relevant law applicable to trusts that qualify and elect to be taxed under I.R.C. § 646. *See also* Priv. Ltr. Ruls. 200835029 and 200927022. I.R.C. § 646. Alaska Native Settlement Trusts are not discussed in this book. Priv. Ltr. Rul. 200733013 discusses the legislative history of I.R.C. § 646 and the issues and relevant law applicable to trusts that qualify and elect to be taxed under I.R.C. § 646. *See also* Priv. Ltr. Ruls. 200835029, 200927022, 201523017, 201527004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. *See generally* B. Edwards, *Understanding and Making the New Section 646 Election for Alaska Native Settlement Trusts*, 18 ALASKA L. REV. 217 (Dec. 2001). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. *See generally* B. Edwards, *Understanding and Making the New Section 646 Election for Alaska Native Settlement Trusts*, 18 ALASKA L. REV. 217 (Dec. 2001).
27. I.R.C. § 664 added by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.
28. Pension trusts, real estate investment trusts, and other special purpose trusts (*e.g.*, Environmental Remediation Trusts) are not discussed in this book. *See generally* Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997). Trusts wholly for charity may be tax exempt under I.R.C. § 501(c)(3) and, if so, are not subject to the rules of subchapter J. Certain other trusts are particularly concerned with the special rules that apply to the charitable contributions of nonexempt trusts. These special rules, which apply to ordinary trusts, are discussed in § 3:2.1. *See* I.R.C. §§ 170(f) and 508(d)(2) for limitations, enacted in 1969, on charitable deductions for gifts of trust interests, or for gifts to trusts insufficiently restricted. Gift and estate tax charitable deductions relating to remainder interests committed to charity are also in certain circumstances tied to the charitable remainder trusts defined in the text. *See* Appert, *Nonexempt Charitable Trusts Under the Tax Reform Act of 1969*, 25 TAX LAW. 99 (1971).

rules come into play concerning how and when that income is reported. Thus, these reporting issues must be resolved before the income of the decedent's estate may be determined and before the taxation of the estate's beneficiaries is calculated. The decedent's final return and the decedent's right to income at death are discussed in chapter 2.

Revocable trusts are sometimes created to achieve certain estate, financial, and management objectives.²⁹ In recent years, the principal use of revocable trusts has been to avoid the so-called probate process by holding property during the grantor's lifetime pursuant to the terms of a revocable trust and then at the grantor's death the property passes in accordance with the trust's terms rather than pursuant to the grantor's will.³⁰ Other reasons for creating a revocable trust include greater confidentiality than is possible by owning assets directly and at death disposing of them by will, providing an arrangement for property management (especially during a time of legal incapacity of the grantor), and avoiding delays in starting and completing the administration process to transfer ownership of property after a grantor's death.³¹ Revocable trusts are discussed in chapter 8.

In 1981, the Internal Revenue Service began an audit program in its North Atlantic region for audits of U.S. fiduciary income tax returns (Form 1041). The audit issues considered by this program are outlined in chapter 10.

In two Revenue Rulings,³² the Service concluded that land trusts that hold title to real estate and will transfer title at the direction of the true owners are not trusts. In those situations, the trustee is agent to hold title and transfer title. Revenue Ruling 92-105 concerned an Illinois land trust, and Revenue Ruling 2013-14 concerned a Mexican land trust. In Revenue Ruling 2004-86, however, the Service concluded that a Delaware statutory trust, as described in the ruling, is an investment trust that is classified as a trust for federal tax purposes.³³ For a discussion of when a trust may be classified as an association under the check-the-box regulations, see section 7:3, Trusts Taxable As Corporations.

29. See generally A. James Casner, *Estate Planning—Avoidance of Probate*, 60 COLUM. L. REV. 108 (1961).

30. Frederick R. Keydel, "Funding" the Revocable Trust—Pros, Cons and Caveats, ACTEC NOTES Fall 1988, Vol. 14-98; *How to Take Title to Trust Property Including a Simple Way to Convert Joint Property into Revocable Trust Property*, 13 ACTEC NOTES 230 (Spring 1988).

31. See generally R. Covey, *Revocable Trusts*, PRAC. DRAFTING, July 1993, at 3244.

32. Rev. Rul. 92-105, 1992-2 C.B. 204; Rev. Rul. 2013-14, 2013-26 I.R.B. 1267.

33. Rev. Rul. 2004-86, 2004-2 C.B. 191.

Chapter 2

Decedent's Final Return and Income in Respect of a Decedent

- § 2:1 Introduction
- § 2:2 Decedent's Final Return
- § 2:3 Income in Respect of a Decedent (IRD)
 - § 2:3.1 Section 691(a)(1)—Inclusion in Income
 - § 2:3.2 Section 691(a)(2)—Disposition of the Right to IRD Items
 - § 2:3.3 Deductions in Respect of a Decedent (DRD): Section 691(b)
 - § 2:3.4 The Section 691(c) Income Tax Deduction for Estate Taxes Paid
 - § 2:3.5 QDOT (Section 2056A) Marital Deduction Trusts
 - § 2:3.6 GST Taxes and Income Tax Deductions

§ 2:1 Introduction

When a decedent dies, income attributable to the decedent's efforts (services income) does not necessarily end and income generated by the decedent's property continues. In general, only the income received before a decedent dies is reported on the decedent's final United States Income Tax Return (Form 1040). Similarly, income generated by the decedent's property and received before death is reported on the decedent's final return. In addition, when a decedent dies with a right to either type of income, special rules come into play concerning how and when that income is reported. Thus, these reporting issues must be resolved before the income of the decedent's estate may be determined and before the taxation of the estate's beneficiaries is calculated. The decedent's final return and the decedent's right to income at death are discussed below.

§ 2:2 Decedent's Final Return

Income earned before a decedent's death, and not reported on a previously filed return, is reported on a return that is filed after death. The Code requires the personal representative to file a decedent's final return for a tax reporting period ending with the decedent's death.¹ The return is due when the decedent's return would have been due if the decedent had not died, typically April 15 of the year following death.² The decedent's final return is filed at an IRS Service Center based on the domicile of the personal representative or executor of the decedent's estate, rather than the decedent's domicile.³ Thus, the decedent's final income tax return may be filed at a different Service Center than where the decedent's United States Estate and Generation-Skipping Tax Return (Form 706) is filed.⁴

The personal representative of a married decedent may file a joint income tax return with the surviving spouse for the year of the decedent's death.⁵ A joint return may be filed also with the estate of a surviving or pre-deceased spouse, so long as both spouses die during the same tax year.⁶ A joint return filing will subject the decedent's estate to joint and several liability for any unpaid taxes arising out of that joint return.⁷

Section 6013(a)(3) provides that if no executor or personal representative is appointed for a decedent's estate by the time the surviving spouse's income tax return is due^{7.1} (typically April 15), the surviving spouse may file a joint return for the decedent and the surviving spouse. After the filing of a joint return in such circumstances, a subsequently appointed executor or administration may "disaffirm" the joint return by filing a separate return within one year of the due date of the surviving spouse's return. If such a return is filed, then the return previously filed by the surviving spouse is deemed a separate return for the surviving

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1. I.R.C. § 6012(b)(1). In Chief Counsel Adv. 201405016 (Jan. 31, 2014), the IRS concluded that the section 2203 definition of an "executor" is only operative in the estate tax context. It specifically states that "[s]ection 2203 does not provide any authority in the income tax regime (Chapter 11) . . .".
 2. Treas. Reg. § 1.6072-1(b).
 3. Treas. Reg. § 1.6091-2(a).
 4. The place of filing for an estate tax return is based on the decedent's domicile. I.R.C. § 6091(b)(3)(A). For foreign estates, the estate tax return is filed at the IRS Service Center in Cincinnati, Ohio. *See* Instructions for IRS Form 706NA. I.R.C. § 6091(b)(3)(B).
 5. I.R.C. § 6013(a)(2).
 6. *Id.*
 7. I.R.C. § 6013(d)(3).
 - 7.1. Section 6013(a)(3) does not say the due date including extensions to file as is common in many other statutes regarding due dates. Thus, it would appear that the deadline is the statutory prescribed due date without extensions.

spouse, with appropriate adjustments made for the items properly reported on the decedent's return.^{7.2} For purposes of section 6013, an executor or administrator "means a person who is actually appointed to such office and not a person who is merely in charge of the property of the decedent."^{7.3} While the statute and regulations are silent, these special rules appear to be applicable only if the surviving spouse, and not the personal representative of a surviving spouse's estate, files the joint return.

Whether an estate should file a joint final return is a question that should be answered only after considering who is responsible for any tax due or who is entitled to any refund. The availability of an estate tax deduction for taxes paid or the inclusion of a refund in the decedent's gross estate for estate tax purposes is controlled by state law or mutual agreement under the estate tax regulations. Only in default of neither state law nor agreement does a tax law apportionment rule apply.⁸ Some states have rules concerning contributions to a liability⁹ and/or the right to refunds.¹⁰ Local law should be consulted to determine if

7.2. Treas. Reg. § 1.6013-1(d)(5).

7.3. Treas. Reg. § 1.6013-4(c).

8. Treas. Reg. § 20.2053-6(f) provides that an estate tax deduction for any liability is:

the portion of the joint liability for the period covered by the return for which a deduction will be allowed is the amount for which the decedent's estate would be liable under local law, as between the decedent and his spouse, after enforcement of any effective right of reimbursement or contribution. In the absence of evidence to the contrary, the deductible amount is presumed to be an amount bearing the same ratio to the total joint tax liability for the period covered by the return that the amount of income tax for which the decedent would have been liable if he had filed a separate return for that period bears to the total of the amounts for which the decedent and his spouse would have been liable if they had both filed separate returns for that period.

When a refund is due the same estate tax regulation continues and provides:

If the decedent's estate and his surviving spouse are entitled to a refund on account of an overpayment of a joint income tax liability, the overpayment is an asset includible in the decedent's gross estate under section 2033 in the amount to which the estate would be entitled under local law, as between the estate and the surviving spouse. In the absence of evidence to the contrary, the includible amount is presumed to be the amount by which the decedent's contributions toward payment of the joint tax exceeds his liability determined in accordance with the principles set forth in this paragraph.

9. See *Johnson v. United States*, 742 F.2d 137, 140 n.3 (1984) (concerning the law in Virginia).

10. See, e.g., S.C. CODE ANN. § 12-6-5550 (1998).

the default rule of the regulations is overridden. An agreement addressing a liability or a refund should be considered if resolution of either issue is of concern to the estate's beneficiaries. It may not matter, however. For example, if the surviving spouse is the sole beneficiary of an estate, the spouse may not care how a liability is paid or a refund divided and the Service may not care because of the estate tax marital deduction. Note, however, that if the surviving spouse is not a U.S. citizen, an estate tax marital deduction may not be permitted.¹¹

The income tax deductions and credits on a jointly filed return attributable to the decedent will only be for the period through the time of the decedent's death; for the surviving spouse, it will be for the entire year (unless the spouse dies the same year, in which event, the deductions and credits attributable to the spouse are through the date of the spouse's death).¹²

The regulations provide that a personal representative of a decedent's estate should file a notice of the fiduciary relationship.¹³ IRS Form 56 may be used, but is not mandatory. The notice should contain information outlined in the regulation.¹⁴

A decedent's last taxable year starts on the first day of the tax year in which the decedent dies, typically on January 1 of that year, and will end with the date of death.¹⁵ The final year is always less than a full taxable year, unless the decedent died on the last day of his or her tax year, typically December 31. The short period may produce tax savings. For example, section 443(c) does not require proration of the personal exemption deduction under section 151 or the standard deduction

11. I.R.C. § 2056(d).

12. Treas. Reg. § 1.451-1(b).

13. *See* Treas. Reg. § 301.6903-1. I.R.C. § 6903 contains no such requirement, but authorizes giving notice in a manner provided in the regulations.

14. Treas. Reg. § 301.6903-1(b) provides:

The notice must state the name and address of the person for whom the fiduciary is acting, and the nature of the liability of such person; that is, whether it is a liability for tax, and, if so, the type of tax, the year or years involved, or a liability at law or in equity of a transferee of property of a taxpayer, or a liability of a fiduciary under section 3467 of the Revised Statutes, as amended (31 U.S.C. [§] 192) in respect of the payment of any tax from the estate of the taxpayer. Satisfactory evidence of the authority of the fiduciary to act for any other person in a fiduciary capacity must be filed with and made a part of the notice. If the fiduciary capacity exists by order of court, a certified copy of the order may be regarded as satisfactory evidence.

15. If the decedent had been filing an income return on a fiscal year, the first day of the final year would be the first day of the fiscal year instead of January 1. Fiscal year individuals are most rare.

under section 63. Thus, income earned in only part of a year is entitled to a full year's exemption and full standard deduction, if claimed.

A decedent's date of death seems to be based on the calendar date at the decedent's domicile at the time of death rather than the calendar date where the decedent actually died. In two Revenue Rulings, the Service held that a decedent's date of death for estate tax purposes is not controlled by the calendar date where the decedent died, but rather the calendar date at decedent's domicile.¹⁶ For example, if a New York domiciled decedent dies shortly after midnight on July 1 while on a European vacation, the date of death is June 30 if it is still June 30 in New York when the decedent died. Similarly, if a New York resident dies on June 30 shortly before midnight while on vacation in Hawaii, the date of death is July 1 because it is already July 1 in New York when the decedent died.

A personal representative must resolve many issues to file a decedent's final income tax return. For example, the estate's fiduciary must determine what constitutes gross income of the decedent during the final taxable year (which ends when the decedent dies) and what is deductible. Income received from the sale of property before a decedent dies is taxable on the decedent's final return even when the proceeds of the sale are not a part of a decedent's probate estate. In *Guyton v. United States*,¹⁷ the decedent sold his farm and placed the proceeds in a joint account with one of his sons. The Eleventh Circuit ruled that the income was not "income in respect of a decedent" because the sale was completed and the proceeds received before the decedent died and the fact that the proceeds were unavailable to the estate did not relieve the estate of the liability for the decedent's income taxes due with the final return.

Usually, cash-basis taxpayers report as income actual or constructive receipts and subtract only deductible items that have been paid. Taxpayers who use accrual accounting report as income amounts that have accrued under the rules of section 451 for accrual accounting, whether or not the income was actually received in the taxable year, and similarly deduct amounts owed that have accrued as provided in section 461. A major exception to the accrual accounting rule is that items of income and deduction that accrue solely because of the decedent's death are not included in gross income and are not deductible on the decedent's final return, even if the income was otherwise reported on the accrual basis.¹⁸

16. Rev. Rul. 66-85, 1966-1 C.B. 213, *modified by* Rev. Rul. 74-424, 1974-2 C.B. 294. The Service does not have a similar published ruling for income tax purposes, however.

17. *Guyton v. United States*, 372 F. App'x 5 (11th Cir. 2010).

18. I.R.C. §§ 451(b), 461(b); Treas. Reg. §§ 1.451-1(b), 1.461-2(b).

A decedent's final return includes income received on the date of death for a cash-basis taxpayer or income accrued for an accrual-basis taxpayer. What income is to be reported on the decedent's final return is not clear. The regulations suggest that the final return includes all the reportable income for the entire day the decedent dies.¹⁹ Nevertheless, General Counsel Memorandum 38960 quotes the 1982 instructions for IRS Form 1041 which states: "The moment of death determines the end of the decedent's tax year and the beginning of the estate's tax year."^{19.1} This instruction is found in more recent instructions for IRS Form 1041 including the 2013 instructions.

Also unclear is whether the decedent's property receives a new basis under section 1014 on the date of the decedent's death, so that when the decedent's property is sold on the date of the decedent's death, the new basis is used to compute gain or loss. There is a good argument that income realized before the moment of death is not entitled to a new basis, but income realized after the moment of death does. When sold after the moment of death, it is property that is "acquired from a decedent," and section 1014 provides that the basis is "fair market value at the date of the decedent's death." This timing of a sale on the date of a decedent's death might occur when the decedent's stocks and bonds are held in a managed account and are sold by the advisor on the date of death.

The deductions, credits, or exclusions from income permitted an individual taxpayer are available on the decedent's final return. For a cash-basis taxpayer, it is necessary to determine whether an item was paid before the decedent's death. If an expense is paid with a check before the decedent's death, it is deductible if the bank pays the check. Of course, a deduction is not permitted if the bank does not pay the check.²⁰ Deductions for accrual-basis taxpayers are determined using the all-events²¹ and economic-performance²² tests generally applicable to accrual accounting.

Some deductions and exclusions may be available for a cash-basis taxpayer's final return, although not paid during the last taxable year. For example, medical expenses are treated as paid under section 213(c)(1) at the time incurred, if the decedent's estate pays the medical expense within one year after the decedent's death.²³ Gains from condemnation awards may be deferred under section 1033 if the

19. Treas. Reg. § 1.451-1(b).

19.1. Gen. Couns. Mem. 38960.

20. See *Estate of Hubbell v. Comm'r*, 10 T.C. 1207 (1948). Cf. *Flint v. United States*, 237 F. Supp. 551 (D. Idaho 1964).

21. See generally *Exxon Mobil Corp. v. Comm'r*, 114 T.C. 293 (2000).

22. I.R.C. § 461(h).

23. Alternatively, the decedent's personal representative may elect to deduct medical bills as a debt of the decedent under I.R.C. § 2053(c)(2).

proceeds are reinvested after the decedent's death.²⁴ A prorated depreciation deduction under sections 167 and 168 for property used in trade or business, or held for the production of income by the decedent before death is permitted.²⁵ Tax-free exchanges under section 1031 may be completed after a decedent dies to avoid recognition of gain.²⁶

If a section 469 passive activity is transferred because a taxpayer-owner dies, suspended losses are deductible on the taxpayer's final return.²⁷ However, the amount deductible is limited to the amount the suspended losses exceed the step-up in adjusted basis permitted by section 1014.²⁸ For example, if the taxpayer has \$25,000 of suspended passive activity losses and the pre-death adjusted basis is \$50,000, only \$15,000 of the passive losses may be deducted on the decedent's final return if the date of death value of the activity is \$60,000. The remaining \$10,000 of passive losses are not deductible on the decedent's final return, on the estate's income tax returns, or by the successor to the passive activity. If in the example, the date of death value of the passive activity exceeds \$75,000, none of the suspended passive activity losses are deductible by anyone.

If the assets of a decedent's estate include U.S. Savings Bonds (Series E, EE, H, or HH), the personal representative may elect to report as income on the decedent's final return all interest that has accrued as of the decedent's death, unless the decedent had elected previously to annually report the income accruing on the bonds.²⁹ Another choice for the personal representative is to elect to report all accrued interest on the estate's United States Fiduciary Income Tax Return (Form 1041) through the year of the election. If the decedent was not reporting the accrued savings bond income and if the personal representative does not make either election to report income, the new owner of the bond(s), for example the estate's residuary legatee to whom the bonds are distributed, may defer reporting the bond income until the redemption of the savings bonds.³⁰

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24. See *Goodman v. Comm'r*, 199 F.2d 895 (3d Cir. 1952).
 25. Treas. Reg. § 1.167(a)-10(b) addresses the issue of prorating depreciation deductions generally.
 26. See Priv. Ltr. Rul. 9829025, discussed *infra* note 114, and accompanying text. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 27. I.R.C. § 469(g)(2).
 28. *Id.*
 29. I.R.C. § 454(a). For a discussion of EE savings bonds, see Philip R. Fink, *Series EE Savings Bonds Offer Investors a Variety of Tax Opportunities*, 81 PRAC. TAX STRATEGIES 160 (Sept. 2008).
 30. See Rev. Rul. 68-145, 1968-1 C.B. 203; Rev. Rul. 64-104, 1964-1 C.B. 223; Rev. Rul. 58-435, 1958-2 C.B. 370.

When the sections 1272–75 original issue discount rules are applicable, interest accrues on a daily basis and accrued income is reportable on a decedent’s final return;³¹ thus, there is no income in respect of a decedent (IRD) under section 691(a).³²

For a decedent who was claiming depletion deductions during his or her lifetime, but was not using percentage depletion to compute the deduction, a depletion deduction is allowed on the decedent’s final return and not on the return of any other person or the decedent’s estate.³³

Section 706(c)(2) closes a partnership’s tax year with respect to a partner who dies during the year. This results in the inclusion on the partner’s final income tax return the deceased partner’s portion of the partnership income earned before the partner died. Section 1366(a)(1) provides a similar rule for shareholders of S corporations. In effect, this is a return to the pre-1942 rule that forced income onto a decedent’s final return.³⁴

If a decedent was the beneficiary of an estate or trust and died during the estate’s or trust’s tax year, the decedent’s final return must include in gross income the amount of income distributions from the estate or trust received before death, limited only by the entity’s distributable net income (DNI) for the year.³⁵ This may result in a bunching of income if the beneficiary and the entity are not using the same year-end. For example, if an estate is filing returns on a June 30 year-end, and the beneficiary dies on November 30, the beneficiary must report income distributed to her or to him in the year ending on June 30 and must report income actually distributed from July 1 until the date of death.³⁶ The validity of the regulations supporting this rule was upheld in *Schimberg v. United States*.³⁷ The allocation of DNI among several beneficiaries is discussed below in section 3:5.2.

31. I.R.C. § 1272.

32. Zero coupon bonds are a classic example of original issue discount bonds.

33. Treas. Reg. § 1.691(b)-1(b).

34. See *infra* notes 41–43 and accompanying text.

35. See Treas. Reg. §§ 1.652(c)-2, 1.652(c)-3, 1.662(c)-2, and 1.662(c)-3 for the applicability of this rule when an individual beneficiary dies or any other beneficiary terminates before the end of the taxable year. See also Rev. Rul. 59-346, 1959-2 C.B. 165 (in case of death, accrual-basis beneficiary of income “required to be distributed currently” includes in his final return such income to date of death); *Estate of Petschek v. Comm’r*, 738 F.2d 67 (2d Cir. 1984) (regardless of when trust’s tax year ends, beneficiary of simple trust must include all DNI through date beneficiary became nonresident alien). For a discussion of how to allocate DNI to the decedent, see the discussion of the tier rule at section 3:5.2.

36. *Id.*

37. *Schimberg v. United States*, 365 F.2d 70 (7th Cir. 1966).

§ 2:3 Income in Respect of a Decedent (IRD)

§ 2:3.1 Section 691(a)(1)—Inclusion in Income

If a taxpayer dies with a right to income that has not been received (or accrued for an accrual-basis taxpayer³⁸), that income and income that accrues only by reason of the death of an accrual-basis taxpayer are not reportable on the decedent's final return.³⁹ Nevertheless, because of the decedent's entitlement to the income, special rules contained in section 691 come into play to determine the taxable income of the decedent's estate or other persons who receive the right from the decedent.⁴⁰

Section 691, and its predecessor, section 126 of the 1939 Code, were designed to change the pre-1942 rule⁴¹ that income accrued up to the date of death of a taxpayer would be included in the decedent's final return even if not yet includible in income under the taxpayer's method of accounting: the pre-1942 rule accrued items of income on a decedent's last return in situations where the items would not yet have been income for a living, accrual-basis taxpayer.⁴² As a result, potentially large sums of income might have been included on a decedent's final return. In addition, if the legal right to receive this income was complete as of the time of death, the value of the right would be includible in decedent's gross estate.⁴³

38. I.R.C. § 451(b).

39. See Treas. Reg. § 1.691(a)-1(b)(2).

40. Treas. Reg. § 1.691(a)-1(a). See generally J. Blattmachr, *Income in Respect of a Decedent*, 12 PROB. NOTES, no. 1, Summer 1986, at 47; Cleary, *Revisions in Deduction for IRD Items Create New Planning Possibilities*, 53 J. TAX'N 70 (1980); Ferguson, *Income and Deductions in Respect of Decedents and Related Problems*, 25 TAX L. REV. 5 (1969); see also Craven, *Taxation of Income of Decedents*, 102 U. PA. L. REV. 185 (1953); Drye, *The Taxation of a Decedent's Income*, 8 TAX L. REV. 201 (1953); Irell, *Income in Respect of Decedents as Affected by the 1954 Internal Revenue Code*, 1955 U.S.C. TAX INST. 535; Spaulding, *Limitations of Income in Respect of a Decedent*, 18 INST. ON FED. TAX'N 1159 (1960). See generally D. Markstein, *Giving Well Is the Best Revenge: Planning Opportunities with Stock Options*, 34 INST. ON EST. PLAN. 12 (Jan. 2000); J. Blattmachr, *Cutting the Federal Tax Bite into IRD Down to Size*, 2 J. TAX'N EST. & TR. 13 (Winter 1990); Choate, *Mysteries of IRD*, 38 TAX MGMT. MEMORANDUM 235 (1997).

41. I.R.C. § 42 (1939).

42. E.g., *Helvering v. Enright's Estate*, 312 U.S. 636 (1941); *United States v. Ellis*, 264 F.2d 325 (2d Cir. 1959); *Comm'r v. U.S. Trust Co.*, 143 F.2d 243 (2d Cir.), cert. denied, 323 U.S. 727 (1944), aff'g in part 44 B.T.A. 1056, 1064–65 (1941); *Helvering v. McGlue's Estate*, 119 F.2d 167 (4th Cir. 1941); *Estate of Wickersham v. Comm'r*, 44 B.T.A. 619, 624 (1941).

43. I.R.C. § 811(a) of the 1939 Code included property in a decedent's estate if the decedent had a right to the property at death and the property or that right to property could be transferred.

To somewhat ameliorate the bunching of income onto a single return, old section 42 was repealed in 1942 and section 126 was added to the 1939 Code.⁴⁴ With some modifications, section 126 was adopted as section 691 of the 1954 Code.⁴⁵

Section 691 provides that all items of IRD, that is, income not properly includible in a return for the period up to the decedent's death, are included in the gross income of the ultimate recipient for the taxable year when received. The taxpayer may be the decedent's estate or the person who, either directly or by distribution of the right from the estate or the decedent, acquires the right to receive the IRD amount.⁴⁶

In addition, if the right is transmitted by the death of a second person who had acquired the right from the first decedent, the same income tax treatment carries over to the new recipient.⁴⁷ In other words, the income is reportable when received just as it would be if the original taxpayer had lived and was on a cash basis.⁴⁸ For an accrued-basis taxpayer, cash accounting applies for IRD items.⁴⁹ Moreover, the right to section 691 income has the same character in the hands of the estate or other person as it had in the hands of the decedent; thus, for example, capital gain, partially exempt interest, and dividend income all retain their special character.⁵⁰

The "new" basis rules of section 1014(a) do not apply to rights to income in respect of a decedent.⁵¹ Under section 1014(c), section 691(a) IRD items are denied a stepped-up basis at the decedent's death; rather, IRD is taxable to the recipient as income and not as a return of

44. Revenue Act of 1942, ch. 619, 56 Stat. 798.

45. Internal Revenue Code of 1954, ch. 736, 68A Stat. 3.

46. The constitutionality of this provision, as against a contention that it is a direct tax on principal, was upheld in *Richardson v. United States*, 294 F.2d 593 (6th Cir. 1961), *cert. denied*, 369 U.S. 802 (1962); *see also* *Irwin v. Gavit*, 268 U.S. 161 (1925).

47. *See* Treas. Reg. § 1.691(a)-2(b), Example (2). Priv. Ltr. Rul. 9901023 (proceeds of a qualified plan distributed to a charitable remainder trust are includible in gross income of trust, which is exempt from income tax under I.R.C. § 664(c)). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

48. Treas. Reg. § 1.691(a)-2(a).

49. *Id.*

50. I.R.C. § 691(a)(3); Treas. Reg. § 1.691(a)-3.

51. I.R.C. § 1014(c). The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, provides that the "stepped-up" basis rules of I.R.C. § 1014 do not apply generally for estates of decedents who die in 2010 (the year in which, under current law, there is no estate tax). Instead, I.R.C. § 2022 provides a carryover basis, subject to certain permitted increases to basis. Nevertheless, the adjustment to basis of rules provided in I.R.C. § 1022 do not apply to IRD items. I.R.C. § 1022(f).

capital. Of course, if the decedent had basis in the item of income, the recipient is entitled to that carryover basis, but not to an adjustment to fair market value as of the date of death. An installment note with basis is an example of a decedent's basis carrying over to the estate or other taxpayer who inherits the IRD item. In addition, the basis adjustment for the surviving spouse's half of community property under section 1014(b)(6) does not apply to the rights to IRD.⁵² However, as discussed in more detail below, a deduction for the estate tax paid on IRD items is provided by section 691(c).⁵³

The denial of a stepped-up basis for IRD items is necessary to prevent the avoidance of income taxes. The rights to IRD items will generally be included in a decedent's estate and a stepped-up basis in the item would avoid an inclusion in income.⁵⁴ IRD items that are not a part of a decedent's gross estate for federal estate tax purposes, of course, do not avoid inclusion in income to the extent that the amount received exceeds the income tax basis of the item.

Taxpayers have argued that a lack of a stepped-up income tax basis at death for an IRD item has an impact on the estate tax value of the item. Courts have not been receptive, however. For example, in *Estate of Robinson v. Commissioner*,⁵⁵ the estate tax value of an installment

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52. *Holt v. United States*, 39 Fed. Cl. 525 (1997); Priv. Ltr. Rul. 200345026 (surviving spouse's half of such an annuity, which is community property, similarly not entitled to be "stepped-up" but taxed as annuity). *But see* Priv. Ltr. Rul. 200439016 (annuity contract entitled to "step up" in basis under I.R.C. § 1014(a) because decedent died before the annuity date and because the contract was acquired before October 21, 1979, Rev. Rul. 70-143, 1970-1 C.B. 167, *revoked*, Rev. Rul. 79-335, 1979-2 C.B. 292, *applies*); *see also* Rev. Rul. 2005-30, 2005-1 C.B. 1015, *superseding* Rev. Rul. 79-335 (holding that the excess above the investment in the contract made by the decedent is IRD when the decedent dies before the annuity starting date). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
53. *See infra* section 2:3.4.
54. In the compensation area, items of income have been classified as IRD without an apparent estate tax inclusion. *See, e.g.*, *Rollert Residuary Trust v. Comm'r*, 752 F.2d 1128 (6th Cir. 1985), *aff'g* 80 T.C. 619 (1983), discussed at *infra* notes 116–17 and accompanying text.
55. *Estate of Robinson v. Comm'r*, 69 T.C. 222 (1977). *See* I.R.S. Tech. Adv. Mem. 200247001 (value for estate tax purposes of an individual retirement account owned by the decedent not to be discounted to reflect income taxes that will be payable upon receipt of the distributions); *Estate of Smith v. United States*, 300 F. Supp. 2d 474 (S.D. Tex. 2004), *aff'd*, 391 F.3d 621 (5th Cir.) (similar); *see also* I.R.S. Tech. Adv. Mem. 200444021 (no deduction permitted under I.R.C. § 2053 for income tax paid on income in respect of a decedent). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

obligation, which was a right to income in respect of a decedent, was not discounted for the estimated “inherent” income tax liability that would be due upon collection of the proceeds after decedent’s death.⁵⁶

Many types of IRD are easily recognized. The most common are salaries and wages due, but unpaid, at a decedent’s death.⁵⁷ IRD also includes bonuses not yet declared, but earned by the decedent,⁵⁸ and renewal commissions due an insurance agent.⁵⁹ Qualified retirement benefits,⁶⁰ including individual retirement accounts (IRAs),⁶¹ are also classic examples. Normal investment proceeds such as accrued interest,⁶² unpaid dividends on stock (if the decedent was

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56. *See also* Kincaid v. Comm’r, 85 T.C. 25 (1985); I.R.S. Tech. Adv. Mem. 200303010 (estate tax value of Series E savings bonds not discounted for estate tax purposes for lack of marketability on account of the inherent income tax liability). *Cf.* Estate of Robinson v. Comm’r, 69 T.C. 222 (1977) (holding that the estate tax value of income in respect of a decedent property would not be reduced on account of the built-in gain and liability for income taxes); Estate of Smith v. United States, 300 F. Supp. 2d 474 (S.D. Tex. 2004), *aff’d*, 391 F.3d 621 (5th Cir.); I.R.S. Tech. Adv. Mem. 200444021. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
57. Treas. Reg. § 1.691(a)-2, ex. (1); Rev. Rul. 59-64, 1959-1 C.B. 31; Halliday v. United States, 655 F.2d 68 (5th Cir. 1981).
58. *See* Rollert Residuary Trust v. Comm’r, 752 F.2d 1128 (6th Cir. 1985), *aff’g* 80 T.C. 619 (1983); O’Daniel’s Estate v. Comm’r, 173 F.2d 966 (2d Cir. 1949). If the bonus has not accrued at death, however, it will not be includible in the decedent’s gross estate. *See* Rev. Rul. 65-217, 1965-2 C.B. 214.
59. Treas. Reg. § 1.691(a)-1(b)(3), -2(b), ex. (2).
60. Ballard v. Comm’r, T.C. Memo. 1992-217; Rev. Rul. 69-297, 1969-1 C.B. 131; Rev. Rul. 68-506, 1968-2 C.B. 332. In Eberly v. Comm’r, T.C. Summ. Op. 2006-45, the decedent requested a distribution from a qualified section 403(b) plan a week before he died. The fund sponsor received the request on the day the decedent died and made the distribution a few days later. The court ruled that the income generated by the distribution was reportable on the decedent’s final return and as a result was not IRD received by decedent’s beneficiary.
61. Rev. Rul. 92-47, 1992-1 C.B. 198, to the extent of the value of the IRA as of the date of the decedent’s death; Priv. Ltr. Rul. 200336020 (undistributed annual minimum required distribution from an IRA and the IRA were income in respect of a decedent, but estate that received these entitled to “set aside” deduction under I.R.C. § 642(c) to the extent these items were “set aside” for charities that were residuary beneficiaries under the will). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
62. Rev. Rul. 79-340, 1979-2 C.B. 320; Rev. Rul. 76-153, 1976-1 C.B. 180; Rev. Rul. 58-435, 1958-2 C.B. 370.

alive on the record date),⁶³ accrued interest on U.S. Savings Bonds,⁶⁴ royalties,⁶⁵ and accrued rents⁶⁶ are also items easily identified as IRD.⁶⁷ However, if the sections 1272–75 original issue discount rules are applicable, interest accrues on a daily basis and accrued income is reportable on a decedent's final return;⁶⁸ thus, there is no IRD.⁶⁹

When the decedent's estate receives an amount that was previously deducted by the decedent, the amount received likely is IRD. Revenue Ruling 78-292^{69.1} provides that reimbursement for previously deducted medical expenses are IRD and thus included in gross income when received by the decedent's estate. The reasoning of Revenue Ruling 78-292 should extend to other amounts recovered by a decedent's estate or some other successor to the decedent's right that would be income to the decedent under that tax benefit rule of section 111. This would include such things as refunds of state income taxes that the decedent claimed as an itemized deduction.

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63. Estate of Putnam v. Comm'r, 324 U.S. 393 (1945).
64. Rev. Rul. 64-104, 1964-1 C.B. 223 (previously unreported increment in "E" and "H" bonds); Rev. Rul. 58-435, 1958-2 C.B. 370 (executor may elect under I.R.C. § 454 to report the interest as estate income on the fiduciary income tax return); Rev. Rul. 68-145, 1968-1 C.B. 203 (executor may elect to have the previously untaxed interest on "E" bonds reported on the decedent's final income tax return); Priv. Ltr. Rul. 200336020 (deferred interest on U.S. "HH" bonds was income in respect of a decedent but the estate that received these was entitled to a "set aside" charitable income tax deduction under I.R.C. § 642(c) to the extent these items were "set aside" for charities that were residuary beneficiaries under the will); Priv. Ltr. Rul. 201409001 (interest earned through the date of death on Series "T" bonds held in community property trust were IRD). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
65. Patent and copyright royalties accruing after death are typically not IRD, although accrued but unpaid royalties at death are. Rev. Rul. 60-227, 1960-1 C.B. 262. Nevertheless, for post-death royalties it may be necessary to distinguish between royalties and a sale of the patent or copyright. The transfer of the exclusive right to exploit a patent or copyright for the life of the copyright or patent may be a sale and may be IRD. See Rev. Rul. 60-226, 1960-1 C.B. 26, *modifying* Rev. Rul. 54-409, 1954-2 C.B. 174. See also Priv. Ltr. Rul. 9549023. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. Because of termination rights for copyrights provided under federal law (17 U.S.C. § 304), it is questionable whether all rights in a copyright may be sold, however.
66. Rev. Rul. 64-289, 1964-2 C.B. 173, 175.
67. For other examples of income in respect of a decedent, see Treas. Reg. §§ 1.691(a)-1, -2; Rev. Rul. 73-327, 1973-2 C.B. 214 (survivor payments under employment contract); Wright v. Comm'r, 336 F.2d 121 (2d Cir. 1964) (insurance renewal commissions).
68. I.R.C. § 1272.
69. Zero coupon bonds are a classic example of original issue discount bonds.
- 69.1. Rev. Rul. 78-292, 1978-2 C.B. 233.

Amounts received as a settlement or recovery of damages from a pending law suit may be IRD if the recovery would have been income if received by the decedent during his or her lifetime. In Revenue Ruling 55-463,^{69.2} the Service ruled that an award for a patent infringement received by a decedent's estate was IRD. Similarly, amounts received from antitrust litigation are IRD.^{69.3}

When a decedent's estate or other successor to the decedent's right receives in one lump sum amounts that would be income if received by the decedent and amounts that would not, it is necessary to apportion the receipt between the portion that is income and the portion that is not. For example, in Private Letter Ruling 8740042,^{69.4} the decedent's estate received a lump sum settlement of a claim for breach of contract and personal injury. The Service ruled that a portion of the settlement received for breach of contract was IRD, but the portion that was recovered for the personal injury was not because it would not have been income if received by the decedent during his lifetime.^{69.5}

Section 706(c)(2) closes a partnership's tax year with respect to a partner who dies during the year. This results in the inclusion on the partner's final income return of the deceased partner's portion of the partnership income earned before the partner died. Section 1366(a)(1) provides a similar rule for shareholders of S corporations. The effect of these rules is to reduce or eliminate the IRD an estate or beneficiary may have as a result of the decedent being a partner or S corporation shareholder during the decedent's lifetime. In effect, it represents a return to the pre-1942 rule that forced income onto a decedent's final return.

Notwithstanding the closing of the partner's year for a deceased partner, it is possible for the estate or other beneficiary of a decedent to receive IRD from the partnership. See, for example, *Estate of Riegelman v. Commissioner*,⁷⁰ in which the decedent's estate was entitled to partnership income earned by the partnership after the decedent died. In the case of a deceased partner, section 753 provides that any distribution that is treated under section 736(a) as a distributive share of partnership income or a guaranteed payment constitutes IRD under section 691. Yet, rights to IRD in the context of a deceased partner

69.2. Rev. Rul. 55-463, 1955-2 C.B. 277.

69.3. *Estate of Carter v. Comm'r*, 298 F.2d 192 (8th Cir. 1962), *cert. denied* 370 U.S. 910 (1962), *aff'g* 35 T.C. 326 (1960).

69.4. Priv. Ltr. Rul. 8740042. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

69.5. The Private Letter Ruling cited Treas. Reg. § 1.691(a)-1(d) for the proposition that amounts that would not be income for the decedent if received during his or her lifetime are not IRD.

70. *Estate of Riegelman v. Comm'r*, 253 F.2d 315 (2d Cir. 1958).

are not limited to certain distributions received from the partnership. Courts have been willing to apply an aggregate view of partnerships in this context by treating a deceased partner's share of unrealized receivables, inventory items, and deferred gain in installment sale contracts as rights to IRD that are not entitled to a basis step-up.⁷¹

If a decedent dies owning S corporation stock, the decedent's final return includes the income attributable to S stock through the date of death.⁷² Nevertheless, section 691 is applied with respect to any item of income of an S corporation in the same manner as if the decedent had directly held a pro rata share of the item.⁷³ This means that the recipient of the S corporation stock may have IRD and any stepped-up basis for the stock under section 1014 attributable to the IRD is denied. Note that the denial of a stepped-up basis is for the increase in stock value attributable to the IRD income and is not necessarily a dollar-for-dollar reduction in basis for the amount of the IRD income. Of course, this may make available a section 691(c) deduction for the deemed IRD items of income deemed passing through the corporation.⁷⁴

In the case of a decedent dying after June 8, 1997, if there was a constructive sale of any appreciated financial position within the meaning of section 1259 (for example, a short sale) before the decedent's death that remains open for not less than two years after the date of the transaction and at any time during the three years ending on the decedent's death, the position may be treated as property constituting a right to receive an item of income in respect of a decedent.⁷⁵

Beyond the more obvious examples of IRD, the determination of what constitutes a right to income in respect of a decedent is somewhat unsettled: IRD is not definitively defined in either the Code or the Treasury Regulations. Over the years, the identification of IRD has been problematic in many instances. The government and taxpayers have disputed the classification of many items of income as IRD.

71. See *Woodhall v. Comm'r*, 454 F.2d 226 (9th Cir. 1972); *Quick Trust v. Comm'r*, 54 T.C. 1336 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1971). For further discussion, see WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* § 23.03 (2007).

72. See *supra* section 2:2 for a discussion of a decedent's final return.

73. I.R.C. § 1367(b)(4).

74. The I.R.C. § 691(c) deduction is discussed in *infra* section 2:3.4.

75. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(d)(2) (as amended by Pub. L. No. 105-206, § 6010(a)(4)). Rev. Rul. 2004-15, 2004-1 C.B. 515 (satisfying obligation to first broker under short sale by transfer of stock borrowed from second broker does not close the short sale and, as a result, does not cause the transition rule in section 1001(d)(2) of the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) to cease to apply).

Resolution of the question of whether a particular item is IRD may involve largely the same tests used to determine whether the item would have been includible in a decedent's final return under the pre-1942 law.⁷⁶ Revenue Ruling 60-227 suggests that IRD "must be an item to which a decedent was entitled in the sense that he had a right to the item, it having been earned during his lifetime, even though actual receipt thereof, or determination of the amount thereof, might be contingent in whole or in part."⁷⁷

Tax litigation has resolved many of the IRD disputes. For example, in *Krakowski v. Commissioner*,⁷⁸ excess campaign contribution funds paid over to the decedent's spouse were IRD, because the money was income under section 61 and the claim of right doctrine, even though the surviving spouse eventually had to repay the money. In *Kitch v. Commissioner*,⁷⁹ amounts received in settlement as unpaid alimony constituted IRD. In *Estate of Riegelman v. Commissioner*,⁸⁰ the court ruled that payments made by a law partnership to a deceased partner's estate representing post-death partnership income were IRD. Similarly, in *Estate of Cartwright v. Commissioner*,⁸¹ insurance proceeds received by a professional corporation and paid to the estate of a deceased shareholder were income in respect of a decedent to the estate to the extent that the payment represented the deceased shareholder's interest in fees earned on work in process. In *Coleman v. Commissioner*,⁸² payments received after death under a decedent's contract not to compete entered into in connection with decedent's sale of business were IRD; and in *Sun First National Bank v. United States*,⁸³ installment notes held in a grantor trust includible in the decedent's gross estate were income in respect of a decedent.

Besides litigation clarifying whether items of income are IRD, the Service has ruled that many income receipts are IRD. For example, in Revenue Ruling 196,⁸⁴ an estate or beneficiary who exercised stock options after the death of an employee who died without exercising them realized income of the same character and amount as if the

76. However, this does not necessarily mean that the particular kind of item must have been taxable at that time. See *Hess v. United States*, 271 F.2d 104 (3d Cir. 1959).

77. Rev. Rul. 60-227, 1960-1 C.B. 262; see Sutter, *Ruling 60-227 Clarifies Income in Respect of a Decedent Arising from Property*, 14 J. TAX'N 214 (1961); Rev. Rul. 78-32, 1978-1 C.B. 198.

78. *Krakowski v. Comm'r*, T.C. Memo. 1993-266.

79. *Kitch v. Comm'r*, 104 T.C. 1 (1995), *aff'd*, 103 F.3d 104 (10th Cir. 1996).

80. *Estate of Riegelman v. Comm'r*, 253 F.2d 315 (2d Cir. 1958).

81. *Estate of Cartwright v. Comm'r*, T.C. Memo. 1996-286.

82. *Coleman v. Comm'r*, T.C. Memo. 2004-126.

83. *Sun First Nat'l Bank v. United States*, 587 F.2d 1073 (Ct. Cl. 1978), *original opinion withdrawn and substituted*, 607 F.2d 1347 (1979).

84. Rev. Rul. 53-196, 1953-2 C.B. 178.

employee had lived and exercised the options. In Revenue Ruling 2005-30,⁸⁵ the Service ruled that amounts paid on an annuity contract were IRD to the extent that the payments exceed the investment in the contract.⁸⁶ In Private Letter Ruling 9326043,⁸⁷ the Service ruled that publishing agreements giving rise to royalties were licenses, not sales, and, therefore, were not IRD.

Self-cancelling installment notes (SCINs) present unique issues for estates of decedents. The typical SCIN provides that no payments are due the decedent-seller or the seller's estate after the decedent's death. Thus, no income is "received" in the sense that no money changes hands after the decedent's death. In *Estate of Frane v. Commissioner*,⁸⁸ the Eighth Circuit held that cancelling the installment sale obligation triggered income under section 453B(f). In addition, the appellate court reversed the Tax Court's holding that the income was reportable on the decedent's final return and was not IRD under section 691. Instead, the appellate court held that the decedent's estate, not the decedent, must report the remaining gain on the installment sale if cancelled upon the seller's death, and the phantom income was IRD.⁸⁹ Self-cancelling installment notes (SCINs) present unique issues for estates of decedents.^{89.1}

The controversial nature of IRD, and the difficulty in determining IRD, is particularly apparent if the sale of property is at issue. The classification of the receipt as income in respect of a decedent may require that the decedent have only a right to receive the proceeds, and that the property was beyond the decedent's dominion and control. In a practical sense, this may mean that income in respect of a decedent arises once a contract of sale is executed if the remaining conditions of closing are not substantial.

85. Rev. Rul. 2005-30, 2005-1 C.B. 1015.

86. See also Priv. Ltr. Rul. 200041018 (death benefit under annuity contract is IRD to the extent payments exceed decedent's investment in the annuity contract). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

87. Priv. Ltr. Rul. 9326043. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

88. *Estate of Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992).

89. See generally Langstraat & Jackson, *Changes in Income Tax Consequences for Self-Canceling Installment Notes: Advantage Taxpayer*, 18 TAX MGMT. EST., GIFTS & TR. J.L. 120 (1993).

89.1. For a discussion of estate and gift tax issues of SCINs, see Chief Counsel Adv. 201330033, *discussed in* S. Oshins, *Ruling on Gift and Estate Tax Consequences of Self-Cancelling Installment Notes*, *Leimberg's Estate Planning Newsletter #2131* (Aug. 15, 2013). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

For example, in *Trust Co. of Georgia v. Ross*,⁹⁰ prior to death, the decedent entered into a binding, executory contract and had substantially fulfilled the prerequisites for the sale. The decedent's executor completed the sale of stock of the closely held corporation. The Fifth Circuit held that the proceeds were income in respect of a decedent using the "entitlement test" set out in the case. The appellate court rejected the district court's use of the "economic activities" completion test.⁹¹ In *Keck v. Commissioner*,⁹² the Sixth Circuit also used the "entitlement test" rather than the "economic activities" completion test to find that the proceeds of a sale were not IRD.⁹³

The Tax Court in *Estate of Peterson v. Commissioner*⁹⁴ used a four-part test to determine that profits from the sale of calves delivered in fulfillment of a decedent's contract were not income in respect of a decedent. The Eighth Circuit affirmed,⁹⁵ finding no income in respect of decedent even as to calves in deliverable form on one of the due dates that occurred before the decedent died, apparently because there was no delivery by decedent.⁹⁶ The Eighth Circuit noted that the Tax Court had

90. *Trust Co. of Ga. v. Ross*, 262 F. Supp. 900 (N.D. Ga. 1966), *aff'd*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968).

91. *See also* Rev. Rul. 78-32, 1978-1 C.B. 198.

92. *Keck v. Comm'r*, 415 F.2d 531 (6th Cir. 1969).

93. *Keck* is discussed in *infra* note 107 and accompanying text. *See also* *Estate of Ernest Napolitano v. Comm'r*, T.C. Memo. 1992-316 (contract contingency of no outstanding housing violations not met and hence no IRD, discussed in *infra* note 102 and accompanying text); *Estate of Bickmeyer v. Comm'r*, 84 T.C. 170 (1985) (distinguishing *Keck*); Rev. Rul. 58-436, 1958-2 C.B. 366; Treas. Reg. § 1.691(a)-2(b), ex. (5); *Comm'r v. Linde*, 213 F.2d 1 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954); *Estate of Sidles v. Comm'r*, 65 T.C. 873 (1976) (proceeds of corporate liquidation), *aff'd*, 553 F.2d 102 (8th Cir. 1977), *acq.* 1976-2 C.B. 2; Priv. Ltr. Rul. 200012076 (profit derived from unexercised nonqualified stock options is IRD, but receipt of IRD by charitable beneficiary prevents imposition of income tax); *Dorsey v. Comm'r*, 49 T.C. 606 (1968) (liquidated corporation); Young, *Farmer's Inventory Problem at Death, Confused by Linde Decision, Clarified*, 9 J. TAX'N 355 (1958). *But see* Rev. Rul. 73-524, 1973-2 C.B. 307 (proceeds received on sale of securities pledged in pre-death short sale are not IRD); Priv. Ltr. Rul. 9319005 (same); *Levin v. United States*, 373 F.2d 434 (1st Cir. 1967) (does not include lender's unearned portion of note discount). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

94. *Estate of Peterson v. Comm'r*, 74 T.C. 630 (1980).

95. 667 F.2d 675 (8th Cir. 1981).

96. *See* Rev. Rul. 82-1, 1982-1 C.B. 26 (apparently rejecting requirement of delivery by decedent to constitute income in respect of a decedent, but holding executor may use the gain exclusion on decedent's principal residence under I.R.C. § 121 sold by executor pursuant to contract entered into by decedent because under income-in-respect-of-a-decedent concept, executor "stands in the shoes" of the decedent).

examined the case law and distilled a four-factor test for determining whether sale proceeds constitute income in respect of a decedent:

- (1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,⁹⁷
- (2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,
- (3) whether there existed at the time of the decedent's death any economically material contingencies that might have disrupted the sale, and
- (4) whether the decedent would have eventually received the sale proceeds if he or she had lived.⁹⁸

The Eighth Circuit's opinion places heavy emphasis on the fact that the decedent had not delivered the calves, rather than on the efforts of the decedent's estate to feed and care for the calves between the date of the decedent's death and the time of delivery. The Eighth Circuit's use of delivery almost as the sole test is not in complete accord with cases decided before *Peterson*, such as *Linde v. Commissioner*,⁹⁹ in which the decedent had delivered crops (grapes) to a marketing cooperative that converted the grapes into wine and then sold the wine. The *Linde* court found that the money received for the grapes delivered to the co-op was IRD even though the conversion into wine and the eventual sale of wine may have occurred after the decedent died. Subsequently, the fact pattern of *Linde* became the basis for an example in the Regulations.¹⁰⁰

The Tax Court's "test" in *Peterson* is not foolproof, however. It has not been uniformly adopted by courts to determine IRD nor followed by the Service. For example, in Revenue Ruling 82-1,¹⁰¹ the decedent had contracted to sell his principal residence. Only ministerial obligations remained to be performed under the contract when the taxpayer died. The sale was completed by the estate and a deed delivered. The

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97. As noted by the Tax Court, "[t]his arrangement may take a variety of forms: an express executory contract of sale as in *Trust Co. of Ga. v. Ross*, 392 F.2d 694 (5th Cir. 1967); an implied contract for sale [A delivers apples to Y, Y accepts the apples, A dies before Y can pay for them]; or a contractual arrangement with a cooperative marketing association [as in *Linde v. Comm'r*, 213 F.2d 1 (no contract or sale, just delivery of grapes to marketing cooperative; proceeds held income in respect of a decedent when received)]." *Estate of Peterson v. Comm'r*, 74 T.C. 630, 639 (1980) (parentheticals substituted and expanded), *aff'd*, 667 F.2d 675 (8th Cir. 1981). See also *Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981) (the right to income need not be legally enforceable).
 98. *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981).
 99. *Linde v. Comm'r*, 213 F.2d 1 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954).
 100. *Treas. Reg. § 1.691(a)-2(b)*, ex. (5) (apples instead of grapes).
 101. *Rev. Rul. 82-1*, 1982-1 C.B. 26.

Service ruled that the sales proceeds were IRD to the extent not excluded under the then-version of section 121.

In deciding *Estate of Napolitano v. Commissioner*,¹⁰² the Tax Court cited two of the *Peterson* tests: the necessity of a legally significant arrangement and the decedent had “performed all substantive (non-ministerial) acts required of him as preconditions to the sale, that is, the subject matter of the sale was in a deliverable state on the date of the decedent’s death.” In *Napolitano*, the decedent had contracted to sell real estate, but at the time of his death, certain housing violations had not been corrected. Thus, the property was not in a deliverable state as of the time of death.¹⁰³ In Private Letter Ruling 9023012,¹⁰⁴ a real estate contract was subject to a financing contingency that was not satisfied at the time of the decedent’s death. Although the contingency could be viewed as economically material under the third prong of the *Peterson* test, the Service ruled that the ultimate sale generated IRD.¹⁰⁵

If a controlling shareholder dies while a corporation is in the process of liquidating, the post-death liquidating distributions may be IRD. In *Estate of Sidles v. Commissioner*,¹⁰⁶ the Tax Court held that liquidating distributions were IRD because before the decedent died the board of the corporation had adopted a plan of liquidation, filed a statement of intent to dissolve with the appropriate secretary of state, had begun to liquidate the corporate assets, and the decedent owned 100% of the stock. The *Sidles* court distinguished *Keck v. Commissioner*,¹⁰⁷ in which the sale of corporate assets as a part of a plan of liquidation was contingent on ICC approval and the decedent was not the controlling shareholder.

The regulations provide that sales of property that cannot close before the decedent has died are not IRD.¹⁰⁸ The classic example is a

102. *Estate of Napolitano v. Comm’r*, T.C. Memo. 1992-316. The Eighth Circuit in *Estate of Gavin v. United States*, 113 F.3d 802 (1997), cited *Peterson* for the principle that the income must “fully vest,” but the item of income in dispute was crop rents, not the sale of property.

103. See also Priv. Ltr. Rul. 200744001, in which the Service ruled that a sale of real estate that was pending when the owner died was not IRD because the sale was subject to economic material contingencies. In the ruling, a gas pipeline was discovered under the property after a binding contract had been executed. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

104. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

105. See also Rev. Rul. 78-32, 1978-1 C.B. 198.

106. *Estate of Sidles v. Comm’r*, 65 T.C. 873 (1976), *aff’d*, 553 F.2d 102 (8th Cir. 1977), *acq.* 1976-2 C.B. 2.

107. *Keck v. Comm’r*, 415 F.2d 531 (6th Cir. 1969).

108. Treas. Reg. § 1.691(a)-2(b), ex. (4).

buy-sell agreement that provides for the decedent's estate to sell the decedent's closely held stock.¹⁰⁹ If the buy-out includes a decedent's interest in work in progress, however, the buy-out may include IRD. For example, in *Estate of Cartwright v. Commissioner*,¹¹⁰ insurance proceeds received by a professional corporation and paid to the estate of a deceased shareholder were income in respect of a decedent to the estate to the extent that the payment represented the deceased shareholder's interest in fees earned on work in process.

If a decedent's property is subject to an option that is exercised after the decedent's death, the Service has ruled that the subsequent exercise of the option and sale does not generate IRD.¹¹¹ For example, in Private Letter Ruling 9325029,¹¹² the IRS determined that the gain realized on the sale of real estate pursuant to an exercise after death of an option granted before death was not IRD. Notwithstanding the favorable rulings, the Service in *Claiborne v. United States*¹¹³ asserted that property subject to an exercised option at the decedent's death was IRD if the sale closed after death. The option payment was described in the contract as "liquidated damages" in the event the buyer defaulted after it exercised the option, but the court determined that specific performance of the contract was enforceable because the buyer had already taken possession of the property and begun site preparation.

Special circumstances, such as IRD in section 1031 like-kind exchange transactions, may arise. In Private Letter Ruling 9829025,¹¹⁴ spouses transferred two investment properties to a "grantor trust"¹¹⁵ to effect a tax-free, like-kind exchange under section 1031, and the properties were sold. After the death of the husband, two replacement properties were timely acquired to avoid recognition of gain under this section: one had been identified and contracted for before the husband's death, but the second had not been identified nor contracted for. The Service ruled the proceeds from the sale of the properties contributed to the grantor trust were not IRD. The proceeds would not have been includible in the decedent's income had he lived because they would have been invested in replacement property

109. *Id.*

110. *Estate of Cartwright v. Comm'r*, T.C. Memo. 1996-286.

111. Rev. Rul. 71-265, 1971-1 C.B. 223, *aff'd*, 183 F.3d 1034 (9th Cir. 1999).

112. Priv. Ltr. Rul. 9325029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

113. *Claiborne v. United States*, 648 F.2d 448 (6th Cir. 1981).

114. Priv. Ltr. Rul. 9829025. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

115. See chapter 5 for a discussion of grantor trusts.

tax-free under section 1031. The Service ruled also that the taxpayer was entitled to a stepped-up adjusted basis in the replacement property.

The interplay between IRD and the section 661 distribution deduction has been litigated. For example, in *Rollert Residuary Trust v. Commissioner*,¹¹⁶ the court ruled that a post-death bonus was IRD, and also held that section 691 overrides sections 661 and 662, so no distribution deduction is available for distribution by the fiduciary of a right to the IRD.¹¹⁷ The Tax Reform Act of 1984 codified this result with the enactment of section 643(e). This subsection permits a distribution deduction only for the estate or trust's basis in the item distributed.¹¹⁸

Health Savings Accounts (HSA) provide special rules for the taxation of the account when the account owner dies.¹¹⁹ If the decedent's spouse is the beneficiary of the decedent's HSA, the account becomes the HSA of the surviving spouse and there is no income tax consequence.¹²⁰ If, however, the decedent's estate is entitled to the account, the amount of the HSA is included in income on the decedent's final return.¹²¹ If anyone else is entitled to the account, that person must report the value of the HSA as income for the tax year in which the decedent died¹²² and a section 691(c) deduction is allowed for the net estate taxes paid and attributable to the HSA income, if any.¹²³ This person may reduce the income by any pre-death medical expenses of the decedent paid from the decedent's HSA within one year of the decedent's death.¹²⁴

§ 2:3.2 Section 691(a)(2)—Disposition of the Right to IRD Items

If a decedent's estate or a person who is entitled to an IRD item transfers the right to the IRD item before it is received and reportable in income, the transfer may accelerate the reporting of the IRD.¹²⁵ If

116. *Rollert Residuary Trust v. Comm'r*, 752 F.2d 1128 (6th Cir. 1985), *aff'g* 80 T.C. 619 (1983) (following *O'Daniel's Estate v. Comm'r*, 173 F.2d 966 (2d Cir. 1949)).

117. *See also* *Estate of Dean v. Comm'r*, T.C. Memo. 1983-276 (to same effect on priority of I.R.C. § 691).

118. I.R.C. § 643(e) is discussed in *infra* section 3:5.6.

119. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, § 1201(a), 117 Stat. 2469-76 (2003).

120. I.R.C. § 223(f)(8)(B)(I).

121. *Id.*

122. I.R.C. § 223(f)(8)(A).

123. I.R.C. § 223(f)(8)(B)(ii)(II).

124. I.R.C. § 223(f)(8)(B)(ii)(I).

125. I.R.C. § 691(a)(2); Treas. Reg. § 1.691(a)-4.

the income is accelerated, the transferor must include in gross income the fair market value of the right at the time of the transfer in excess of any basis in the item or the amount of consideration received for the item in excess of any basis in the item, whichever is greater.¹²⁶ Excepted from this rule are transfers of the right by reason of the death of the person entitled to the IRD item from the first decedent, that is, to someone who will treat the right as IRD when received.¹²⁷ Excluded transfers also include transfers by a decedent's estate to the person designated by the decedent's will to receive the right to the IRD item, for example, a specific devise of the right to an IRD item or a residuary devise that includes the right to an IRD item.¹²⁸ Also excepted are transfers to those taking through a trust that had received the right from the decedent.¹²⁹ Not excluded, and thus triggering income, would be a gift of the IRD right.¹³⁰

The installment sales rules except from the acceleration rule of section 453B(a) the transmission of installment notes that are items of IRD, except as provided in section 691.¹³¹ Not within the section 453B(c) exception are installment notes that are not items of IRD, transferred by an estate or trust.¹³² For example, the distribution of a note received in a sale of an asset by an estate on the installment basis will result in the recognition of gain.

The installment sales rules¹³³ provide that any previously unrealized gain from an installment sale is recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor, or is canceled by the executor.¹³⁴

Distribution of a right to IRD in satisfaction of a pecuniary (fixed sum-of-money) devise causes realization of IRD to the distributor.¹³⁵

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126. Treas. Reg. § 1.691(a)-4(a).
 127. Treas. Reg. § 1.691(a)-4(b)(1).
 128. Treas. Reg. § 1.691(a)-4(b)(2). Note, however, Rev. Rul. 69-486, 1969-2 C.B. 159, rules that gain is recognized if non-pro-rata distributions that were not authorized under the governing instrument or state law are made to beneficiaries.
 129. I.R.C. § 691(a)(5)(A)(I); Treas. Reg. § 1.691(a)-4(b)(3).
 130. Treas. Reg. § 1.691(a)-4(a).
 131. I.R.C. § 453B(c).
 132. See section 3:2.1[N] for a discussion of when acceleration occurs.
 133. I.R.C. §§ 453B(f), 691(a)(4)-(5).
 134. See Rev. Rul. 86-72, 1986-1 C.B. 253 (unrealized gain in installment note that is cancelled upon death of seller recognized by such self-cancellation); *Estate of Frane v. Comm'r*, 98 T.C. 341 (1992), *modified*, 998 F.2d 567 (8th Cir. 1993) (decedent-seller recognizes gain, to be reported on decedent's final income tax return, upon death by reason of self-cancellation, and, therefore, gain is not IRD, but treated as IRD by the Eighth Circuit on appeal).
 135. See, e.g., Chief Counsel Adv. 200644020 (right to portion of IRA distributed to charity in satisfaction of specific pecuniary devise), Priv. Ltr.

This may be a significant problem if the decedent has created a marital deduction devise using a pecuniary formula and the personal representative wishes to satisfy the devise in whole or in part with the right to IRD such as an IRA or an installment note. Often a married decedent's will disposes of the estate pursuant to tax-driven formula clauses designed to use available credits and exemptions and the marital deduction so no estate tax is payable at the decedent's death.¹³⁶ For some married decedents, the major asset of the estate is an IRA and its value is larger than the value of any non-marital share of the estate. This means that the IRA must be used, at least in part, to fund the marital deduction devise. To avoid the problem the marital deduction devise could be created with a fractional-of-the-residue formula or the non-marital devise may be drafted as a pre-residuary devise. In both of these situations, the IRA is passing as a part of the residue and the IRD income is not accelerated. Of course, if the non-marital deduction devise is a pecuniary amount, the IRD would be accelerated to the extent the devise is funded with the IRD item. Another way around the problem is to designate the surviving spouse the beneficiary of the IRA or name the marital trust as beneficiary.¹³⁷

In Private Letter Ruling 201438014,^{137.1} the Service ruled that the distribution of an IRA to two charities that were entitled to pecuniary bequests resulted in the recognition of income for the trust under section 691(a)(2) as sales or exchanges. Moreover, the distributions to the charities did not qualify for section 642(c) income tax charitable deductions because the document did not require the amounts to be paid from gross income. Finally, a reformation of the trust was not respected because the purpose of the reformation was not to resolve a conflict but instead sought to "obtain tax benefits." The reformation sought "to ensure that Trust's distribution of IRA assets to Charity1 and Charity2 would be treated as direct bequests to the charities rather than as income in respect to Trust of a decedent under § 691.

Rul. 9315016 (U.S. Series E and H bonds to fund charitable pecuniary devise). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

136. See generally J. Blattmachr, *Don't Be Driven by Tax Driven Formula Clauses*, 5 PROB. & PROP. 34 (Sept./Oct. 1991).

137. NATALIE B. CHOATE, *LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS: THE ESSENTIAL HANDBOOK FOR ESTATE PLANNERS* (2003). See also Priv. Ltr. Rul. 200702007. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

137.1. Priv. Ltr. Rul. 201438014. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

Alternatively, the purpose of the reformation was to qualify the Trust for a charitable deduction under § 642(c)."

Private letter ruling 201338028 permitted a decedents' intestate estate to subdivide an IRA into three sub-IRAs, one for the benefit of each intestate heir without invoking the acceleration rule of section 691(a)(2).^{137.2}

Several private letter rulings have permitted decedent's estates to assign IRAs and other retirement benefits to charities and not invoke the acceleration rule of section 691(a)(2).¹³⁸ The rulings all occur where the decedent names the estate the beneficiary of the retirement benefit. Rather than withdraw the funds from the retirement accounts and report gross income, the estates assign the benefits to charitable beneficiaries who receive the income when distributed from the account. Of course, the charities are tax-exempt entities and no income tax is due on the distribution. The rulings all seem to be dependent on the estate's authority to make non-pro rata distributions of assets and occur where the residuary estate is payable to both charitable and non-charitable remaindermen.¹³⁹ The Service ruled similarly when an IRA was payable to an estate and the estate's beneficiary was a trust whose residue was divided among several charities.¹⁴⁰ Of course, if the charity is a devisee of a sum certain, the assignment of an IRA to the charity in satisfaction of the amount due would accelerate the income.¹⁴¹ The Service has

137.2. Priv. Ltr. Rul. 201338028. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

138. Priv. Ltr. Rul. 200234019 (estate does not include the IRAs in income where it has assigned them to charity pursuant to a bequest of them under decedent's will to the charity); Priv. Ltr. Rul. 200520004 (distribution of IRAs and 401(k) plan benefits to charity as its share of residuary estate does not invoke I.R.C. § 691(a)(2)); Priv. Ltr. Rul. 200633009 (distribution of IRAs to charity "in satisfaction of its share of the residue of the Estate will not be a transfer within the meaning of § 691(a)(2)"); Priv. Ltr. Rul. 200845029 (distribution of interest in defined benefit plan to charity is not a transfer within the scope of I.R.C. § 691(a)(2)). *See also* Priv. Ltr. Ruls. 200221011, 200226015, 200520004, 200850004 (similar). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

139. *Cf.* Rev. Rul. 69-486, 1969-2 C.B. 159.

140. Priv. Ltr. Ruls. 201013033 and 201333011. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

141. *See, e.g.*, Chief Counsel Adv. 200644020 (right to portion of IRA distributed to charity in satisfaction of specific pecuniary devise); Priv. Ltr. Rul. 201438014 (portion of IRA assets paid the charity to satisfy pecuniary bequests). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

ruled similarly when the beneficiary of the IRA was a pour over trust and the trust remainder, after two pecuniary bequests, was payable to charity.^{141.1}

The Service ruled in Private Letter Ruling 200803002¹⁴² that the assignment of an annuity contract by a trust to the charitable beneficiaries of the trust was not a section 691(a)(2) taxable disposition.¹⁴³ In the ruling, the decedent owned a non-qualified deferred annuity contract and named the trust the beneficiary. Under state law, the trustee had the power to make distributions in kind, although the trust document did not so provide. Thus, only the charities were required to report the income distributions from the annuity.

In Private Letter Ruling 200620025,¹⁴⁴ a decedent's disabled son was one of four designated beneficiaries of the decedent's IRA. Because the disabled son was eligible for Medicaid, his guardian sought permission of a local court to create a special needs trust for the son and to transfer the IRA to the trust. The Service ruled that the court-created special needs trust was a grantor trust under sections 671 and 677(a) and that the transfer of the IRA to the trust was not a taxable disposition under section 691(a)(2).¹⁴⁵ The Service ruled similarly in Private Letter Ruling 200826008, in which an IRA beneficiary was a minor.¹⁴⁶

Section 643(e) permits a personal representative or a trustee to elect to treat distributions in kind as sales or exchanges. Although the Service has not addressed the issue in regulations, there appears no reason why the election would not cause the electing entity to recognize the IRD item as income if the right is distributed, even if it would not otherwise be recognized. Consequently, the distributable net income (DNI) of the estate or trust will be increased, and the distribution of the

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- 141.1. Priv. Ltr. Rul. 201444024. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
142. Priv. Ltr. Rul. 200803002. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
143. The annuity contract in the letter ruling appears to be similar to the annuity described in Rev. Rul. 2005-30. *See supra* note 85 and accompanying text.
144. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
145. *See also* Priv. Ltr. Rul. 201116005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
146. Priv. Ltr. Rul. 200826008. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

IRD item will carryout DNI. The section 643(e) election seems to reverse the result in *Rollert Residuary Trust v. Commissioner*,¹⁴⁷ but, of course, gross income is accelerated by the election.

**§ 2:3.3 Deductions in Respect of a Decedent (DRD):
Section 691(b)**

Some, but not all, of a decedent's accrued deductible expenses that were not paid before death are treated in a manner somewhat similar to items of income in respect of a decedent; that is, they are deductible by his or her estate (or other successor) after the decedent dies, if and when paid.¹⁴⁸ The deductions subject to section 691(b) are limited to trade or business expenses deductible under section 162, interest deductible under section 163, taxes deductible under section 164, investment and other expenses deductible under section 212, and the depletion deduction allowable under section 611.

In addition, section 691(b) permits the foreign tax credit allowed by section 27 to a taxpayer who receives foreign-source income from the decedent, but only if the income is IRD. The regulations provide:

an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to any income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section [27] when he pays the tax.¹⁴⁹

Besides section 691(b) permitting a deduction or credit for the certain expenses, section 642(g) provides that section 691(b) deductions are not subject to the double deduction disallowance rule.¹⁵⁰ This means that a decedent's estate may be allowed an estate tax deduction under section 2053 for the accrued debt and an income tax deduction also is allowed for the same obligation.

The 691(b) deduction applies only to those listed in the statute and, by implication, the deduction does not apply to such things

147. See *infra* section 3:5.6 for a discussion of section 643(e) and *Rollert*.

148. I.R.C. § 691(b); see Rev. Rul. 71-422, 1971-2 C.B. 255 (because "income in respect of a decedent" includes income to which decedent had a contingent claim, "it is similarly concluded that the term 'deduction . . . in respect of a decedent' . . . includes a deduction for which the decedent had a contingent liability at the time of his death"). It is not necessary for the person to have received income in respect of the decedent. Treas. Reg. § 1.691(b)-1. In the case of depletion, the deduction goes to the person who receives the income to which the deduction relates, in the taxable year when such income is received.

149. Treas. Reg. § 1.691(b)-1(a).

150. See I.R.C. § 642(g) (last sentence); *infra* section 3:2.1[F].

as alimony due before the decedent's death and paid after death,¹⁵¹ losses deductible under section 165 or 166,¹⁵² the charitable deduction carryover under section 170,¹⁵³ the net operating carryover under section 172,¹⁵⁴ or the capital loss carryover under section 1212.¹⁵⁵ The decedent's unpaid medical expenses are not covered by section 691(b) either, but are deductible for income tax purposes (but on the decedent's final income tax return) if paid within one year of the decedent's death.¹⁵⁶ However, the income tax deduction for medical expenses is available only if the estate tax deduction as a debt is waived.¹⁵⁷

In Revenue Ruling 71-422, the Service ruled that the estate of an accrual-basis decedent could deduct, under section 691(b), interest that had accrued on a tax deficiency that was being contested at the time of the decedent's death, but was later paid.^{157.1} The interest was also deductible under section 2053(a).

The Service has ruled that trustee commissions attributable to a decedent's income-producing property held in a trust that accrue before a decedent dies, but that are unpaid, are deductible under section 212 and thus are section 691(b) deductions.¹⁵⁸ Similarly, legal fees and guardian fees incurred before a decedent died are section 691(b) deductions if related to management of the decedent's investments before death.¹⁵⁹

In *Batchelor-Robjohns v. United States*,^{159.1} the taxpayer sold a business and reported a capital gain on the sale. Thereafter, he was sued in connection with the sale of the business. The litigation continued after his death and ultimately settled. The estate claimed a section 2053 estate tax deduction and an income tax deduction for the amount of settlement. The Service challenged the double deduction on the basis of section 642(g) which disallows a double deduction unless the income tax deduction qualifies under section 691(b). The district court did not sustain the estate's income tax deduction

151. Rev. Rul. 67-304, 1967-2 C.B. 224. The ruling permitted both an estate tax deduction and a distribution deduction, but not an alimony paid deduction.

152. Sletteland v. Comm'r, 43 T.C. 602 (1965).

153. Treas. Reg. § 1.170A-10(d)(4)(iii).

154. Rev. Rul. 74-175, 1974-1 C.B. 52.

155. *Id.*

156. I.R.C. § 213(c)(1).

157. I.R.C. § 213(c)(2).

157.1. Rev. Rul. 71-422, 1971-2 C.B. 255.

158. Rev. Rul. 76-498, 1976-2 C.B. 199.

159. Rev. Rul. 71-423, 1971-2 C.B. 255.

159.1. *Batchelor-Robjohns v. United States*, 113 AFTR 2d 1392 (S.D. Fla. 2013); I.R.C. §§ 162, 212, 642, 691, 1341.

because it determined that when the decedent died he was not “liable” for the debt (settlement amount) within the meaning of section 691(b). The court applied section 461(h) to decide if the settlement would have been accrued for income tax purposes if the taxpayer had been an accrual-basis taxpayer and concluded that it would not have been accrued. The application of section 461(h) seems incorrect, however. The section 691(b) regulations have no such requirement. Moreover, in Revenue Ruling 71-422,^{159.2} the Service ruled “‘deduction . . . in respect of a decedent’ . . . includes a deduction for which the decedent had a contingent liability at the time of his death.” Nevertheless, the real problem for the taxpayer was the court’s final basis for its negative decision: to be deductible under section 691(b) and avoid the section 642(g) double deduction limitation, the deduction must be allowable by sections 162, 163, 164, 212 or 611. The taxpayer argued that the payment was a deductible expense under section 162 or 212. The court disagreed with both, citing *Kimbrell v. United States*^{159.3} against the section 162 deduction, and *Sorrell v. Commissioner*^{159.4} against the section 212 deduction. While not cited by the district court, the Supreme Court’s decision in *Arrowsmith v. Commissioner*^{159.5} would characterize the settlement as a capital loss because it relates to the prior capital gain on the stock and thus is deductible under section 165, if deductible.

On appeal, the Eleventh Circuit in *Batchelor-Robjohns*^{159.6} affirmed the District Court’s ruling that section 642(g) prevented the estate from claiming an estate tax deduction and an income tax deduction. The court concluded that the payment was not an income tax deduction under section 162, 163, 164, 212, or 611 or a credit specified in section 27. The taxpayer argued that payment was within the mitigation provisions of section 1341 and deductible. The Eleventh Circuit concluded that section 1341 applied only if a deduction (or credit) is allowable under another section of the code, which it was not in the case because of section 642(g).

The section 691(b) deductions are allowed generally to the decedent’s estate, except that if the estate is not liable for the amount owed, then the deduction is allowed for the person who, by reason of the death of the decedent or by bequest, devise, or inheritance, acquires from the decedent an interest in property of the decedent, subject to the obligation.¹⁶⁰ The regulations provide an example:

159.2. Rev. Rul. 71-422, 1971-2 C.B. 255.

159.3. *Kimbrell v. United States*, 490 F.2d 203 (5th Cir. 1974).

159.4. *Sorrell v. Comm’r*, 882 F.2d 484 (11th Cir. 1989).

159.5. *Arrowsmith v. Comm’r*, 344 U.S. 6 (1952).

159.6. *Batchelor-Robjohns v. United States*, 788 F.3d 1280 (11th Cir. 2015).

160. I.R.C. § 691(b)(1)(B).

If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.¹⁶¹

The obligation must exist at the time of the decedent's death and actually must be paid to be deductible. For example, interest on a decedent's loan that has accrued as of the date of death and is otherwise deductible under section 163 is subject to section 691(b), but the interest on the same loan accruing after death is not. The effect of the "paid" rule is to require cash accounting for the taxpayer who is entitled to the deduction regardless of the taxpayer's normal method of accounting.

The taxpayer who receives the income in respect of a decedent that is subject to the section 611 depletion is allowed the section 691(b) deduction for the depletion deduction.¹⁶² The depletion deduction is allowed whether or not the person who is entitled to the deduction receives the property that is generating the income.¹⁶³ The regulations provide an example:

[A]n heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income.¹⁶⁴

However, if the decedent was not using percentage depletion to compute the depletion deduction, section 691(b) is not applicable.¹⁶⁵ Any depletion deduction is allowed on the decedent's final return and not to any other person.¹⁶⁶

Neither the Code nor Regulations provides that the nature of the deduction passes through. For example, a section 162 business expense for the decedent is a section 691(b) deduction, but the Code does not expressly provide that it is a section 162 business expense when

161. Treas. Reg. § 1.691(b)-1(a)(2). *See also* Rev. Rul. 58-69, 1958-1 C.B. 254.

162. I.R.C. § 691(b)(2).

163. Treas. Reg. § 1.691(b)-1(b).

164. *Id.*

165. *Id.*

166. *Id.*

deductible. This issue raises questions of whether section 691(b) deductions are subject to the 2% rule of section 67 or the phase-out of deductions under section 68 and whether any of them may be above the line for individual taxpayers who may be entitled to the deduction.

§ 2:3.4 **The Section 691(c) Income Tax Deduction for Estate Taxes Paid**

All rights to IRD are denied a step-up in basis at a decedent's death.¹⁶⁷ Nevertheless, to the extent that rights to IRD are included in the gross income of the recipient and are included in a decedent's gross estate for federal estate tax purposes, double taxation may occur if income taxes are paid and estate taxes are paid in the same IRD item.¹⁶⁸ To soften the tax bite of two taxes, section 691(c) permits the recipient of IRD an income tax deduction for the federal estate taxes attributable to the right to the IRD.

For purposes of the section 691(c) income tax deduction, the estate tax means the net federal estate tax payable after applicable credits.¹⁶⁹ The amount of the federal estate tax that is deductible equals the federal estate tax paid by the decedent's estate in excess of the federal estate tax the estate would pay computed without including the net IRD items in the decedent's gross estate.¹⁷⁰ Note that the value for estate tax purposes of the rights to IRD must be reduced by the DRD items described in section 691(b).¹⁷¹ This netting rule may at times produce an unfair

167. I.R.C. § 1014(c).

168. See *Rollert Residuary Trust v. Comm'r*, *supra* notes 116–17 and accompanying text, for a discussion of instances in which income was IRD but not estate taxable.

169. I.R.C. § 691(c)(2)(A). This may be tax under I.R.C. § 2001 or 2101. It seems that the amount of federal estate tax used to determine the I.R.C. § 691(c) deduction would take into account the estate tax deduction permitted under I.R.C. § 2058 (for state death taxes paid for years after 2004 and before 2010), although neither the Code nor any regulation has made that explicit. See generally J. Blattmachr & M. Gans, *Planning for IRD After Elimination of the State Death Tax Credit*, 33 EST. PLAN. 3 (Mar. 2006).

170. I.R.C. § 691(c)(2)(C). As a result of the change from a credit under I.R.C. § 2011 for state death taxes paid to a deduction under I.R.C. § 2058 for state death taxes paid, it is not clear whether the amount of the state death tax deduction is recomputed when the federal estate tax is recomputed under I.R.C. § 691(c)(2)(C). For example, if the amount of the state death tax would be less on the amount of the "reduced" taxable estate under I.R.C. § 691(c)(2)(C), is the I.R.C. § 2058 deduction still the amount the estate "actually paid" as I.R.C. § 2058 provides, or is it a reduced amount that would be due to the taxing state on the value of the smaller estate? Neither the Code nor the Regulations address this question. Not recomputing the state death tax deduction will produce a larger deduction under I.R.C. § 691(c).

171. I.R.C. § 691(c)(2)(B). See *supra* section 2:3.3.

result as the person who receives an IRD item of income and who must report it as income may not be the same person who benefits from the section 691(b) deduction.

Of course, if no federal estate tax is payable by a decedent's estate, there will be no section 691(c) deduction as there is no estate tax attributable to IRD items.

If there is more than one taxpayer who receives IRD items of income, the section 691(c) deduction is shared proportionally.¹⁷² In addition, the deduction allowable to an estate or trust is reduced to the extent the rights to IRD are properly paid, credited, or to be distributed to a beneficiary or beneficiaries during the taxable year.¹⁷³ Thus, to the extent the IRD is reported by a beneficiary, the beneficiary will be entitled to some portion or all of the section 691(c) deduction.¹⁷⁴ To avoid making a circular computation, the DNI of the estate or trust is determined without the section 691(c) deduction.¹⁷⁵ When the IRD item is allocated to corpus for fiduciary accounting purposes, but is to be distributed to a beneficiary in a subsequent year, the section 691(c) deduction is allowed only to the estate or trust.¹⁷⁶

Section 691(c)(1)(A) provides that the deduction for a receipt of an IRD item of income is: the total section 691(c) deduction times a fraction, the numerator is the amount of income reported (but not more than the estate tax value of the right to the IRD for estate tax purposes), and the denominator is the total estate tax value of all rights to IRD.¹⁷⁷ This means that if the amount of income received exceeds the value of the right to the IRD item as reported on the decedent's estate tax return, the amount of the deduction will not increase, but is instead limited by its estate tax value. On the other hand, if the amount of the IRD item received is less than the value reported for estate tax purposes, the section 691(c) deduction is proportionately reduced.¹⁷⁸ It's heads the federal fisc wins, tails the taxpayer loses! The same apportionment rule will apply if a single IRD item is received over several tax years.¹⁷⁹

172. I.R.C. § 691(c)(1)(A); Treas. Reg. § 1.691(c)-1(a)(2).

173. I.R.C. § 691(c)(1)(B).

174. Treas. Reg. § 1.691(c)-2(a)(1).

175. Treas. Reg. § 1.691(c)-2(a)(2).

176. Treas. Reg. § 1.691(c)-2(a)(3).

177. Treas. Reg. § 1.691(c)-1(a).

178. Treas. Reg. § 1.691(c)-1(d), ex. (1).

179. I.R.S. Tech. Adv. Mem. 8702004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

Section 691(d)(1) provides that the income from joint and survivor annuities is taken into account when computing the section 691(c) deduction,¹⁸⁰ and section 691(c)(2)(B) requires that stock options covered by section 421(c)(2) be included in the section 691(c) calculation.

The regulations provide additional guidance on how to compute the section 691(c) deduction.¹⁸¹ The net effect of section 691(c) and the regulation is to compute the estate taxes attributable to the net IRD items at the estate's marginal federal estate tax rate (or rates):¹⁸² the deduction is the amount the estate tax actually paid exceeds the estate tax that would have been paid if the net IRD items had not been a part of the decedent's estate.

If the right to the IRD is devised specifically to a surviving spouse and qualifies for the estate tax marital deduction, the recomputation of estate taxes on the hypothetical estate is straightforward. The IRD item is not included in the gross estate and no marital deduction is available for the amount of the devise.¹⁸³ This rule should apply if the right to the IRD is specifically devised to a charity.

Determining the estate tax on the reduced hypothetical estate can be complex if the estate is entitled to an estate tax marital or charitable deduction based on a formula or is a residuary devise.¹⁸⁴ Some commentators believe that the deduction is reduced or lost to the extent that the right to income in respect of a decedent passed to a surviving spouse for which a marital deduction under section 2056 was allowable, or to an organization for which a charitable deduction under section

180. Treas. Reg. § 1.691(c)-1(c)(2). Treas. Reg. § 1.691(d)-1 explains that the section 691(c) deduction for an annuity when the decedent dies after the annuity starting date is determined using the principles of section 72.

181. Treas. Reg. § 1.691(c)-1.

182. I.R.C. § 691(c)(2)(C).

183. Treas. Reg. § 1.691(c)-1(a)(2) and § 1.691(d)-1(e), ex. (2); Rev. Rul. 67-242, 1967-2 C.B. 227.

184. In I.R.S. Tech. Adv. Mem. 9219006, the I.R.C. § 691(c) deduction was determined by reducing the marital deduction where spouse was to receive one-half of the net estate. I.R.S. Tech. Adv. Mem. 7827008, relating to a testator who died in 1975, states that the income tax payable on receipt of future payments of I.R.C. § 691(a) installment notes by the surviving spouse as part of the marital deduction share or charitable legatee will not reduce the estate tax marital or charitable deduction. *See also* Priv. Ltr. Rul. 200316008 in which the spouse's one-third elective share was reduced by one-third of the IRD items when computing the marital deduction for the hypothetical estate. Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110(k)(3).

2055 was allowable.¹⁸⁵ An examination of several cases reveals how complex the issue is and how theoretical the recomputation may be.

In *Chastain v. Commissioner*,¹⁸⁶ the decedent devised a specific sum (\$1 million) to his son that was to be funded in part with rights to certain IRD items. He devised the residuary of his estate to charity. The dispute between the taxpayer and the government turned on how to recompute the value of the devise to the decedent's son and the charitable devise, that is, which devise was reduced when the recomputed estate tax was determined. The *Chastain* court agreed with the taxpayer that the residuary charitable devise was not reduced when recomputing the taxes.¹⁸⁷ It did not say so specifically, but the court seemed to rule that the gift to the decedent's son was deemed to be reduced by the amount of the rights to the IRD rather than a deemed reduction of the charitable devise. What is not clear is whether, under the decedent's will, the son would have received other assets of the estate if the IRD items had not existed, or whether his devise would have been reduced.

In *Kincaid v. Commissioner*,¹⁸⁸ the decedent's estate was divided between marital deduction and non-marital deduction portions using a pre-residuary formula that devised 50% of the estate to the marital deduction share. Typical for this type of formula, the 50% marital deduction share was offset by specific gifts to the surviving spouse which included rights to IRD. When the tax on the recomputed estate was calculated, the taxpayer asserted that the 50% marital deduction was not reduced dollar-for-dollar for the full amount of the rights to the IRD, because there were sufficient other non-IRD assets in the estate to fund the 50% marital devise. Instead, the estate argued that the allowable marital deduction was half of the hypothetical estate.¹⁸⁹ The court agreed.

185. Cf., e.g., T. Englebrecht, *Section 691(c) Deduction: A Review and Analysis*, 55 TAXES 201 (1977). See also R. COVEY, *THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISIONS* 115 (4th ed. 1997), for a general discussion about some interrelationships between IRD and the estate tax marital deduction. The spouse shares in the deduction even if spouse's items of IRD qualify for the marital deduction. *Findlay v. Comm'r*, 39 T.C. 580 (1962), *aff'd in part*, 322 F.2d 620 (2d Cir. 1964).

186. *Chastain v. Comm'r*, 59 T.C. 461 (1972), *acq.* 1978-2 C.B. 1, *nonacq.* 1978-2 C.B. 3, *appeal dismissed (nolle pros.)* (5th Cir. 1973).

187. The Commissioner argued that the specific devise should be satisfied with other non-IRD items and that would result in less property passing to the charity.

188. *Kincaid v. Comm'r*, 85 T.C. 25 (1985).

189. With a 50% marital deduction formula, the taxpayer conceded that the marital deduction was reduced by half of the amount of IRD items. The Commissioner contended that the marital deduction was reduced by the full amount of the IRD items. If the Commissioner were correct, there would have been no estate taxes attributable to the IRD items as

Chastain and *Kincaid* are difficult to distinguish. In *Chastain*, the decedent left his son a sum certain that was to be funded in part with IRD items, but the balance was funded with non-IRD items. For purposes of recomputing the tax on the hypothetical estate, the court seems to assume that other assets of the decedent's estate would not be used to fully fund the specific devise. In *Kincaid*, the decedent left his spouse a pre-residuary marital deduction formula devise. When recomputing the tax on the hypothetical estate, the court assumed that other assets of the decedent's estate would be used to fund the pre-residuary marital devise. The formula in *Kincaid* was clearer that the marital formula was to be fully funded. That result seems less clear in *Chastain*.

In *Estate of Cherry v. United States*,¹⁹⁰ the decedent made \$11 million in pre-residuary devises. Seven million dollars of rights to IRD passed to a residuary marital deduction trust that was charged with the payment of the decedent's estate taxes. The taxpayer argued that the amount of marital deduction used to determine the taxes of the hypothetical estate should not be reduced, relying on *Chastain*. The government argued that because the rights to the IRD items

the taxable estate would have remained constant. The below chart used by the court illustrates the differing recomputation of estate taxes.

Actual Computation		Petitioner's recomputation	Respondent's recomputation
Gross estate	\$1,000,000	\$900,000	\$900,000
Adjusted gross estate	1,000,000	900,000	900,000
Marital deduction	(500,000)	(450,000)	400,000
Exemption	<u>(60,000)</u>	<u>(60,000)</u>	<u>(60,000)</u>
Taxable estate	440,000	390,000	440,000
Estate tax	<u>126,500</u>	<u>100,500</u>	<u>126,500</u>
Sec. 691(c)(1)(A) deduction		16,000	0

Id.

190. *Estate of Cherry v. United States*, 133 F. Supp. 2d 949 (W.D. Ky. 2001).

passed to the marital deduction trust, the amount of the marital deduction should be reduced when the IRD items are eliminated from the estate to compute the hypothetical estate tax. The court sided with the government and distinguished *Chastain*, because in *Chastain* the IRD items were devised to the pre-residuary devisees. The court also distinguished *Kincaid* because in *Kincaid* the marital deduction devise was a pre-residuary devise that would have been funded even if the estate had not included any IRD items.

These three cases may be distinguished, if not totally reconciled, with the following principles:

1. The *Chastain* Rule. When the right to IRD is specifically devised to a particular person, such as in *Chastain*, the recomputed tax on the hypothetical estate is calculated assuming that the rights to IRD do not exist and that the devisee will not receive other property of the estate. This is consistent with Revenue Ruling 67-242.¹⁹¹
2. The *Kincaid* Rule. When a charitable or marital devise is a pre-residuary “formula gift,” the rights to IRD are removed from the hypothetical estate and the charitable or marital deduction is calculated assuming other assets of the estate will be used to fully fund the devise, to the extent available.
3. The *Cherry* Rule. When the marital deduction or charitable devise is a residual gift and the rights to IRD pass to it, the amount of the marital or charitable deduction will be reduced because there are fewer assets passing to the hypothetical residuary estate.

Examples illustrate other situations.

Example 1: IRD items are received by the surviving spouse and estate taxes are payable out of the marital devise.

In 2007, the decedent died with a gross estate of \$5.1 million and a \$5 million net estate before deducting the marital deduction. The estate included a \$2.1 million devise to the decedent’s child. The specific devise to the child is not charged with the payment of estate taxes. The balance of the decedent’s estate, which qualifies for the estate tax marital deduction after the payment of estate taxes, is devised to the decedent’s surviving

191. Rev. Rul. 67-242, 1967-2 C.B. 227.

spouse. The assets of the estate include a \$1.1 million IRA (a right to IRD) that is payable to the surviving spouse. All of the estate's \$100,000 in debts are section 691(b) deductions in respect of a decedent. As a result, the net section 691(c) amount is \$1 million.¹⁹²

The total estate taxes for *D*'s estate are \$81,818. The amount of the residue, that is, the marital devise is \$2,818,182 (\$2.9 million less \$81,818). The taxable estate is \$2,181,818. The reduced estate is \$4 million (\$5 million less \$1 million net right to IRD). Because the residuary marital devise is still charged with the payment of estate taxes, the hypothetical estate tax is \$81,818. (The hypothetical marital devise is \$1,818,182.) The hypothetical taxable estate is \$2,181,818. Thus, the actual taxes paid by the decedent's estate are the same as the hypothetical estate tax liability.

This result occurs because the pre-residuary devise to the decedent's child is still \$2.1 million, which leaves only \$1.9 million to pay taxes and fund the marital devise in the reduced estate. Thus, in this example there is no section 691(c) deduction because the reduced hypothetical estate does not owe a smaller estate tax. All of the rights to IRD are being attributed to the marital devise.

Example 2: The rights to IRD are received by someone other than the surviving spouse or a charity and the estate taxes are payable out of the marital deduction portion of the estate:

The facts are similar to the prior example, except that the decedent's child receives only \$1 million of estate assets and the decedent's child is the designated beneficiary of the decedent's \$1.1 million IRA. Thus, the decedent's child is still entitled to \$2.1 million, but \$1.1 million is the right to the IRD item. The remainder of the decedent's estate is payable to the surviving spouse, and the marital devise is charged with the payment of estate taxes.

The total estate taxes for the decedent's estate are still \$81,818. The taxable estate is \$2,181,818. The reduced estate is \$4 million (\$5 million less \$1 million of net right

192. I.R.C. § 691(c)(2)(B) provides that the net amount for I.R.C. § 691(c) purposes is the value of the I.R.C. § 691(a) items less the I.R.C. § 691(b) deductions.

to IRD). The hypothetical estate now includes only a \$1 million devise to the child and a residuary devise to the surviving spouse. As a result, the hypothetical estate tax is zero as there is only \$1 million left to someone other than the decedent's spouse, that is, the hypothetical taxable estate is \$1 million. Thus, the section 691(c) deduction is \$81,818. When the decedent's child includes the IRA in income, the child will be entitled to an income tax deduction of \$81,818.

This second example illustrates another point about the section 691(c) deduction. The person who is entitled to the section 691(c) deduction may not be the same person who was charged with the payment of the estate taxes that generated the deduction. In example 2, the decedent's son is entitled to the deduction although the estate taxes are paid out of the marital devise. The estate taxes are payable from property otherwise passing to the surviving spouse, as a "mechanical" matter only. The estate tax is attributable to the devises to the son, and thus the son may be viewed as paying the estate tax. Indeed, the result in the example would be the same had the devises to the son "grossed up" by the amount of the estate tax with a direction that the gross-up devises bear the burden of the estate tax.

The section 691(c) deduction is a section 63 itemized deduction¹⁹³ for an individual recipient because it is not designated as an above the line deduction in section 62.¹⁹⁴ The deduction is not subject to the 2% rule of section 67,¹⁹⁵ but is subject to the phase-out rule of section 68, as are all itemized deductions.¹⁹⁶ For the alternative minimum tax computation, the section 691(c) deduction is not an adjustment to determine alternative minimum taxable income.¹⁹⁷

As noted above, rights to IRD may pass through several estates and as a result be subject to estate taxes in more than one estate. If this happens, the recipient who ultimately reports the IRD item in income may claim a section 691(c) deduction for estate taxes paid in all of the estates.¹⁹⁸

193. See, e.g., *Goodwin v. United States*, 458 F.2d 108 (1972).

194. Rev. Rul. 78-203, 1978-1 C.B. 199.

195. I.R.C. § 67(b)(7).

196. I.R.C. § 68.

197. I.R.C. § 56(b)(1).

198. Treas. Reg. § 1.691(c)-1(b) and -1(d), ex. (2).

If the IRD item generates capital gain income or qualified dividends eligible for the capital gains tax rate, the section 691(c) deduction must be deducted against capital gain income, including the qualified dividend income.¹⁹⁹ This rule prevents the recipient from offsetting ordinary income normally taxed at higher rates with a deduction attributable to capital gains or qualified dividend income taxed at lower rates.

§ 2:3.5 QDOT (Section 2056A) Marital Deduction Trusts

A marital deduction of sorts is permitted under section 2056A when the decedent's spouse is not a U.S. citizen. However, when the surviving spouse dies, the estate taxes attributable to the special marital deduction trust (a so-called Qualified Domestic Trust or QDOT) is determined with reference to the original decedent's estate. The regulations provide that the tax imposed at the time of the surviving spouse's death is an estate tax for purposes of section 691(c).²⁰⁰ This scheme may result in the recognition of IRD income long before the final amount of the first decedent's final estate tax is known. For example, the decedent's IRA will be income when distributed to the designated beneficiary, but all the estate taxes attributable to it at the estate's marginal rate have yet to be determined. Neither the Code nor the regulations provide any guidance on how the section 691(c) deduction is determined in this circumstance, that is, when the IRD item is included in income before the estate tax (generally not due until the surviving spouse dies) is determinable.

§ 2:3.6 GST Taxes and Income Tax Deductions

The Tax Reform Act of 1986²⁰¹ enacted a generation-skipping transfer (GST) tax system that imposes a tax on generation-skipping transfers.²⁰² Two potential income tax deductions are permitted for GST taxes.

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199. I.R.C. § 691(c)(4). The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, provides that qualified dividends are taxed at capital gains tax rates. The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 402, amended section 691(c)(4) to make clear the matching of the section 691(c) deduction attributable to capital gains income including qualified dividends with capital gains income and qualified dividends. *See* H.R. REP. NO. 108-696 (2004) (Conf. Rep.).
200. Treas. Reg. § 20.2056A-6(a).
201. Pub. L. No. 99-514, 100 Stat. 2085.
202. I.R.C. § 2601.

If a GST tax is imposed on a taxable termination or a direct skip²⁰³ occurring as a result of the death of a transferor,²⁰⁴ an income tax deduction is allowed for the GST taxes paid, under principles similar to the income tax deduction for estate tax under section 691(c).²⁰⁵ The deduction is computed for the portion of the GST tax attributable to items of gross income of the trust²⁰⁶ that were not properly includible in the gross income of the trust for periods before the date of the termination. No deduction under section 691(c) is permitted for any state generation-skipping transfer tax, although, as explained below, a deduction is permitted for any state generation-skipping transfer tax imposed on certain distributions of accounting income.²⁰⁷ There are many questions concerning this deduction similar to the issues that arise out of the regular section 691(c) deduction discussed above, but there are no Treasury Department regulations to provide guidance on how that deduction is computed.

A second income tax deduction is available under section 164 for generation-skipping transfer taxes imposed by the federal government or a state on income distributions.²⁰⁸ However, this deduction only applies to the extent that the distribution of income is includible in the gross income of the distributee and does not apply to distributions of undistributed net income (and applicable taxes added to the amount included in gross income of the beneficiary) under section 666.²⁰⁹

The deduction of state GST taxes under section 164 requires the state GST to be described in section 2604. However, the credit for certain state generation-skipping transfer taxes under section 2604 was eliminated for transfers after 2004 at the same time as the credit for state death taxes under section 2011 was phased out.²¹⁰ (Under

203. Taxable terminations and direct skips are two of the three types of generation-skipping transfers. The third is taxable distributions. *See* I.R.C. §§ 2603(a), 2611(a), 2612. As a result, no deduction is provided under I.R.C. § 691(c) with respect to taxable distributions. *But see* I.R.C. § 164(a)(4), discussed in *infra* notes 208–12 and accompanying text.

204. For generation-skipping transfer tax purposes, the term “transferor” is defined in I.R.C. § 2652. Presumably, it has the same meaning under I.R.C. § 691(c)(3).

205. I.R.C. § 691(c)(3).

206. For generation-skipping transfer tax purposes, the term “trust” includes any arrangement (other than an estate) that has substantially the same effect as a trust. I.R.C. § 2652(b)(1). Although not specified, it would seem that for the purposes of I.R.C. § 691(c)(3) the term trust should have the same meaning as it does for purposes of the GST tax.

207. *See* I.R.C. § 164(a)(4), (b)(4)(A)(ii).

208. I.R.C. § 164(a)(4), (b)(4).

209. Even prior to the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, there was an “adjustment” for the generation-skipping transfer tax provided under the “throwback” rules. *See* I.R.C. § 667(b)(6).

210. *See* I.R.C. § 2604(c).

current law, both of these credits are scheduled to be restored beginning in 2011.) It seems uncertain whether any state GST tax is allowed as an income deduction during the time there is no credit against the federal GST tax. Arguably, qualifying state generation-skipping transfer taxes should be deductible as they are still described in section 2604, even if not an offset against the federal GST tax.

If a deduction under section 164(a)(4) is allowed for a generation-skipping transfer tax for a generation-skipping transfer occurring in the taxable year of the distributee that is paid not later than the time the return is due, including extensions, on account of that transfer, the GST tax is deemed paid on the last day of the tax year in which the transfer was made.²¹¹ A similar rule applies to the tax year of a trust for a taxable termination.²¹² This provision apparently is intended to "match up" the deduction to the beneficiary's tax year in which the distribution of gross income occurred.

211. I.R.C. § 164(b)(4)(B).

212. *Id.*

Chapter 3

Ordinary Trusts; Estates in the Process of Administration

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§ 3:1 Introduction

The 1954 Internal Revenue Code (as amended, the “Code”) introduced new, detailed rules for the taxation of estates and trusts and their beneficiaries.¹ These rules were modified in 1969, 1976, 1984,

1. The new 1954 sections were taken largely from the American Law Institute’s proposals, which are discussed in Holland, Kennedy, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft*, 53 COLUM. L. REV. 316 (1953).

1986, and 1997 legislation, but the fundamental scheme of taxation was not significantly altered.²

Under the Code, an estate or trust is not taxed to the extent that it distributes or is required to distribute its income to the beneficiaries, but is taxed as an entity on net income that is not distributed or distributable to the beneficiaries. This structure makes the taxation of an estate or trust similar to a partnership to the extent of distributions—the beneficiaries are taxed on the income earned by the trust or estate if it is passed through. But a trust is taxed similarly to a regular corporation to the extent that the income earned is not distributed. Thus, in any given year it is possible for a trust or estate to be either a reporting entity like a partnership, a taxpaying entity like a corporation, or a combination of both. It is this chameleon-like nature of subchapter J taxation that makes tax reporting complex for trusts and estates, as this chapter explains.

In general, taxable income of an estate or trust is computed in the same manner as taxable income of an individual.³ There are exceptions to this, particularly with respect to charitable contributions.⁴ Moreover, a special deduction is allowed to estates and trusts for amounts of income actually distributed or required to be distributed to the beneficiaries.⁵ The amounts deducted for distributions are included in the gross income of the beneficiaries.⁶ It is through this deduction for income distributed or distributable to the beneficiaries that the estate or trust is a conduit for income tax purposes.

When income flows to the beneficiaries, the character of that income remains the same in the hands of the beneficiaries.⁷ The beneficiary is entitled to treat special classes of income received from the estate or trust, such as dividends or tax-exempt interest, in the

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2. Although several other acts involving income taxation have been enacted, including acts in 1993, 1994 and 1996, their direct impact on the income taxation of estates, trusts and beneficiaries has been much less significant than those acts mentioned in the text. The Treasury Department was authorized, effective August 20, 1996, to prescribe regulations necessary or advisable to carry out the purposes of part I of subchapter J (I.R.C. §§ 641–85) “including regulations to prevent avoidance of such purposes.” I.R.C. § 643(a)(7). Treas. Reg. § 1.7012 (the so-called “anti-abuse” partnership regulations) are an example of regulations issued by the Treasury Department under similar authority, but no subchapter regulations have been issued.
 3. I.R.C. § 641(b).
 4. See generally Jungck & Barnes, *Fiduciary Return Offers Tax Planning Opportunities for Estates and Trusts*, 18 TAX’N FOR LAW. 176 (Nov.–Dec. 1989).
 5. I.R.C. §§ 661, 651; Treas. Reg. §§ 1.652(b), 1.662(b).
 6. I.R.C. §§ 652, 662.
 7. I.R.C. §§ 652(b), 662(b).

same manner as if received directly. Finally, there is a progressive tax rate structure similar to individuals, although, as a result of changes made by the Tax Reform Act of 1986,⁸ the highest rate is imposed on significantly lower levels of taxable income for estates and trusts than for individuals.⁹

Under subchapter J, all distributions, except certain narrowly defined distributions out of principal, are includible in the gross income of the beneficiary or beneficiaries to the extent of the least of (1) the amount of the distribution, (2) the net income of the trust,¹⁰ or (3) in certain situations, the net income of a separate share of the estate or trust.¹¹ If all of the income of an estate or trust is distributed, distributions of principal generally are not taxable to the beneficiaries.¹² This limitation derives from the basic exclusion in section 102 for gifts, bequests, and devises. Section 102 distinguishes, however, between ordinary gifts and gifts of income, and taxes the latter.¹³ For purposes of the distinction, section 102 provides a rule that any amount included in the income of a beneficiary under subchapter J of chapter 1 shall be treated as a gift of income.¹⁴

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8. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.
 9. I.R.C. § 1(e) imposes a separate rate schedule for estates and trusts. For 2014, the maximum rate of 39.6% is reached when taxable income exceeds \$12,150.
 10. I.R.C. §§ 652(a), 662(a)–(b). *See* *Geftman v. Comm’r*, 154 F.3d 61 (3d Cir. 1998) (distribution to the beneficiary from a testamentary trust not includible in beneficiary’s gross income where court found trust had no income on account of distributions from the estate based upon the court’s finding that there was no loan outstanding between the trust and the estate and interest on mortgages belonged to corporations and not the trust).
 11. See section 3:5.3 for a discussion of the separate share rules of I.R.C. § 663.
 12. See section 3:5.2 for a detailed discussion.
 13. I.R.C. § 102 thus adopts the rule of *Irwin v. Gavit*, 268 U.S. 161 (1925). *See generally* *Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied*, 414 U.S. 820 (1973); *Del Cotto, The Trust Annuity as Income: The Constitutional Problem of Taxing Gifts and Bequests as Income*, 23 TAX L. REV. 231 (1968).
 14. I.R.C. § 273 specifically provides that the amount that the holder of a life or terminable interest acquired by gift receives as income may not be reduced by any deduction for shrinkage, because of the lapse of time, in the value of his interest. The purchaser, even if he is the remainderman, may amortize his cost. *Bell v. Harrison*, 212 F.2d 253 (7th Cir. 1954), *aff’g* 108 F. Supp. 300 (N.D. Ill. 1952); *Fry v. Comm’r*, 31 T.C. 522 (1959), *aff’d*, 283 F.2d 869 (6th Cir. 1960); *see* *Ehrick v. Comm’r*, 73-2 U.S. Tax Cas. (CCH) ¶ 9,641 (D.C. Cir. 1973) (rule not applicable where life estate deemed acquired by gift); *Early v. Comm’r*, 445 F.2d 166 (5th Cir.), *cert. denied*, 404 U.S. 855 (1971) (same); Rev. Rul. 62-132, 1962-2 C.B. 73. *See* STAFF OF THE SUBCOMM. ON INTERNAL REVENUE TAXATION OF THE COMM. ON WAYS

The net income available for distribution to beneficiaries is benchmarked by a defined term: “distributable net income” or “DNI.”¹⁵ Distributable net income is basically the same as taxable income, but adjustments are made to eliminate capital gains that are not distributed¹⁶ and some income that is treated as principal for trust accounting purposes.¹⁷ Nontaxable income is included in distributable net income, but retains its nontaxable character, so that a portion of the distributions received by beneficiaries may be nontaxable.¹⁸ Thus, to the extent that a trust or estate has distributable net income, all distributions, with certain narrow exceptions, are treated as distributions of taxable or nontaxable income.¹⁹

When distributions exceed distributable net income, amounts that are required to be distributed currently as income (as determined under the governing instrument and applicable local law)²⁰ first absorb the distributable net income and are taxable to that extent.²¹ Any remaining balance of distributable net income is then applied to distributions that are discretionary distributions of current income, distributions of accumulated income,²² or distributions of corpus not within the defined exceptions.²³ Discretionary distributions falling in this second

AND MEANS, 84TH CONG., 2D SESS., UNINTENDED BENEFITS AND HARDSHIPS item 15 (Comm. Print 1956); Freeland, Lind & Stephens, *What Are the Income Tax Effects of an Estate's Sale of a Life Interest*, 34 J. TAX'N 376 (1971); Plumb, *Tax Effects of Sales of Life Interests in Trusts*, 9 TAX L. REV. 39 (1953); see also Danzis, *The Favorable Tax Treatment of Remainder Interest Investment*, 24 TAX L. REV. 527 (1969). In some instances a purchaser may first be permitted to recover his entire cost. See Rev. Rul. 56-78, 1956-1 C.B. 648. Note that I.R.C. § 167(e) denies any amortization for the cost of a temporary interest in property, in some cases, when purchased in a transaction involving the purchase of another interest in the property by a related party. *Jones v. Comm'r*, 40 T.C. 249 (1963), *vacated and remanded*, 330 F.2d 302 (3d Cir. 1964) (indicating that gain on sale of remainders in trusts by person in business of buying same would be ordinary income if received by reason of death of life tenant but would be capital gain if sold after tenant's death).

15. Distributable net income or DNI is defined in I.R.C. § 643(a) and appears in I.R.C. §§ 652(a) and 662(a)-(b) as a limit on the amount of income a beneficiary must report.
16. I.R.C. § 643(a)(3). Treas. Reg. § 1.643(a)-3 provides guidance on when capital gains are included or excluded from DNI. See section 3:3.2[C].
17. I.R.C. § 643(a)(4). See section 3:3.2[E].
18. I.R.C. § 643(a)(5); Treas. Reg. §§ 1.652(b)-1, 1.662(b)-1.
19. H.R. REP. NO. 83-1337, at A199 (1954); S. REP. NO. 83-1622, at 349 (1954): “It is thus possible largely to avoid the necessity for tracing of income which exists generally under existing law.” See Craven, *Estate and Trust Income*, 93 TR. & EST. 688 (1954).
20. I.R.C. § 643(b). Distributable net income is discussed in section 3:3.2.
21. I.R.C. § 662(a)(1)-(2).
22. Taxing distributions of accumulated income is very limited. See section 3:6.
23. I.R.C. § 663.

class are taxable to the extent of the remaining distributable net income. The rules for determining the order in which distributable net income is to be applied to these different types of distributions are commonly referred to as the “two-tier” system.²⁴

Under law existing before the progressive rates applicable to trusts were compressed greatly, it was possible to effect a tax saving by accumulating income in a trust or estate where it would be subject to lower tax rates than would be applicable to that income in the hands of the beneficiary.²⁵ The use of a trust (but not an estate) for this purpose was impeded by the adoption of “throwback” rules.²⁶ Under the throwback rules, distributions in excess of the income for the year are treated as taxable to the extent that they do not exceed the distributable net income accumulated in preceding years. The throwback rules no longer apply, except to foreign trusts (including domestic ones that were formerly foreign) and certain domestic trusts created before March 1, 1984.²⁷

§ 3:2 Computation of Net Taxable Income and Credits

The taxable income of an estate or trust must be computed separately before the income tax consequences for the beneficiaries can be determined.

The 2010 Patient Protection and Affordable Care Act (“2010 Health Care Act”)²⁸ added Code section 1411. Under this Code section, estates and trusts are subject to an additional 3.8% tax on their “undistributed net investment income” beginning in tax years starting after December 31, 2012.²⁹ The amount of income subject to the tax is limited by the amount of adjusted gross income, as defined in section 67(e), in excess of the dollar amount that begins at the highest income tax bracket of the estate or trust for the year under section 1(e).³⁰ Net investment income for purposes of section 1411 is defined somewhat differently than how net investment income is

24. See section 3:5.2.

25. The progressive rate structure for under trusts as effected the Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, for years after 1987 so severely limits the lower-rate brackets for trusts compared to individuals that little savings can be achieved by taxing income at a trust’s lower brackets.

26. The throwback rules are discussed in section 3:6.

27. Trusts that were created before March 1, 1984, and that would be considered multiple trusts under I.R.C. § 643(f) are still subject to the throwback rules. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 507, 111 Stat. 788.

28. Pub. L. No. 111-148.

29. I.R.C. § 1411(a)(2)(A).

30. I.R.C. § 1411(a)(2)(B).

defined for purposes of section 163(d).³¹ This additional tax will require fiduciaries to consider the impact of the tax when determining the amount of income the estate or trust will accumulate or distribute in a particular year. This planning will likely be complex as individual beneficiaries are subject also to the 3.8% tax on net investment income if the taxpayer's adjusted gross income for the year exceeds \$250,000 for married individuals filing joint returns and surviving spouses.³² For other taxpayers, the threshold is \$200,000,³³ except for married individuals filing separately where the threshold amount is \$125,000.³⁴

§ 3:2.1 Trust or Estate

The Code provides that, in general, the "taxable income of an estate or trust is computed in the same manner as in the case of an individual."³⁵ This means that generally a fiduciary must report all items of gross income that an individual is required to report, and that the entity is allowed the same deductions³⁶ as an individual. The principal exception—the special deduction for distributions to beneficiaries—is discussed below in section 3:5.

Notwithstanding the general rule, a number of special rules apply if a trust or estate is an S corporation shareholder. Those rules are discussed in detail in chapter 8.

Of course, other aspects of federal taxation may apply to an estate or trust. For example, if a trust or estate is a partner in a partnership, the rules of subchapter K may apply. For example, in *Tiberti v. Commissioner*,³⁷ transfers in trust were held to be bona fide, and thus each trust owned a capital interest in a partnership in which capital was a material income-producing factor within the meaning of the family partnership rules of section 704(e). As a consequence, the distributive shares of partnership income were properly includible in the gross income of the trusts.

Other special situations may impact the amount of gross income a trust (or estate) must report. For example, in *Fidelity Trust Co. v. United States*,³⁸ two trusts agreed that each trust would sell 5,000

31. I.R.C. § 1411(c).

32. I.R.C. § 1411(b)(1).

33. I.R.C. § 1411(b)(3).

34. I.R.C. § 1411(b)(2).

35. I.R.C. § 641(b).

36. Many deductions available to individuals cannot apply to a trust. See, for example, the medical expense deduction under I.R.C. § 213.

37. *Tiberti v. Comm'r*, T.C. Memo. 1962-174.

38. *Fid. Trust Co. v. United States*, 49 F. Supp. 240 (W.D. Pa. 1943).

shares of the same stock, and the proceeds would be equally divided between them if the amount each received varied. The court ruled that the amount transferred by one to the other was not a taxable gain to the transferor trust.³⁹

The characterization of a trust's income as capital or ordinary may depend on sections outside of subchapter J. For example, section 1239 provides that gain recognized on certain sales between a trust and its beneficiaries of certain depreciable property is treated as ordinary income.⁴⁰ The deductibility of losses realized between a trust and a related taxpayer must pass muster under section 267 to be recognized.⁴¹

[A] Depreciation and Depletion

Property held by an estate or trust may give rise to a tax depreciation or depletion deduction if the rules governing those deductions are satisfied. An amortization deduction may be allowed as well.⁴²

The section 179 bonus depreciation deduction permitted to taxpayers is not available to estates and trusts.⁴³ If a trust or an estate owns an interest in a partnership or an S corporation that elects the additional deduction permitted by section 179, the pass-through deduction is not available to the estate or trust, but basis is not reduced to the extent that the deduction is not permitted.⁴⁴

Note that depreciation is generally deductible from gross income in determining adjusted gross income⁴⁵ and, as a result, is not subject to the section 67(a) 2% phase-out rule, but it is possible for depreciation to be an itemized deduction subject to section 67(a). Nevertheless, the Code provides that the allowable deductions for depreciation and depletion are to be "apportioned between the income

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39. See also Priv. Ltr. Rul. 200203006 (interest on bank accounts and dividends on stock held by non-resident alien decedent should be included in gross income of his foreign estate, which was on the cash receipts and disbursements method of accounting, in the taxable years in which they are actually received, and not when earned under the constructive receipt doctrine; where foreign estate representative could not act in the United States, a U.S. estate representative was appointed and had to write to the treasurers of all fifty states to inquire about abandoned property in decedent's name). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
40. Tax Reform Act of 1984, Pub. L. No. 98-369, § 175, 98 Stat. 494. See Gerhart, *Trust and Estate Income Taxes Changed by Tax Reform Act*, 124 TR. & EST., Feb. 1985, at 16.
41. I.R.C. § 267(a)(1), (b)(6), (b)(13).
42. See *infra* section 3:2.1[B].
43. I.R.C. § 179(d)(4).
44. Treas. Reg. § 1.179-1(f)(3).
45. See I.R.C. § 62(c)(4).

beneficiaries and the trust in accordance with the pertinent provisions of the instrument creating the trust,⁴⁶ or, in the absence of such provisions, on the basis of the trust income allocable to each."⁴⁷ For this purpose, a charity is considered to be a beneficiary.⁴⁸ The depreciation regulations state that:

the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example . . . [if] the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee . . . [but if] the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction).⁴⁹

The regulation was sustained in *Dusek v. Commissioner*.⁵⁰ The trust instrument's specific allocation of deduction was not effective because it was inconsistent with reserve and income allocations.

This provision apportions the deduction to the taxpayer (beneficiary) who has income to absorb it, rather than to the taxpayer (the estate or trust) who potentially suffers the economic loss of the

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46. The regulation expands the Code rule of following the trust instrument to include local law. See Treas. Reg. §§ 1.167(h)-(b), 1.611-1(c)(4).
 47. I.R.C. §§ 167(d), 611(b)(3). See generally Keene, *Choosing the Best Depreciation Alternative for Trust Property*, 26 EST. PLAN. 260 (1999); *Grey v. Comm'r*, 118 F.2d 153 (7th Cir. 1941); *Scott v. United States*, 78 F. Supp. 811 (Ct. Cl. 1948). A similar view is taken in the example in Treas. Reg. § 1.662(c)-4(j). The example does not show how to take account of a trust's own depreciation deduction in computing distributable net income, which, in turn, may determine the beneficiaries' inclusions and thus the division of the depreciation deduction.
 48. Treas. Reg. § 1.642(e)-1. As discussed in section 3:2.1[J], a charity is not considered a beneficiary for DNI distribution purposes.
 49. Treas. Reg. § 1.167(h)-1(b); see *Comm'r v. Netcher*, 143 F.2d 484 (7th Cir.), cert. denied, 323 U.S. 759 (1944); *Kearney v. United States*, 116 F. Supp. 922 (S.D.N.Y. 1953).
 50. *Dusek v. Comm'r*, 45 T.C. 355 (1966), aff'd, 376 F.2d 410 (10th Cir. 1967).

wasting asset.⁵¹ Arguably, this merely conforms to the grantor's intention: if the income beneficiary is not charged with a depreciation reserve, the grantor effectively has given the beneficiary, in part, a gift of capital, which is free of tax. Note that in some circumstances the tax effect to the beneficiary may be the same whether the depreciation or depletion deduction is allocated to the fiduciary, which may reduce the fiduciary's taxable income and, therefore, distributable net income "passed out" to the beneficiary, or to the beneficiary who will include the income of the estate or trust in gross income but then diminished it by the depreciation or depletion allowance allocated to the beneficiary.

The depreciation deduction that passes to the beneficiary may exceed the accounting income received by the beneficiary.⁵² Thus, the depreciation deduction is allowed to a beneficiary who is entitled to the income from trust property acquired on foreclosure, even though under state law, as under former New York law, the income cannot be distributed until completion of mortgage-salvage operations.⁵³

A beneficiary who is entitled to all of a trust's income (if under local law or the governing instrument distributable income is not reduced for a depreciation reserve) receives the tax deduction for depreciation of trust property, even though no income may be derived from the trust property in the particular taxable year.⁵⁴ This result may be different if the depreciable property is a passive activity within the meaning of section 469, as it limits deductions from passive activities to the amount of income from the passive activity. For more discussion of section 469 and its application to estates and trusts, see section 3:2.1[H], below.

The governing instrument or state law may permit or require the trustee to maintain a depreciation reserve. The regulations⁵⁵ quoted above and Revenue Ruling 74-530⁵⁶ explain how the depreciation deduction is apportioned between a trust and its beneficiary when the trust maintains a reserve. First, the depreciation deduction is allocated to the trust to the extent of the reserve. The remainder of the deduction, if any, is then apportioned between the trust and beneficiary "on the basis of the trust income [in excess of the income set aside for the reserve] allocable to each."⁵⁷ If the amount of

51. See generally Keene, *Choosing the Best Depreciation Alternative for Trust Property*, 26 EST. PLAN. 260 (1999).

52. Rev. Rul. 74-530, 1974-2 C.B. 188.

53. *Comm'r v. Gutman*, 143 F.2d 201 (2d Cir. 1944).

54. *Carol v. Comm'r*, 30 B.T.A. 443 (1934); Rev. Rul. 74-530, 1974-2 C.B. 188.

55. Treas. Reg. § 1.167.

56. Rev. Rul. 74-530, 1974-2 C.B. 188.

57. *Id.*

the deduction exceeds the income of the trust, the depreciation deduction is still allocated on the basis of the income retained by the trust compared with the income distributed to the beneficiary, and the deduction is not limited by the amount of the net income of the trust.

The special rules for allocating depreciation and depletion deductions apply to estates as well as to trusts,⁵⁸ except that the apportionment of the deductions between the estate and its beneficiaries is made “on the basis of the income of the estate allocable to each,”⁵⁹ rather than in accordance with the will.⁶⁰ The creation of a special reserve for depreciation by an estate apparently will not result in the special allocation of depletion or depreciation to the accounting principal of an estate regardless of the terms of the will. The rule applies to depreciation and depletion allowances apportioned from partnerships and from other trusts.⁶¹ However, if an estate or trust owns an interest in a partnership or an LLC that is allocated a share of the partnership’s or LLC’s depreciation or depletion deduction, the deduction is separately taken into account.⁶² The division of the deduction between the fiduciary and the beneficiaries is then made on the basis otherwise applicable to depreciation deductions. Note, however, that under the regulations the depletion allowance is allocated on the basis of the income “from such property” and not on the allocation of the entire income of the estate.⁶³

Separately stating a partnership’s or an LLC’s depreciation that will pass through may create an unexpected income tax problem for a trust or estate if the distributions from the partnership or LLC are less than the income subject to taxes. When fiduciary accounting income is less than taxable income and all the fiduciary accounting income is distributed by the estate or trust, the entire depreciation deduction will pass out to the beneficiaries. Nevertheless, the entity’s distribution deduction will be limited to the amount of the fiduciary accounting income distributed.

58. See Gen. Couns. Mem. 39,709 (suggesting that a pooled income fund defined in I.R.C. § 642(c)(5) may be required to set up a reserve for depreciation as a condition to allowing a charitable deduction for contributions to the fund). Cf. Rev. Rul. 74-530, 1974-2 C.B. 188.

59. I.R.C. §§ 167(h), 611(b)(4).

60. *In re Nissen*, 345 F.2d 230 (4th Cir. 1965). *But cf.* S. REP. NO. 83-1622 (1954); *Lamkin v. United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9,479 (W.D. Tex. 1975), *aff’d*, 533 F.2d 303 (5th Cir. 1976) (distinguishing *Nissen*: depreciation allocable even to estate’s discretionary income beneficiary).

61. Rev. Rul. 61-211, 1961-2 C.B. 124.

62. Rev. Rul. 74-71, 1974-1 C.B. 158.

63. Treas. Reg. § 1.611-1(c)(5).

Example: A partnership's K-1 issued to a trust shows ordinary income of \$5,000 and a depreciation deduction of \$4,000. The cash distributed to the trust from the partnership is \$2,000. If the only asset of the trust is the partnership interest and the trust distributes to its beneficiaries the entire \$2,000 of fiduciary accounting income, the beneficiary will be entitled to the entire \$4,000 depreciation deduction and the trust will be left with \$3,000 of taxable income (\$5,000 gross income less the \$2,000 distributed).⁶⁴

Of course, this same problem can arise if the trust owns directly the depreciable asset and the taxable income exceeds cash flow.

In *In re Nissen*,⁶⁵ the Fourth Circuit Court of Appeals distinguished the provisions for estates from those applicable to trusts, in that the former do not provide for apportioning the allowable depreciation deduction in accordance with the governing instrument. The Nissen estate beneficiaries who received discretionary distributions of estate income during the period of administration were not necessarily "heirs, legatees and devisees" within state law as required by section 167(g). Thus, the estate was entitled to take the entire depreciation deduction.

In *Lamkin v. United States*,⁶⁶ an estate in administration was not permitted to take the depreciation deduction when it distributed income generated by real property to the income beneficiary of a trust that would eventually hold the property. The will did not authorize discretionary distributions of income to the future income beneficiary of the trust. The Fifth Circuit Court of Appeals held that the distributions of income were made to the beneficiary based on her status vis-à-vis the trust, and thus, the depreciation deduction followed the income and the estate was not entitled to take the depreciation deduction.

The *Lamkin* court noted that the will in *Nissen* provided for the discretionary distributions of income that might have been composed of income from sources other than the property that generated the depreciation deduction. The residue of the Nissen estate was devised to trusts and the discretionary recipients of the estate income were income beneficiaries of the trusts. Thus, *Nissen* and *Lamkin* may be factually distinguished on the basis that the will in *Nissen* authorized

64. For a detailed discussion of this problem and some possible solutions, see J. Ransome, *Allocating Partnership Depreciation Between Trusts and Fiduciaries*, 38 TAX ADVISER 388 (July 2007).

65. *In re Nissen*, 345 F.2d 230 (4th Cir. 1965).

66. *Lamkin v. United States*, 533 F.2d 303 (5th Cir. 1976), *aff'g* 75-1 U.S. Tax Cas. (CCH) ¶ 9,479 (W.D. Tex. 1975).

discretionary distribution to the testamentary trust beneficiaries, but the will in *Lamkin* did not.

When a trust or estate has more than one beneficiary, the issue arises of how to allocate depreciation or depletion deductions if one beneficiary is to receive income from a depreciable or depletable asset and another beneficiary is not. The depletion deduction issue is answered by the regulations, which provide for allocation of the deduction based on the "income from such property."⁶⁷ No such clear rule exists for the depreciation deduction, however. The applicable regulation refers more generally to trust income or estate income.⁶⁸ Notwithstanding the lack of specificity by the depreciation regulation, the separate share rules of section 663 likely answer the question.⁶⁹ The regulations provide that a deduction applicable to one share of an estate or trust is not available to another.⁷⁰ When one beneficiary of a trust is entitled to the income from specific property, that property is likely treated as a separate share and thus within the regulation allocation rule.

Section 613A limits percentage depletion for oil and gas wells.⁷¹ The regulations under section 613A provide that the amount of depletion for an estate or trust is first computed by an estate or a trust under the rules contained in section 611.⁷² Whether cost or percentage depletion is used also is determined at the entity level, but that determination does not control whether the beneficiary's deduction is limited.⁷³

[B] Amortization

Section 642(f) provides that amortization deductions permitted by sections 169 (pollution control facilities) and 197 (goodwill and other intangibles) are apportioned between an estate or trust and the beneficiaries as provided in regulations. The regulation provides that amortization deductions are apportioned between the fiduciary and the beneficiaries using the same principals applicable to depreciation and depletion deductions.⁷⁴ The regulation provides also that amortizations permitted by sections 169, 184, 187, and 188 are allowed "in the same manner and to the same extent as in the case of an individual."⁷⁵ Section 197 is referred to in the statute, but is not mentioned in the regulation. This is not surprising as section 197 was enacted in 1993, and the regulation has not been amended since 1980.

67. Treas. Reg. § 1.611-1(c)(4)-(5).
68. Treas. Reg. § 1.167-(h)(1)(b), (c).
69. See section 3:5.3.
70. Treas. Reg. § 1.663(c)-2(b)(5).
71. I.R.C. § 613A.
72. Treas. Reg. § 1.613A-3(g)(1).
73. *Id.*
74. Treas. Reg. § 1.642(f)-1.
75. *Id.*

Section 171(c) provides for an election to amortize a taxable bond premium. Neither the Code nor regulations provide any special rules as to how a trust or estate makes the election, but because the election is made by the “holder” it seems clear that the fiduciary must make the election. How the amortization may be allocated between the fiduciary and beneficiaries is covered by neither Code nor regulation provision. Nevertheless, because bond premiums offset interest income of the bond, no allocation between the fiduciary and beneficiaries seems needed.

For taxpayers, in general, reforestation expenditures are currently deductible up to a limit of \$10,000,⁷⁶ and the balance of reforestation expenses are amortizable over eighty-four months.⁷⁷ Trusts are not permitted the \$10,000 reforestation deduction,⁷⁸ but are allowed to amortize reforestation expenses as a result of 2004 amendments to section 194.⁷⁹ The Joint Committee Explanation of a 2005 technical correction to the 2004 changes to section 194 provides that the 2005 amendment “clarifies that the amortization provision applies to estates and trusts, but the deduction applies to estates (and not to trusts).”⁸⁰

Section 194(c)(4) provides the reforestation expenditures are apportioned between estates and trusts and their beneficiaries as provided in regulations. Regulations issued before the 2004 amendments to section 194 apportion the amortization deduction between an estate and its beneficiaries based on income of the estate apportioned to each.⁸¹ The Code provides also that any deduction apportioned to a beneficiary is taken into account as an expenditure by the beneficiary in applying section 194 to the beneficiary.⁸²

76. I.R.C. § 194 provides for a deduction of up to \$10,000 for each qualified timber property. The legislative history of the deduction implies that the annual deduction is limited to \$10,000 per taxpayer. *See* S. REP. NO. 108-92.

77. I.R.C. § 194(a)–(b).

78. I.R.C. § 194(b)(1)(B)(iii).

79. Before 2004 amendments, I.R.C. § 194(b)(3) specifically denied the amortization deduction to trusts. This prohibition was repealed, effective for expenditures after the date of enactment of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 322(c)(1).

80. Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § 403(i)(1)(B); Joint Committee on Taxation, Technical Explanation of Gulf Opportunity Zone Act of 2005 [JCZ-88-05], § 403.

81. Treas. Reg. § 1.194-2(b)(7) (interpreting I.R.C. § 194 before amendment by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 322). The regulations also prohibited an I.R.C. § 194 deduction pass-through from partnerships, estates and S corporations to a trust. Treas. Reg. § 1.194-2(b)(3)(ii). The regulations have not been amended since I.R.C. § 194 was amended in 2004.

82. I.R.C. § 194(c)(4).

[C] Tax Preference Items

To assure that some federal tax is paid on income and not offset by deductions that were regarded as preferentially treated under the tax laws, the Tax Reform Act of 1969 introduced a 10% minimum tax imposed on tax preference items to the extent the total exceeded a certain threshold level.⁸³ Since 1969, Congress has repeatedly altered the alternative minimum tax provisions. Under current law, individual taxpayers, including estates and trusts, are subject to an alternative minimum tax that is payable to the extent it exceeds the taxpayer's regular tax.⁸⁴ The alternative minimum taxable income⁸⁵ of an estate or trust and any beneficiary is to be determined by applying part I of subchapter J (sections 641–85) with the adjustments provided for under the minimum tax rules.⁸⁶

The Supreme Court's decision in *Knight v. Commissioner*,⁸⁷ discussed below in section 3:2.1[G], impacts the computation of the alternative minimum tax. The computation of the alternative minimum tax denies a deduction for miscellaneous itemized deductions.⁸⁸ Generally, this means that no deduction is allowed for investment adviser fees under the rule established by *Knight* and the regulations under section 67. For larger trusts with significant adviser fee expenses, the result may be a significant alternative minimum tax liability.

The Tax Reform Act of 1986 rewrote and renumbered the Code sections that provide for the alternative minimum tax, including the portion that relates to estates and trusts.⁸⁹ Before the rewrite, the Treasury Department issued regulations under section 58 that dealt with how tax preference items were allocated between the entity and its beneficiaries.⁹⁰ These regulations have not been repealed, although they are no longer applicable. A new section 59 includes a rule to determine the alternative minimum taxable income of an

83. See generally STAFF OF THE JOINT COMM. ON TAXATION, 91ST CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 104–07 (Comm. Print 1970).

84. I.R.C. § 55(a).

85. See I.R.C. § 57(a). For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction. I.R.C. § 56(b)(1)(A)(i). There appears to be no special rule for an estate or trust for such alternative minimum tax purposes.

86. I.R.C. § 59(c). See *Dunn v. Comm'r*, T.C. Memo. 2000-12 (determining alternative minimum tax for payment of estate taxes).

87. *Knight v. Comm'r*, 552 U.S. 181 (2008).

88. I.R.C. § 56(b)(1)(A)(i).

89. Tax Reform Act of 1986, Pub. L. No. 99-514, § 701.

90. Treas. Reg. §§ 1.58-1, 1.58-3, 1.58-3T.

estate or trust.⁹¹ No regulation has been issued for section 59(c), but the legislative history for section 59 provides:

In the case of an estate or trust, instead of allocating items of tax preference between the estate or trust and its beneficiaries (as under present law), it is provided that the minimum tax will apply by determining distributable net income on a minimum tax basis (except to the extent inconsistent with the modifications under section 643(a), with the minimum tax exemption amount being treated the same way as the deduction for personal exemptions under section 643(a)(2)).⁹²

Schedule I of the United States Fiduciary Income Tax Return (Form 1041 (2007)) provides line-by-line instructions for computing the AMT of an estate or trust. The form contains a list of adjustments that are made to taxable income. Part II of Schedule I (Form 1041) computes a “distributable net alternative minimum taxable income” (DNAMTI) for the alternative minimum tax purposes. The form’s effect is to compute DNI after the adjustments for preference items and to recompute the distribution deduction. As a consequence, the amount of AMT income of a beneficiary may be higher than regular income, or the trust or estate may have alternative taxable income on which a tax may be due.

In *Ungerman Trust v. Commissioner*,⁹³ the Tax Court ruled that interest, paid on deferred estates pursuant to a section 6166 extension to pay estate tax, is considered an administration expense, and, therefore, the estate was not subject to the alternative income tax.

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91. I.R.C. § 59(c). See also Barnett, *Demystifying the New Fiduciary Alternative Minimum Tax*, 127 TR. & EST., Aug. 1988, at 8 (discusses analysis of how adjustments and tax preferences should be allocated among fiduciary and beneficiaries); W. Douglass, *Alternative Minimum Tax Creates Special Unexpected Problems for Trusts and Estates*, 12 EST. PLAN. 72 (Mar. 1985); T. Rohman, *Alternative Minimum Tax Rules Under TRA '86 Affect Allocation Between Entity, Beneficiary*, 14 EST. PLAN. 228 (July/Aug. 1987); E. Chan, *Income Taxation of Trusts and Estates Is Increasingly Complex After TAMRA*, 17 TAX'N FOR LAW, 324 (May/June 1989); V. Coleman, *Application of Alternative Minimum Tax (“AMT”) to Estates and Trusts*, C482 ALI-ABA 125 (Feb. 22, 1990); MICHAEL M. MARIANI, *USE OF TRUSTS IN ESTATE PLANNING: DRAFTING TIPS, TAX CONSEQUENCES AND ETHICAL CONSIDERATIONS 2001* (PLI 2001); W. LaPiana, *Fiduciary Income Taxation and Planning for the Complex Estate*, Chapter 2 in *Valuation, Taxation and Other Planning Techniques for Large Estates*, at 103–179 (PLI 1997).
92. H.R. REP. NO. 99-841 (1986) (Conf. Rep.), reprinted in 1986 U.S.C.C.A.N. 4075, 4351.
93. *Ungerman Trust v. Comm’r*, 89 T.C. 1131 (1987).

[D] Net Operating Loss Deduction

Estates and trusts are allowed the deduction for net operating losses (NOLs) under section 172.⁹⁴ The regulation provides for two adjustments.⁹⁵ The section 642(c) charitable contribution deduction and the sections 651 and 661 distribution deductions are not allowed for NOL computation purposes.⁹⁶ In addition, income and deductions attributable to the grantor or another person are ignored.⁹⁷ When an NOL is carried back to prior years, DNI is recomputed and the amount of income reportable by a beneficiary may be reduced.⁹⁸ The time for the beneficiary to file a claim for refund is extended by section 6511(d)(2).⁹⁹

Upon termination of an Electing Small Business Trust (ESBT), or upon revocation of an ESBT election, the NOL carryover under section 172, capital loss carryover under section 1212, and excess deduction are governed by the provisions of section 642(h).^{99.1} This means that the deductions are taken into account by the entire trust or the trust beneficiaries if the trust terminates.^{99.2} The regulations provide an example.^{99.3}

In Chief Counsel Advisory 200734019 a testamentary ESBT succeeded to an estate's NOL resulting from S corporation losses.^{99.4} The Service ruled that section 642(h)(1) permitted the non-S portion a deduction for the NOL, but section 642(c)(2)(C) did not permit the S portion of the ESBT to use the NOL because the deduction was not specifically included in the list of permitted deductions for ESBTs. For additional discussion of ESBTs see section 8:7.

Section 642(h)(1) permits excess NOLs to be carried out to the estate or trust's beneficiaries in the terminating year of the entity.¹⁰⁰

[E] Personal Exemption and Standard Deduction

An estate's personal exemption or deduction is \$600.¹⁰¹ For a trust that is required to distribute all of its income currently under the

94. I.R.C. § 642(d). As to transactions between related trusts and corporations, see *Snively v. Comm'r*, 20 T.C. 136 (1953); *Lexmont Corp. v. Comm'r*, 20 T.C. 185 (1953). For a discussion of the NOL deduction of estates and trusts, see Laura H. Peeples & Dawn Angermaier, *A Silver Lining*, 148 TR. & EST., June 2009, at 30.

95. Treas. Reg. § 1.642(d)-1.

96. Treas. Reg. § 1.642(d)-1(b).

97. Treas. Reg. § 1.642(d)-1(a).

98. Rev. Rul. 61-20, 1961-1 C.B. 248.

99. *Id.*

99.1. Treas. Reg. § 1.641(c)-1(j).

99.2. *Id.*

99.3. Treas. Reg. § 1.641(c)-1(l), exs. 2, 3(i)-(ii).

99.4. Chief Couns. Adv. 200734019.

100. I.R.C. § 642(h).

101. I.R.C. § 642(b)(1).

governing instrument, the personal exemption is \$300.¹⁰² Income for this purpose means income as determined for trust-accounting purposes. Thus, a trust that is required to distribute all of its trust accounting income would pay no tax if taxable income allocable to corpus is less than \$300. In applying this test, trust provisions that depart fundamentally from traditional principles of income and principal are generally not recognized.¹⁰³ All other trusts have a personal exemption of only \$100.¹⁰⁴

For tax years ending after September 10, 2001, the personal exemption for a qualified disability trust¹⁰⁵ under section 642(b)(2)(c) is the same as that for an individual if all of the beneficiaries, as of the close of the year, are determined by the Commissioner of Social Security to have been disabled for some portion of the year.¹⁰⁶

The standard deduction for a trust or estate is zero.¹⁰⁷

[F] Expenses and Losses; Nature of Gain

Like individuals, a trust or estate may deduct “all the ordinary and necessary expenses paid or incurred during the taxable year— (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax,” as well as expenses connected with a “trade or business.”¹⁰⁸ Thus, deductions are allowed for reasonable amounts paid on account of administration expenses, including

102. I.R.C. § 642(b)(2)(B).

103. Treas. Reg. § 1.643(b)-1.

104. I.R.C. § 642(b)(2)(A).

105. A qualified disability trust is described in section (c)(2)(B)(iv) of section 917 of the Social Security Act (42 U.S.C. § 1396p). I.R.C. § 642(b)(2)(c).

106. I.R.C. § 642(b)(2)(C). See Wilcox, *A (d)(4)(A) QeA*, 13 LEGAL NETWORK NEWS, no. 4, Spring 2003, for a discussion of this provision with respect to so called “(d)(4)(A)” special needs trusts.

107. I.R.C. § 63(c)(6).

108. I.R.C. §§ 212, 162; *Trust of Bingham v. Comm’r*, 325 U.S. 365 (1945) (expenses in connection with termination of trust); see *Comm’r v. Burgwin*, 277 F.2d 395 (3d Cir. 1960) (no deduction for beneficiary for his expenses in attempting to cause a tax-free distribution); *Munn v. United States*, 455 F.2d 1028 (Ct. Cl. 1972) (beneficiary may not deduct legal expense concerning share of sale proceeds allocated to him); *Grabien v. Comm’r*, 48 T.C. 750 (1967) (no deduction for expense of residuary legatee in successfully opposing executor’s claim where estate ended with loss in its last taxable year); *Estate of Movius v. Comm’r*, 22 T.C. 391 (1954) (beneficiaries were permitted to deduct taxes on estate realty, which were paid out of income distributable to the beneficiaries); *Herbst v. Comm’r*, 2 T.C.M. (CCH) 361 (1943); see also Baker, *Income Tax Planning for Executors*, 9 TAX L. REV. 281 (1954).

fiduciaries' fees.¹⁰⁹ For example, in Revenue Ruling 55-447,¹¹⁰ an executor was permitted to deduct compensation paid by him to coexecutors.¹¹¹

A fuller definition of administration expenses appears in the estate tax regulations, which provide that estate administration expenses are deductible for estate tax purposes if "actually and necessarily, incurred in the administration of the decedent's estate."¹¹² For estate tax purposes, this definition has been construed restrictively by courts. For example, in *Estate of Millikin v. Commissioner*,¹¹³

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109. Treas. Reg. § 1.212-1(i); *N.Y. Trust Co. v. United States*, 115 F. Supp. 661 (S.D.N.Y. 1953); *James H. Knox Trust v. Comm'r*, 4 T.C. 258 (1944) (principal commissions as well as income commissions); *Di Borgo v. Comm'r*, 23 T.C. 76 (1954); I.T. 3830, 1946-2 C.B. 47 (same). See H.R. REP. NO. 83-1337, at A203 (1954), S. REP. NO. 83-1622, at 352 (1954) (same). For whether a beneficiary who voluntarily makes such payments may deduct them, see *Lindley v. Comm'r*, 63 F.2d 807 (2d Cir. 1933); *Kenan v. Bowers*, 50 F.2d 112 (2d Cir. 1931); *Jones v. Comm'r*, 13 T.C.M. (CCH) 882 (1954); *Agnew v. Comm'r*, 16 T.C. 1466, 1468 (1951). *BUT CE Fletcher v. Comm'r*, 10 T.C.M. (CCH) 793 (1951).
110. Rev. Rul. 55-447, 1955-2 C.B. 533.
111. A fiduciary who proposes to waive commissions would do well to do so in advance of his services to avoid inclusion of the income. Rev. Rul. 64-225, 1964-2 C.B. 15. A later ruling liberalized the evidence required to show the requisite intent to serve on a gratuitous basis, particularly if the waiver is within six months after appointment. Rev. Rul. 66-167, 1966-1 C.B. 20; see also Rev. Rul. 70-237, 1970-1 C.B. 13. In *Breidert v. Comm'r*, 50 T.C. 844 (1968), an executor's fee not income when formally disclaimed fourteen months after appointment, although estate tax return claimed deduction and court approved the fee. In light of the 1976 enactment of I.R.C. § 2518 concerning qualified disclaimers, a reasonable period of time may now be nine months, although I.R.C. § 2518 is a gift and estate tax rule and not an income tax rule. In this connection, consideration might also be given to the effect of local law with respect to entitlement to commissions and the intentional or inadvertent waiver thereof. See, e.g., N.Y. SURR. CT. PROC. ACT LAW § 2309(c) (McKinney 1984) (which provides that a trustee who neither takes nor retains an amount from income to cover annual income commissions loses them entirely).
112. Treas. Reg. § 20.2053-3. Note that proposed regulations under I.R.C. § 2053 have been issued, and if finalized, would change the circumstances when administrative expenses may be deductible. See generally J. Blattmachr & D. Zeydel, *Prop. Regs. on the Deduction for Administration Expenses and Claims*, 34 EST. PLAN., no. 10, Oct. 2007.
113. *Estate of Millikin v. Comm'r*, 125 F.3d 339 (6th Cir. 1997), *overruling Estate of Park v. Comm'r*, 475 F.2d 673 (6th Cir. 1973). *But see Estate of Smith v. Comm'r*, 510 F.2d 479 (2d Cir.), *cert. denied sub nom. Lowe v. Comm'r*, 423 U.S. 827 (1975). See also *Estate of Henning v. Comm'r*, 68 T.C. 374 (1977) (opinion withdrawn Dec. 27, 1977, indicating that fiduciary fees in excess of state statutory amount are not allowable as estate tax deduction).

the court held that expenses allowable under state law were deductible, but only if they were necessary to the administration of the estate. Failing to satisfy the estate tax definition of an administration expense does not necessarily foreclose an income tax deduction, however. Expenses that satisfy section 212, but not section 2053, will be income tax deductible. However, expense deductions for trusts as well as estates may be subject to the 2% rule of section 67(a).¹¹⁴ For example, expenses of selling property may be income tax deductible, even though the proceeds are not needed for an estate function.¹¹⁵

To the extent provided in the regulations, state or local taxes or administration expenses are to be considered in computing income tax payable by an electing small business trust defined in section 1361(e) to the extent they are allocable to the S corporation income and gain or loss on the disposition of stock of the S corporation attributed to the trust.¹¹⁶ These items are excluded from the determination of the amount of tax attributable to other income of the trust or its distributable net income.¹¹⁷

The deductibility of expenses related to personal use property is not totally clear. The issue has arisen in the context of whether the payments of such expenses are indirect payments to a trust beneficiary. For a discussion of the issues and the authorities, see section 3:5.1[C], Indirect Payments.

The deductibility of losses is generally covered by section 165, which requires a loss arise in a trade or business or in a transaction entered into for profit. The issue has arisen of whether an estate is permitted a loss deduction on the disposition of an estate asset if it can not be established that decedent had the requisite motive when acquiring or holding the asset. One court that has considered the question has said: "the controlling consideration is, therefore, whether the acquisition of the [asset] . . . by the executor in behalf of the estate was a 'transaction entered into for profit' in the statutory sense. That it was follows from the nature of the duty of the executor in dealing with assets of the estate coming into his hands."¹¹⁸ The dissent, however, argued that the general applicability of this view is not clear.

114. For a discussion of section 67 and its application to estates and trusts, see section 3:2.1[G].

115. The authors understand that the Internal Revenue Service has taken the position in audits that interest incurred by a fiduciary on debt incurred through borrowing by the fiduciary is not deductible for income tax purposes unless either state law or the governing instrument authorizes the fiduciary to borrow.

116. Treas. Reg. § 1.641(c)-1(d)(4); section 8:7.6.

117. I.R.C. § 641(d); Treas. Reg. § 1.641(c)-1(h); section 8:7.6.

118. *Waterman's Estate v. Comm'r*, 195 F.2d 244, 245 (2d Cir. 1952), *rev'g* 16 T.C. 467 (1951); *cf.* *Kress v. Stanton*, 98 F. Supp. 470 (W.D. Pa. 1951), *aff'd*,

Whether an asset is a capital asset in the hands of a personal representative or trustee may be different than when the same asset was held by the decedent or grantor of a trust. The special duty of the personal representative or of a trustee may convert ordinary income assets of the decedent or grantor into a capital asset in the fiduciary's hands.¹¹⁹

The deductibility of net capital losses presents additional issues. Before the enactment of the Tax Reform Act of 1986, net capital losses were allowable to the lesser of taxable income, net capital losses, or \$3,000.¹²⁰ This had the effect of carrying forward unusable losses where the taxpayer's income was insufficient to use it. The Tax Reform Act of 1986, however, eliminated the taxable income limitation. This has the effect in some cases of causing trusts that distribute all of their income to beneficiaries to lose the benefit of a net capital loss.¹²¹

Section 642(g) provides that administration expenses (for example, fiduciary fees) allowable in computing a decedent's taxable estate will not be allowed as income tax deductions unless the right to use the particular amounts as estate tax deductions is waived.¹²² The same rule applies to casualty and theft losses of an estate.¹²³ The section 642(g) rule against double deductions applies to income tax deductions for estates, trusts, or any other persons.¹²⁴ The rule even applies to offsets against the sale price of property in determining gain or loss.¹²⁵ However, it would not appear to apply to amounts used as offsets other than against sales price for purposes of gain and loss.¹²⁶

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- 196 F.2d 499 (3d Cir. 1952). *Cf.* the language used in I.R.C. § 183 ("activities not engaged in for profit").
119. Estate of Ferber v. Comm'r, 22 T.C. 261 (1954); *see* Bachler v. United States, 231 F. Supp. 138 (D. Minn. 1964); Garrett v. United States, 120 F. Supp. 193 (Ct. Cl. 1954).
120. I.R.C. § 1211(b).
121. *See* Barton, *Changes Affect Estates and Trusts As Well As Individuals*, 127 TR. & EST., Aug. 1988, at 47, 49. Rev. Rul. 59-220, 1959-1 C.B. 210 (period of ownership by the decedent is not added to the recipient's holding period).
122. I.R.C. § 642(g). *See also* Estate of Stick v. Comm'r, T.C. Memo. 2010-192. As to the time for waiver, *see* Treas. Reg. § 1.642(g)-1, -2.
123. I.R.C. § 642(g).
124. *But compare* Rev. Rul. 53-293, 1953-2 C.B. 257, Haggart's Estate v. Comm'r, 182 F.2d 514 (3d Cir. 1950), and Rev. Rul. 74-509, 1974-2 C.B. 302, with Treas. Reg. § 20.2053-8(d) ex. (1), and Rev. Rul. 76-498, 1976-2 C.B. 199; Rev. Rul. 81-287, 1981-2 C.B. 183 (estate tax reduction based on deduction for interest paid on deferred estate tax limited under doctrine of equitable recoupment where no waiver filed and interest previously taken on "expired" income tax returns).
125. I.R.C. § 642(g) after the 1976 amendments.
126. I.R.C. § 642(g). *But cf.* Gillespie v. Comm'r, 23 F.3d 36 (2d Cir. 1994).

A similar rule applies as between an estate tax deduction for medical expenses of the decedent and an income tax deduction on the decedent's return if the estate pays the expenses within one year after death.¹²⁷

The section 642(g) rule does not apply to accrued deductions in respect of decedent within the meaning of section 691(b).¹²⁸ The deduction for estate tax paid on income in respect of a decedent is divided between the trust or estate and the beneficiaries in accordance with the distribution and division of such income.¹²⁹

The section 642(g) election has the potential to impact the estate tax marital and charitable deductions. Estate administration expenses that may be paid from the share of an estate passing to a surviving spouse or charity and deducted for income tax purposes without reducing the estate tax marital or charitable deduction may produce substantial tax savings. The Supreme Court allowed such deductions for estate administration expenses that were not, on the date of death, expected to be material.¹³⁰

In response to and at the invitation of the Supreme Court opinion in *Commissioner v. Estate of Hubert*,¹³¹ the Treasury issued regulations that detail the tax treatment of estate administration expenses that are charged against marital or charitable shares.¹³² The regulations make a distinction between "estate transmission expenses" and "estate management expenses."

Estate management expenses are those expenses that could have been incurred by the decedent during life or by the beneficiaries, had they received the property on the date of death without any intervening period of administration. Estate management expenses include, for example, costs of maintaining and preserving estate assets during the estate administration, investment advisory fees, stock brokerage commissions, custodial fees, and interest.¹³³ Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the resultant need to collect the decedent's assets, pay debts and wealth transfer taxes, and distribute the decedent's property to the beneficiaries. Estate transmission expenses include, for example, personal representative commissions and attorney fees (except to the extent they are specifically related to investment, preservation, and maintenance of the assets), probate fees,

127. I.R.C. § 213(d). However, medical expenses are deductible on a decedent's final return only to the extent the amount exceeds 10% of adjusted gross income for the year. I.R.C. § 213(a).

128. I.R.C. §§ 642(g), 691(b). See section 2:3.3 for a discussion of deductions in respect of a decedent.

129. I.R.C. § 691(c). See section 2:3.4 for a discussion of income tax deduction for estate taxes attributable to income in respect of a decedent.

130. *Comm'r v. Estate of Hubert*, 520 U.S. 93 (1997).

131. *Id.*

132. T.D. 8819, 64 Fed. Reg. 23,187 (Apr. 29, 1999).

133. Treas. Reg. §§ 20.2055-3(b)(1)(i), 20.2056(b)-4(d)(1)(i).

expenses incurred in construction proceedings and defending against will contests, and appraisal fees. Any expense that is not an estate management expense is an estate transmission expense.¹³⁴

Under the regulations, estate management expenses may be paid from the income of a marital or charitable share and deducted for income tax purposes without a corresponding reduction in the estate tax marital or charitable deduction. The regulations clarify that such estate management expenses deducted on the estate tax return as administration expenses, rather than on the fiduciary income tax return, must reduce the estate tax marital or charitable deduction.¹³⁵ Estate management expenses paid from a marital or charitable share also reduce the estate tax marital or charitable deduction, if the expense is attributable to another share of the estate.¹³⁶ Estate transmission expenses paid from a marital or charitable share will reduce the estate tax marital or charitable deduction, regardless of whether they are deducted on the estate tax return or the fiduciary income tax return.

Because the impact of a section 642(g) election is essentially an estate tax issue, the scope of this discussion is limited.¹³⁷

[G] Limitations on Certain Deductions

[G][1] Interest Generally

Section 163(h) disallows any deduction for personal interest for all taxpayers other than corporations. Nevertheless, qualified personal interest is not disallowed.¹³⁸ Qualified personal residence interest is interest on debt secured by the principal or second residence of the taxpayer, but subject to the \$1 million loan limit, plus \$100,000 for a home equity loan. Any residence held by an estate or trust is treated as a qualified residence for interest deduction purposes if the estate or trust establishes that the residence is a qualified residence of a beneficiary who has a present interest in the estate or trust or an interest in the residue of the estate or trust.¹³⁹

134. Treas. Reg. §§ 20.2055-3(b)(1)(ii), 20.2055-3(b)(2), 20.2056(b)-4(d)(1)(ii), 20.2056(b)-4(d)(2).

135. Treas. Reg. §§ 20.2055-3(b)(3), 20.2056(b)-4(d)(3), 20.2056(b)-4(d)(5) (ex. 4).

136. Treas. Reg. §§ 20.2055-3(b)(4), 20.2056(b)-4(d)(4), 20.2056(b)-4(d)(5) (ex. 3).

137. For a detailed discussion, see M. Gans, J. Blattmachr & C. McCaffrey, *The Anti-Hubert Regulations*, 87 TAX NOTES 969 (May 15, 2000); 28 EXEMPT ORG. TAX REV. no. 3 (June 2000).

138. I.R.C. § 163(h)(2)(E). Cf. *Ungerman Trust v. Comm'r*, 89 T.C. 1131 (1987) (interest, paid to the Service under I.R.C. § 6166 extension to pay estate tax, considered an administration expense, and, therefore, not subject to alternative income tax).

139. I.R.C. § 163(h)(4)(D).

[G][2] Interest on Estate Taxes

Generally, an estate will seek to deduct on the estate tax return interest paid on a loan to pay estate taxes by claiming the interest expense as an administration expense under section 2053 of the Code. However, in some instances, the estate may want to take an income tax deduction rather than an estate tax for the interest paid. When the payment of estate taxes is deferred using section 6163 (relating to the deferral of payment of estate tax on certain remainders and reversionary interests), the interest due is income tax deductible.¹⁴⁰ When the payment of estate taxes is deferred using section 6166 (relating to deferral of payment of estate tax attributable to certain closely held business interests), the interest due is not income tax deductible.¹⁴¹ For all other borrowing to pay estate taxes, the interest payments may be income tax deductible, but the path for a deduction is not always clear.

Section 163 permits a deduction for some, but not all, interest paid by a taxpayer. Section 163(h)(1) provides that, in the case of a taxpayer other than a corporation, no income tax deduction is permitted for “personal interest” paid or accrued during the taxable year.¹⁴² Section 163(h)(2) of the Code defines “personal interest” as any interest allowable as an income tax deduction other than (1) interest paid or accrued on indebtedness properly allocable to a trade or business; (2) any investment interest; (3) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer; (4) any qualified residence interest; (5) any interest payable under section 6601 on any unpaid portion of the estate tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163; and (6) any interest allowable as a deduction under section 221 (relating to education loans). The regulation provides for substantially the same rules.¹⁴³

Because the interest on a loan to pay estate taxes does not fall under any of these enumerated exceptions, it would seem that the loan interest is personal interest for which an income tax deduction would not be allowed. Moreover, to the extent loan proceeds might be used to pay fiduciary income taxes, the loan interest is likely deemed to be personal interest which would not be deductible for income tax purposes.¹⁴⁴

Nevertheless, there is reasonable basis to conclude that the interest on loans to pay estate taxes (other than interest on the deferral of

140. See I.R.C. § 163(h)(2)(E).

141. See I.R.C. § 163(k).

142. See also Treas. Reg. § 1.163-9(b)(1).

143. Treas. Reg. § 1.163-9T(b)(1).

144. See Treas. Reg. § 1.163-9T(b)(2).

payment of estate tax pursuant to section 6166) is not personal interest under section 163(h)(2) and, therefore, deductible under section 212. Congress enacted section 163(h) in the Tax Reform Act of 1986. The Report of the Committee on Finance of the Senate states that personal interest “generally includes all interest not incurred or continued . . . in connection with an activity described in section 212.”¹⁴⁵ This language indicates that although an administration expense under section 212 is not one of the enumerated personal interest exceptions in section 163(h)(2), Congress did not intend for such an administration expense to be deemed personal interest. Therefore, if the interest is an administration expense under section 212, then it would not seem to be nondeductible personal interest.

There is an alternative basis to conclude that interest paid or incurred on indebtedness obtained to pay estate tax is not automatically deemed personal interest. Before 1997, section 163(h)(2)(E) provided that interest expense incurred due to an extension to pay estate taxes under section 6163 (reversionary or remainder interest) and 6166 (closely held business interest) is deductible for income tax purposes. In 1997, Congress amended section 163(h)(2)(E) to remove the reference to section 6166. In its place, Congress added section 163(k), which provides that interest due on an extension to pay estate taxes under section 6166 is nondeductible for income tax purposes. If nondeductible personal interest under section 163(h) was meant to include *all* interest expense paid or incurred on indebtedness obtained to pay estate tax other than under section 6163, it would have been unnecessary for Congress to enact section 163(k) specifically to disallow an income tax deduction for such interest expense under section 6166. It also would suggest that, in some other situations, an interest expense paid or incurred on indebtedness obtained to pay estate tax would be deductible for income tax purposes. Therefore, it is reasonable to infer that section 163(h) does not bar an income tax deduction for all interest expense paid or incurred on indebtedness obtained to pay estate tax.

The Service’s private letter ruling position on this matter is not favorable to estates, however. In Private Letter Ruling 9449011, the Service addressed the applicability of section 163(h) and Treasury Regulation section 1.163-9T in the context of borrowing to pay estate tax.¹⁴⁶ The estate obtained a loan from a bank to pay its federal and state estate taxes. The Service denied an income tax deduction under section 163 and ruled that “interest on an estate tax

145. S. REP. NO. 99-313, at 806 (1986), *reprinted in* 1986-3 C.B. 1 (1986).

146. Priv. Ltr. Rul. 9449011. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be used as precedent.

deficiency is personal interest under section 163(h)."¹⁴⁷ It should be noted that the taxpayer in this ruling apparently did not make any arguments on why interest on a loan used to pay estate tax is not personal interest under section 163(h). It appears that the Service simply read the Code and Treasury Regulation without examining the underlying congressional intent. Moreover, the ruling predates the 1997 congressional amendments that add clarity to the scope of section 163(h).

As indicated above, Congress did not, it seems, intend to foreclose a deduction for administration expenses under section 212 for interest on loans to pay estate tax. Section 212 allows an income tax deduction for all ordinary and necessary expenses paid or incurred during the taxable year: (1) for the production or collection of income; (2) for the management, conservation or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. Section 212 generally applies to individuals, but also it applies to estates and trusts.¹⁴⁸ The provisions of section 212(1) and 212(3) generally do not seem applicable in this context; thus, the question is whether interest on a loan to pay estate taxes is an expense incurred for the management, conservation and maintenance of property held for the production of income.

The language in the applicable Treasury Regulation is broad and arguably permits a deduction for interest paid on a loan obtained to pay estate taxes to avoid a forced sale of assets held by the estate for the production of income. Treasury Regulation section 1.212-1(i) provides:

Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are *ordinary and necessary in connection with the performance of the duties of administration* are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.¹⁴⁹

147. *Id.*

148. *See, e.g.,* Schwan v. United States, 264 F. Supp. 2d 887 (D.S.D. 2003); Ungerman Trust v. Comm'r, 89 T.C. 1131 (1987). *See also* 26 U.S.C. § 641(b), which directs that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided."

149. Treas. Reg. § 1.212-1(i) (emphasis added).

Under a plain reading of the treasury regulations, a fiduciary of an estate may deduct reasonable amounts incurred for administration expenses that are *ordinary and necessary in connection with* the fiduciary's duties of administration. This is a broad definition that may reasonably include interest on a loan connected with the administration of an estate. *Ungerma Trust v. Commissioner*¹⁵⁰ holds that interest incurred on a deferred federal estate tax liability is deductible as an administration expense under section 212.

The regulations explain that "ordinary and necessary" means that the expense "must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income."¹⁵¹ Another regulation further provides that an expense incurred to manage, conserve, or maintain property held for investment may be deductible under section 212 even though the property is not currently productive, is unlikely to be sold at a profit, and is held merely to minimize a loss.¹⁵² These Treasury Regulations suggest that if the expense incurred bears a reasonable and proximate relation to the management and conservation of the property, even if the property is being held to minimize a loss, then the expense would be deductible for income tax purposes under section 212. The Tax Court has also opined on the meaning of "ordinary and necessary" in this context. In *Hosbein v. Commissioner*,¹⁵³ the Tax Court ruled that "[o]rdinary has been defined as normal, usual or customary" and that "necessary has been defined as appropriate and helpful."¹⁵⁴

When a decedent's estate consists in large measure of illiquid assets, a forced sale of the estate's assets may likely result in a significant loss in value for the estate. Therefore, loans and the interest thereon seem quite certainly to bear a reasonable and proximate relation to the management, conservation, and maintenance of property held for the production of income within the meaning of Treasury Regulation section 1.212-1(b) and (d). Also, obtaining loans to pay for estate taxes is normal, usual, and customary for an estate with a lack of available liquid resources. Thus, there is a reasonable basis to conclude that these type of loans are "ordinary" and "necessary" within the meaning of section 212(2) as interpreted by the Tax Court in *Hosbein*.

In addition, Treasury Regulation section 1.212-1(i) provides that administration expenses that are ordinary and necessary *in connection with* the fiduciary's duties of administration are deductible under section 212. The U.S. Supreme Court has held (although it was

150. *Ungerma Trust v. Comm'r*, 89 T.C. 1131 (1987).

151. Treas. Reg. § 1.212-1(d).

152. Treas. Reg. § 1.212-1(b).

153. *Hosbein v. Comm'r*, T.C. Memo. 1985-373.

154. *Id.*

analyzing section 174 (research and experimental expenditures) and not Treasury Regulation section 1.212-1(i)), that the words “in connection with” are all-encompassing and allow for a broader inclusion than what would be permissible without such words.¹⁵⁵ Thus, there is a reasonable basis to conclude that, when an estate’s fiduciary borrows and incurs an interest expense, it is in connection with their duty of administering the estate when the estate is essentially illiquid. Therefore, it is reasonable to conclude that the interest attributable to loan proceeds used to pay estate taxes is deductible under Treasury Regulation section 1.212-1(i).

An additional argument supports a section 212 deduction for interest. Treasury Regulation section 1.212-1(i) refers to section 642(g), which provides, in part, that except under certain circumstances, an amount allowable under section 2053 is not allowable as a deduction in computing the taxable income of the estate. The Service provided further guidance on its interpretation of section 642(g) in two Revenue Rulings. In Revenue Ruling 77-357, the Service stated:

Certain other deductions allowable for income tax purposes are also allowable as deductions for estate tax purposes. For example: section 2053 of the Code provides for the deduction, among other things, of *administration expenses* in determining the value of the taxable estate for estate tax purposes. *Such expenses would also constitute allowable deductions as expenses for the production of income under section 212 of the Code in determining the net income of the estate for Federal income tax purposes. . . .* The purpose of section 642(g) of the Code is to prevent an estate from obtaining a *double* deduction with respect to the same items of administration expenses.¹⁵⁶

Section 642(g) does not independently confer an income tax deduction for an expense that otherwise qualifies for an estate tax deduction.¹⁵⁷ Nevertheless, the language in these two Revenue Rulings indicates that if an expense incurred by an estate is an administration expense deductible under section 2053, it should also be deductible as an administration expense within the meaning of the Treasury Regulation section 1.212-1(i) as an expense incurred by the fiduciary in connection with the performance of the duties of

155. See *Snow v. Comm’r*, 416 U.S. 500, 504 (1963).

156. Rev. Rul. 77-357, 1977-2 C.B. 328 (second emphasis added). See also Rev. Rul. 70-361, 1970-2 C.B. 133 (stating substantially the same text).

157. See *Estate of Yetter v. Comm’r*, 35 T.C. 737 (1961) (holding that § 642(g) does not allow the “shifting of all of the items enumerated in section 2053, such as ‘funeral expenses,’ ‘claims against the estate,’ and ‘unpaid mortgages’ from estate tax to income tax by the simple expedient of filing the statutory notice and waiver required by 642(g)”).

administration. In *Turner v. United States*,¹⁵⁸ the court held that statutory interest paid for a belated charitable bequest was necessary and, therefore, was deductible as an administration expense for estate tax purposes under section 2053(a). Note that it does not follow that loan interest may be deducted for both federal estate tax and income tax purposes. Section 642(g), in fact, prohibits such a double deduction for items that are deductible under both sections 2053 and 212.

In one case, neither the court nor the Service questioned whether section 212 was the appropriate section to apply to a taxpayer's claim of a similar interest deduction. In *Schwan v. United States*,¹⁵⁹ an estate claimed a section 212 deduction for interest payable under state law on deferred legacies. Neither the Tax Court nor the Service challenged the deduction on the basis that it was not deductible under section 212. Rather, the parties focused on the issue of whether the interest incurred was necessary. The Tax Court agreed with the Service that the interest incurred was not necessary under the circumstances and denied the deduction. This case would imply that statutory interest paid on deferred legacies would have been allowed under section 212 if the facts were such that the interest incurred was necessary. Because interest on a loan to pay an estate tax is similar to statutory interest paid on deferred legacies, instead of borrowing from, for example, a bank at the bank's interest rate, the estate in *Schwan* essentially "borrowed" from the legatees at the statutory interest rate. Consequently, it is reasonable to conclude that under *Schwan*, the interest, if necessary, would likely be deductible under section 212. Note, however, that Treasury Regulation section 1.663(c)-5, example 6(ii), specifically provides that interest paid on deferred bequests is nondeductible personal interest, but the regulation is not applicable to interest on loans to pay estate taxes. Whether the regulation is valid in light of the authority permitting a deduction is uncertain.¹⁶⁰

Another case where neither the court nor the Service questioned an income tax deduction for interest paid was *Estate of Street v. Commissioner*.¹⁶¹ In this case, an estate initially claimed an income tax deduction for interest paid on funds borrowed to pay estate taxes and later sought to claim an estate tax deduction on the same amount. The court disallowed the subsequent estate tax deduction

158. *Turner v. United States*, 306 F. Supp. 2d 668 (N.D. Tex. 2004).

159. *Schwan v. United States*, 264 F. Supp. 2d 887 (D.S.D. 2003).

160. For a discussion of this issue, see J. Blattmachr, *A Potential New Problem in Estate and Trust Administration*, 15 PROB. PRAC. REP., May 2003, at 1 (explaining how Treas. Reg. § 1.663(c)-5, example 7, may result in double taxation of interest paid on legacies and other interests and denial of deduction under I.R.C. § 642(c)).

161. *Estate of Street v. Comm'r*, T.C. Memo. 1994-568.

on procedural grounds. Although the court did not opine on whether the initial income tax deduction was proper, it did not object or reverse the income tax deduction, nor did the Service raise this as an issue. (It is unclear whether the disallowance of the income tax deduction would have been precluded because the applicable statute of limitations had expired.)

On two other occasions, the Service either argued or explicitly agreed that a similar interest deduction was permissible for income tax purposes. In *Turner v. United States*,¹⁶² the Service rejected the taxpayer's claim that statutory interest on a belated payment of a charitable bequest is deductible under section 2053 and instead argued that the interest expense should be deducted on the estate's income return. In another case that was settled before an opinion was issued, the Service stipulated that an interest expense incurred on a loan to pay administration expenses from a family limited partnership that was partially held by the estate was a proper income tax deduction.¹⁶³ The applicability of section 212 was not discussed in either of these cases. The fact that the Service argued or stipulated that an income tax deduction was allowed indicates that the Service has in the past taken the position that an income tax deduction was permitted under similar circumstances. This provides a reasonable basis to assert that interest on a loan to pay estate taxes is deductible for income tax purposes.

[G][3] Section 67—Two-Percent Limitation on Deductions

Section 67 limits the deduction of miscellaneous itemized deductions (generally including those described under section 212). Only to the extent that these deductions, in the aggregate, exceed 2% of the taxpayer's adjusted gross income is a deduction permitted.¹⁶⁴ Under sections 67(c) and (e), the Treasury Department is granted regulatory authority to prohibit the indirect deduction through pass-through entities of amounts that are not allowable as a deduction if paid or incurred directly. Nevertheless, section 67(c)(3)(B) provides that this pass-through rule does not apply to estates and trusts, except as otherwise provided in regulations.¹⁶⁵ Section 67(e) provides that appropriate adjustments to the 2% rule are to be prescribed in regulations in the application of part I of subchapter J, sections 641 to 685

162. *Turner v. United States*, 306 F. Supp. 2d 668 (N.D. Tex. 2004).

163. *Estate of Hansen v. Comm'r*, T.C. Docket No. 016607-04 (2004).

164. I.R.C. § 67.

165. Temp. Treas. Reg. § 1.67-2T(g)(2) excludes nongrantor trusts and estates from the pass-through entity rules of the regulations and section 67(c). A common trust fund is included in the definition of a pass-through entity.

(apparently so the section 67 2% threshold can be applied, in certain cases, at the beneficiary level).¹⁶⁶

The Treasury Department issued final regulations for section 67(e) in 2014.¹⁶⁷ Previously, proposed regulations were issued in 2007¹⁶⁸ and re-issued in 2011.¹⁶⁹ The final regulation generally adopted the 2011 proposed regulations, but with a few modifications and clarifications.

The final regulations provide that a cost (expense) of a non-grantor trust or estate is subject to the 2% rule if the cost “is included in the definition of miscellaneous itemized deductions under section 67(b), . . . and commonly or customarily would be incurred by a hypothetical individual holding the same property.”¹⁷⁰ “In analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative.”¹⁷¹

Ownership costs for estates and non-grantor trusts such as condominium fees, insurance costs, and property maintenance and lawn fees, are deemed to be commonly and customarily incurred by individual owners and thus subject to the 2% limitation of section 67.¹⁷² Nevertheless, the regulations seem to assume that property associated with these costs is not used in a trade or business, as such business expenses would be deductible under section 162 or section 62(a)(4) and would not be subject to section 67. Other ownership costs that are subject to the 2% limitation include partnership costs that pass through to partners if such costs would be miscellaneous itemized deductions under section 67(b).¹⁷³ However, the regulations acknowledge that “expenses incurred merely by reason of the ownership of property may be fully deductible under other provisions of the Code, such as sections 62(a)(4), 162, or 164(a), which would not be miscellaneous itemized deductions subject to section 67(e).”¹⁷⁴ The 2011 proposed regulations included real estate taxes within the coverage of

166. I.R.C. § 67(c), (e). For an academic discussion of I.R.C. § 67(e), see Pamela Chamine, *Taxing Middle Class Trust(s)*, 7 FLA. TAX REV. 505 (2006).

167. Treas. Reg. § 1.67-4, 79 Fed. Reg. 26,616 (May 9, 2014).

168. Prop. Treas. Reg. § 1.67-4, 72 Fed. Reg. 41,243 (July 27, 2007).

169. Prop. Treas. Reg. § 1.67-4, 76 Fed. Reg. 55,322 (Sept. 7, 2011).

170. Treas. Reg. § 1.67-4(a).

171. Treas. Reg. § 1.67-4(b)(1).

172. Treas. Reg. § 1.67-4(b)(2).

173. *Id.*

174. *Id.*

the 2% limitation, but were excluded by the final regulations because real estate taxes are not a miscellaneous itemized deduction.¹⁷⁵

The application of section 67 to the costs of preparing tax returns for estates and non-grantor trusts depends on the type of return.¹⁷⁶ Estate and generation-skipping transfer (GST) tax returns, fiduciary income tax returns, and a decedent's final return are not subject to the 2% limitation, but other returns that are prepared for individuals (for example, gift tax returns) are. The Summary of Comments and Explanation of Revisions (the "Summary") for the final regulations states that the list of returns costs that are not subject to the 2% limitation is exclusive.¹⁷⁷ Nevertheless, the Summary acknowledges that the cost of preparing some returns, such as returns for sole proprietorships and retirement plans may be fully deductible under section 162 and thus not subject to the 2% limitation.¹⁷⁸

The regulations generally conclude that investment advisory fees are subject to the 2% limitation.¹⁷⁹ However, in deference to the Supreme Court's opinion in *Knight*, discussed below, the proposed regulations acknowledged that it is possible that "certain incremental costs of investment advice" might not be, to the extent charged in excess of the amount normally charged an individual, subject to the 2% limitation.¹⁸⁰ Thus, if a trust or estate pays an extra charge because advice is being given to an estate or trust rather than to an individual, the amount in excess of the amount charged an individual would not be subject to the 2% limitation.¹⁸¹ For example, an extra cost might be "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen)."¹⁸²

Appraisal fees incurred by an estate or non-grantor trust may or may not be subject to section 67(e). Appraisals that are used to determine value for purposes of filing tax returns or for determining distributions are not subject to section 67(e).¹⁸³ For example, appraisals to determine the amount of a unitrust payment of a taxable trust or to file a generation-skipping tax return are not subject to the

175. Section 67 Limitations on Estates or Trusts, Summary of Comments and Explanation of Revisions, 79 Fed. Reg. 26,616 (May 9, 2014).

176. Treas. Reg. § 1.67-4(b)(3).

177. Section 67 Limitations on Estates or Trusts, Summary of Comments and Explanation of Revisions, 79 Fed. Reg. 26,616 (May 9, 2014).

178. *Id.*

179. Treas. Reg. § 1.67-4(b)(4).

180. *Id.*

181. *Id.*

182. *Id.*

183. Treas. Reg. § 1.67-4(b)(5).

limitation. However, the regulations state that appraisals for other purposes are commonly obtained by individuals and are subject to the 2% floor. An example is an appraisal for insurance purposes.

The regulations acknowledge that certain fiduciary expenses are not commonly incurred by individuals.¹⁸⁴ Examples in the regulations include “[p]robate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent’s death certificate; and costs related to fiduciary accounts.”¹⁸⁵

When a single fee is charged for bundled services or products provided to an estate or a non-grantor trust, the regulations require an allocation of the cost between the portion of the fee that is subject to the 2% limitation and the portion that is not.¹⁸⁶ Bundled fees include fiduciary commissions, legal fees and accounting fees. However, when the fee “is not computed on an hourly basis, only the portion of that fee that is attributable to investment advice is subject to the 2-percent floor.”¹⁸⁷ The balance of a bundled fee is not subject to the 2% floor.¹⁸⁸ The regulations permit the use of “[a]ny reasonable method . . . to allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not.”¹⁸⁹

The regulations provide some non-exclusive factors to consider when unbundling fees:

Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary’s attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those

184. Treas. Reg. § 1.67-4(b)(6).

185. *Id.*

186. Treas. Reg. § 1.67-4(c)(1).

187. Treas. Reg. § 1.67-4(c)(2).

188. *Id.*

189. Treas. Reg. § 1.67-4(c)(3). For a discussion of how to possibly unbundle fees see, Austin W. Bramwell, Elisabeth Madden Mullen & Sharon L. Klein, *How to Allocate “Bundled” Fees*, 73 LISI INCOME TAX PLANNING NEWSLETTER, July 14, 2014 (available at www.LeimbergServices.com).

payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.¹⁹⁰

The 2011 proposed regulations contained an example that concluded that a “separate real estate management fee is subject to the 2-percent floor because it is a fee commonly or customarily incurred by an individual owner of rental real estate.”¹⁹¹ The final regulations deleted the example because separate fees for managing real estate are fully deductible under section 162 or 62(a)(4).¹⁹²

The final regulations are effective for tax years beginning on or after January 1, 2015.¹⁹³

In *Knight v. Commissioner*,¹⁹⁴ the Supreme Court determined that investment adviser fees paid by a trust were subject to the 2% rule of section 67. The Court rejected the Second Circuit’s view that section 67 exempts only expenses that “could not” be incurred by an individual and instead determined that section 67 exempts expenses that “would not” be incurred by an individual. The distinction is subtle, but allows some room to argue that section 67 does not apply to expenses that could be incurred by an individual but are of a nature that are not typically incurred by an individual. Nevertheless, this distinction was of no help to the taxpayer in *Knight*, as the Court concluded that investment adviser fees are not unusual expenses for individuals. However, the Court’s opinion acknowledges that it is possible for trusts to incur investment adviser fees that include an additional or special charge applicable only to fiduciaries. In this circumstance, the incremental expense would not be subject to section 67 as the final regulations acknowledge.

For purposes of applying section 67 to estates and trusts directly, the adjusted gross income of an estate or trust¹⁹⁵ is computed in the same manner as an individual, with certain exceptions. The distribution deduction allowable to an estate or trust under sections 651 and 661, the personal exemption allowable to an estate or trust under section 642(b), and the deduction for costs paid or incurred in connection with the administration of an estate or trust, which would

190. Treas. Reg. § 1.67-4(c)(4).

191. See Prop. Treas. Reg. § 1.67-4(c)(2), 76 Fed. Reg. 55,322 (Sept. 7, 2011).

192. Section 67 Limitations on Estates or Trusts, Summary of Comments and Explanation of Revisions, 79 Fed. Reg. 26,616 (May 9, 2014).

193. Treas. Reg. § 1.67-4(d).

194. *Knight v. Comm’r*, 552 U.S. 181 (2008).

195. The I.R.C. § 62 definition of adjusted gross income is limited to individuals and has no meaning to estates and trusts except as defined in I.R.C. § 67(e).

not have been incurred if the property were not held in such an estate or trust, are treated as allowable in computing the adjusted gross income of the estate or trust, with the result that section 67(a) does not apply to them.¹⁹⁶ The charitable deduction allowable to an estate or trust under section 642(c) is not treated as a miscellaneous itemized deduction for purposes of the section 67 2% threshold—thus, it is allowable in full.¹⁹⁷

The computation of the alternative minimum tax denies a deduction for miscellaneous itemized deductions.²⁰⁰ This means that generally no deduction is allowed for investment advisor fees under the rule established by *Knight* and the regulations for section 67. For larger trusts with significant adviser fee expenses, the result may be a significant alternative minimum tax liability.²⁰¹

By regulation, common trust funds are treated as pass-through entities and subject to the rules of section 67(c).²⁰² The regulation requires investors in common trust funds to report taxable income or net loss computed without taking into account “affected expenses,” which are separately treated as section 212 expenses.²⁰³

An important exception to section 67 exists for the section 691(c) deduction (relating to the income tax deduction for certain federal estate taxes imposed with respect to the right to income in respect of a decedent dealt with in section 691(a)); section 691(c) deductions are not subject to section 67.²⁰⁴ Note, however, that the section 691(c) deduction is not excluded from disallowance of deductions under section 68 when deductible by a beneficiary rather than by an estate or trust.²⁰⁵ However, the provisions of section 68 to reduce miscellaneous itemized deductions when a taxpayer’s adjusted gross income exceeds \$100,000 (adjusted for inflation) do not apply to an estate or trust.²⁰⁶

In *Bay v. Commissioner*,^{206.1} the Tax Court held that section 67(e) did not apply to grantor trusts, and therefore investment advisory fees incurred by a grantor trust are not eligible for section 67(e)

196. I.R.C. § 67(e).

197. I.R.C. § 67(b)(4).

198.–199. [Reserved.]

200. I.R.C. § 56(b)(1)(A)(i).

201. For a further discussion of the alternative minimum tax, see section 3:2.1[C], *supra*.

202. Temp. Treas. Reg. § 1.67-2T(d).

203. *Id.*

204. I.R.C. § 67(b)(8).

205. I.R.C. § 68 is applicable only to individuals.

206. I.R.C. § 68(e).

206.1. *Bay v. Comm’r*, T.C. Memo. 1998-411.

exemption, if any, and are reported on a grantor's personal income tax return as a miscellaneous itemized deduction subject to the limitations of section 67(a).

Charitable remainder trusts are exempt from income tax except to the extent the trust has unrelated business taxable income.^{206.2} Thus, in all years other than those in which a charitable remainder trust has unrelated taxable income, it will be unnecessary to compute adjusted gross income for purposes of the application of the section 67 2% threshold for certain deductions. However, in years in which the trust does have unrelated business income, application of section 67 may be important to the beneficiaries who receive distributions from the trust. Nevertheless, neither the regulations under section 664 nor the regulations under section 67(e) describe the interplay, if any, of the 100% tax on a charitable remainder trust's unrelated business taxable income (UBTI) and miscellaneous itemized deductions which are subject to the 2% threshold.

The regulations under section 861 provide guidance on how to allocate interest expense to foreign source income.^{206.3} Complex trusts that are beneficially owned by individuals and estates are treated like individuals for this purpose. A trust that is beneficially owned by a corporation or corporations is treated like either a partnership or a corporation, depending how section 7701 characterizes the trust.

Section 1212(c)(7) provides that the carryback of losses to offset prior gains from section 1256 contracts permitted generally by section 1212(c) is not allowed to estates and trusts.

The regulations concerning the deductibility of alimony paid provides: "The deduction . . . is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse."^{206.4}

[G][4] Deduction of Trade or Business Interest

The instructions for IRS Form 4952 (Investment Interest Expense Deduction) provide that an estate or trust should report all investment interest expense on line 8 even if the expense is attributable to interest expense passing through to the trust from a partnership that is trading securities for its own account as a trade or business. This reporting differs from the reporting for individuals where such an interest expense is reported with other pass-through deductions for the trade or business.

206.2. I.R.C. § 664(c).

206.3. Temp. Treas. Reg. § 1.861-9T(d)(3).

206.4. Treas. Reg. § 1.215-1(b).

[H] Passive Losses

Section 469 limits deductions generated from a passive business activity to the extent the deductions exceed income from all such passive activities. Generally, the excess passive activity deductions may not be deducted against other income. Also, credits from passive activities generally are limited to the tax attributable to the passive activities. These disallowed losses and credits are “suspended” and carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses (but not credits) are allowed in full when the taxpayer disposes of its entire interest in the activity to an unrelated party in a transaction in which all of the gain or loss is recognized. The passive loss rules apply to individuals, including estates and trusts.²⁰⁷

If the decedent actively participated in a rental real estate activity, his or her estate may deduct up to \$25,000 of losses from the activity for the estate’s first two tax years after the decedent’s death.²⁰⁸ However, the estate’s limit of \$25,000 is reduced by the exemption allowable to the decedent’s surviving spouse, determined without the phase-out under section 469(i)(3).²⁰⁹

If any interest in a passive activity is distributed by an estate or trust, the basis of the interest immediately before the distribution is increased by the amount of any passive activity losses allocable to the interest, but the losses are not allowable as a deduction for any taxable year.²¹⁰ Presumably, gain or loss to the trust or estate and the basis of the property in the hands of the beneficiary is to be determined under normal rules for such taxpayers.

In *Frank Aragona Trust v. Commissioner*,^{210.1} the Tax Court determined a trust could materially participate in real estate activities and

207. The passive loss rules generally are applicable to tax years after 1986.

208. I.R.C. § 469(i)(4).

209. I.R.C. § 469(i)(4)(B).

210. I.R.C. § 469(j)(12). See Howard M. Zaritsky, *District Court Adopts Broad Rule for Trust Deduction of Passive Losses*, 30 EST. PLAN. 472 (Sept. 2003). Virtually no guidance as to the application of passive loss activities as applied to estates, trusts, and their beneficiaries has been forthcoming from the Treasury Department or the Internal Revenue Service. See Abbin, *To Be [Active] or Not to Be [Passive]; That Is the Question Confronting Fiduciaries and Beneficiaries Trying to Apply the Passive Activity Loss (PAL) Rules*, 23 INST. ON EST. PLAN. 300 (1989); Abbin, *The Unsolved Dilemma: PALS, PIGs and Subchapter J*, 127 TR. & EST. Aug. 1988, at 16 (contains a discussion of the possible approaches to applying passive activity loss limitations to fiduciaries and beneficiaries); Hilker, *Estate Planning for Passive Activity Losses*, 8 EST. PLAN. & CAL. PROB. REP. 29 (1987).

210.1. *Frank Aragona Trust v. Comm’r*, 142 T.C. No. 9 (2014).

was not subject to the passive activity loss limitation rules of section 469 because of the personal services of trustees performed on behalf of the trust. The Service argued that a trust could not qualify for the material participation in real estate activities exception of section 469(c)(7) because the exception applies only to individuals and closely held C Corporations. In *Aragona*, much of the trust's daily business operations were delegated to one "executive trustee." However, the trust's six trustees met periodically to make all major decisions. Most of the trust's real estate was owned through a single-member LLC and the real estate was managed by the LLC. The LLC employed three of the trustees and approximately twenty other individuals. The court did not decide whether the activities of the non-trustee employees could be considered as personal services as it determined that the activities of the trustees and trustee-employees were sufficient to satisfy section 469(c)(7).

In *Mattie K. Carter Trust v. United States*,²¹¹ a loss deduction for a ranch owned and operated by the trust was allowed. The court considered not only the activities of the trustee but also those of the trustee's agents and employees in determining whether there was material participation, and thus the losses were not attributable to a section 469 passive activity.

In Technical Advice Memorandum 200733023, the Service rejected the court's ruling in *Mattie K. Carter Trust*. It ruled that the activities of the fiduciary-trustees could satisfy the material participation requirements of section 469, but special trustees were not considered fiduciaries for section 469 purposes, and, as a result, the trust did not materially participate.²¹²

Upon the death of the owner of the passive loss activity, the suspended losses are carried over except to the extent of an increase in basis under section 1014.²¹³

In Technical Advice Memorandum 201317010, a special trustee of two trusts was also a trust beneficiary.²¹⁴ The trusts owned interests in an S corporation, and the special trustee owned the rest of the

211. *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N. Tex. 2003).

212. *See also* Priv. Ltr. Rul. 201029014. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. Byrle M. Abbin, *IRS Essentially Bars Trusts from Currently Deducting Business Losses*, 35 EST. PLAN., Feb. 2008, at 12.

213. I.R.C. § 469(g)(2).

214. I.R.S. Tech. Adv. Mem. 201317010. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

corporation. As special trustee, his control of the trust was limited to making all decisions related to the retention or sale of the stock and to voting the stock. As president of the S corporation's 100%-owned subsidiary, the special trustee was also involved in the day-to-day operations. The Service ruled that only the special trustee's activities as a fiduciary are considered in the section 469 determination and not his activities as employee of the S corporation's subsidiary. It concluded the trusts did not materially participate within the meaning of section 469. The Service rejected the argument that the special trustee's time spent as president of the S corporation's subsidiary should also be considered when determining whether the trusts materially participated in the company's business on a regular, continuous, and substantial basis. The trusts argued that activities as special trustee, individual shareholder, and president of the wholly owned subsidiary were all inter-related, and made it impossible to differentiate the special trustee's time in the different capacities. The Service noted that time spent serving as special trustee—voting the stock or considering sales of stock in either company—would count for purposes of determining the trusts' material participation, but the Service concluded that "time spent performing those specific functions does not rise to the level of being 'regular, continuous, and substantial' within the meaning of § 469(h)(1)."

[I] Disallowance of Deductions Under Section 265

Section 265(a)(1) denies deductions for expenses that are attributable to income that is "wholly exempt" from income taxes. For an estate or trust, this means that a portion of its deductions may not be deductible if it has tax-exempt income. In addition, a foreign trust²¹⁵ with gross income not taxable in the United States may be denied some portion of its otherwise deductible expenses, because the foreign income may be exempt for income taxes.

For a trust or estate, the deduction disallowed under section 265 is based on the proportion of exempt income included in the entity's DNI to the total income included in DNI (before reduction for expenses).²¹⁶

215. See section 5:3 for a definition of a foreign trust or estate.

216. See Treas. Reg. §§ 1.652(c)-4, ex.; 1.661(c)-2, ex.; 1.662(c)-4, ex. 1.643(d)-2(a), ex. *But see* Treas. Reg. § 1.652(b)-3(b). For a discussion of DNI, see section 3:3.2.

Example: A trust has \$10,000 of tax-exempt income and \$15,000 of rental income and has directly related rental expenses of \$5,000. For the tax year, the trustee fees are \$5,000. Section 265 does not apply to the real estate expenses because those expenses are directly related to the rental income.²¹⁷ However, the trustee's fee is subject to the disallowance rule. Thus, the ratio in the example is \$10,000/\$25,000 times \$5,000 equals \$2,000.

The Second Circuit in *Tucker v. Commissioner*,²¹⁸ held that a simple trust could not include capital gains realized by the trust in the denominator of the allocation fraction because the capital gains were not included in DNI. For fiduciary accounting purposes, the expenses in question were all chargeable to accounting principal. Somewhat similarly, in Revenue Ruling 80-165,²¹⁹ the Service ruled that a corporate dividend that was not taxable under section 301(c)(2) because the corporation had no "earnings and profits," but that was distributed to the trust's beneficiary was not included in the denominator of the allocation formula because the corporate distribution was not taxable income.

When a trust terminates, the issue has arisen of whether and how to allocate expenses to tax-exempt income and the application of the disallowance rule of section 265.²²⁰ In Revenue Ruling 77-466,²²¹ a trust had owned tax-exempt bonds during its existence, but did not own any exempt bonds in its year of termination. During its term, the trust had realized capital gains and losses. At the time of termination, many of the trust's assets were appreciated so that the terminating distribution included unrealized capital appreciation. Upon termination, the trustee was entitled to a termination fee that was not related to any particular class of income. The Service ruled that the fee was allocable to:

- 1) the trust's ordinary income (including tax-exempt income) realized during its existence;
- 2) net realized capital gains from its inception to its termination; and
- 3) any net unrealized capital appreciation of the assets distributed by the trust.

217. *Id.*

218. *Tucker v. Comm'r*, 322 F.2d 86 (2d Cir. 1963); *see also* Rev. Rul. 77-355, 1977-2 C.B. 82.

219. Rev. Rul. 80-165, 1980-1 C.B. 134.

220. *See above* paragraphs for a discussion of I.R.C. § 265 disallowance rule.

221. Rev. Rul. 77-466, 1977-2 C.B. 83.

However, the method used by the trustees resulted in none of the commissions being allocated to tax-exempt income, even though the trust had realized tax-exempt income during the period of its existence.²²²

The ruling cited the section 265 regulation²²³ that provides that the allocation should be reasonable and appropriate based on “all the facts and circumstances in each case.” No “particular method of allocation” is mandatory. In the ruling, the Service stated that an appropriate formula might be one with a numerator equal to the tax-exempt income realized by the trust during its existence over a denominator that is composed of all ordinary income realized by the trust during its existence, including the tax-exempt income, plus the net capital gains (that is, capital gains in excess of capital losses) realized over the life of the trust, plus the unrealized capital appreciation of the assets being distributed in excess of unrealized capital losses.

Similar to Revenue Ruling 77-466, the First Circuit in *Fabens v. Commissioner*,²²⁴ held that for purposes of allocating a trustee's termination fee to tax-exempt income, realized and unrealized net capital gains are included in the denominator of the formula. Revenue Ruling 77-466 makes no mention of *Fabens*, but it appears to be an acquiescence in the court's holding.

For a discussion of DNI and allocation of expenses to different classes of income, see section 3:5.3.

[J] Charitable Contributions

The deductions allowed to individuals for charitable contributions under section 170 are limited (a) to those made to certain specified types of charitable organizations or governments, and (b) to an amount not exceeding 20% to 50% of the taxpayer's contribution base, depending on the type of charitable donee and the asset contributed.²²⁵ These limitations do not apply to charitable “contributions” made by an estate or trust, which are generally allowed under section 642(c) and not section 170, although there are different limitations for trusts, which are discussed below.

Under section 642(c), distributions out of gross income for a charitable purpose are generally deductible in full, although, the deduction is permitted only if the distribution is pursuant to the terms of the governing instrument.²²⁶ This deduction is in lieu of a

222. Rev. Rul. 80-165, 1980-1 C.B. 134.

223. Treas. Reg. § 1.2651(c).

224. *Fabens v. Comm'r*, 519 F.2d 1310 (1st Cir. 1975).

225. A taxpayer's contribution base is adjusted gross income computed without regard to any net operating loss carryback. I.R.C. § 170(b)(1)(F).

226. I.R.C. § 642(c)(1).

deduction for a distribution to a beneficiary even though under the controlling document and state law the charity is considered a beneficiary of the trust or estate.²²⁷

Apparently the charitable deduction is permissible even if paid to individuals, provided that “pursuant to the terms of the governing instrument” the funds are “paid” for a purpose specified in section 170(c).²²⁸ In determining whether the income is to be “used exclusively” for the purposes specified in the statute, *Estate of Whitehead v. Commissioner* held that if the primary use is charitable, a “purely incidental” other use will not prohibit the deduction.²²⁹ In addition, a trust exclusively for charity can be tax-exempt under section 501(c)(3), and thus a deduction for a gift to a qualified charity under section 642(c) would not be necessary.²³⁰

The “domesticity” requirement (that is, only U.S. domestic organizations) contained in section 170(c)(2)(A) is not found in section 642(c). The necessary factor in section 642(c) is the type of purpose rather than the type of organization.²³¹

Section 642(c) permits estates and trusts a charitable deduction for amounts “paid” for the requisite purposes. In addition, a deduction for amounts “to be used exclusively” or “permanently set aside” for such

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227. Under I.R.C. § 663(a)(2), distributions of a nature that would qualify them to be taken as a charitable deduction are not treated as deductible distributions to beneficiaries. This disqualification from deductibility as a distribution to a beneficiary applies even if the charitable deduction has been limited by I.R.C. § 681 or the like. *See also* Treas. Reg. § 1.663(a)-2; H.R. REP. NO. 83-1337, at A205, S. REP. NO. 83-1622, at 354. I.R.C. § 651(a) is not applicable to trusts with a charitable deduction. In I.R.S. Tech. Adv. Mem. 8446007, it was held that a “simple” trust was not entitled to a deduction under either I.R.C. § 642(c) or I.R.C. § 651(a) for amounts paid to charity pursuant to a valid assignment by the life income beneficiary (resulting in such amounts being taxed to the trust). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
228. I.R.C. § 642(c). This means that the charitable deduction disallowed to individual taxpayers in *Davis v. United States*, 495 U.S. 472 (1990), might have been allowed if paid by a trust. Note also that I.R.C. § 664(d) refers to an organization described in I.R.C. § 170(c); I.R.C. § 642(c) refers to a purpose specified in I.R.C. § 170(c).
229. *Estate of Whitehead v. Comm’r*, 3 T.C. 40, 50 (1944), *aff’d*, 147 F.2d 977 (5th Cir. 1945). *See also* *Estate of Bedford v. Comm’r*, 39 B.T.A. 1039 (1939), *nonacq.* 1939-2 C.B. 42.
230. A trust whose major interests are for charities, but that is nonexempt, is subject to much the same rules as private foundations under I.R.C. § 4947.
231. *See* Rev. Rul. 53-96, 1953-1 C.B. 264; Priv. Ltr. Rul. 9326025 (trust entitled to section 642(c) deduction for payment of gross income to foreign charity). *But see* Rev. Rul. 78-436, 1978-2 C.B. 187, in which the Service ruled gifts of income to a foreign government are deductible, but in the facts of the ruling, the government’s use of the money was not limited to charitable purposes.

purposes is permitted for estates, “pooled income funds,”²³² pre-October 9, 1969 trusts,²³³ and trusts that are included in an effective section 645 election.²³⁴ To not pay taxes on income set aside for charity, other trusts must pass muster as tax exempt because the trust is exclusively for charity or is a section 664 charitable remainder trust.

The meaning of the phrase “permanently set aside” for charitable purposes was considered in *United States v. MacIntyre*.²³⁵ At issue was whether the United States could collect unpaid gift taxes from funds of a trust where the trustees “permanently set-aside for charity” more than \$1 million. The money was not actually distributed to charity nor was it physically segregated but remained in the same account with other trust assets. The United States did not challenge “whether the Trust properly or improperly set aside those funds. Instead, it asks whether, once those funds were set aside, may the government access them to pay the transferee liability.”²³⁶ The court held that the money was not available to satisfy the government’s claim, but the court also held the fiduciaries were individually liable under 31 U.S.C. § 3713 (2006) for the total amount set aside. While the facts are not overly clear, it appears that the only act the trustees took to permanently set aside the money for charity was to claim the income tax deduction on the combined estate and trust income tax return.²³⁷

232. I.R.C. § 642(c)(3). See section 3:3.2[D] for a discussion on the definition of income for pooled income funds.

233. I.R.C. § 642(c)(2). Trusts that qualify as pre-October 9, 1969 trusts are: (A) *inter vivos* trusts created before October 9, 1969, where an irrevocable remainder interest was created for the use of an organization described in section 170(c), or where the grantor is, at all times after October 9, 1969, under a mental disability to change the terms of the trust; or (B) testamentary trusts established by wills executed before October 9, 1969, if (1) the testator died before October 9, 1972, without having republished the will by codicil or otherwise; (2) the testator at no time after October 9, 1972, had the right to change the trust provisions of the will; or (3) the will was not republished by codicil or otherwise before October 9, 1972, and the testator was on that date and thereafter under a mental disability to republish. See *Rush v. United States*, 694 F.2d 1072 (6th Cir. 1982) (example of pre-1969 trust that became irrevocable in 1970 and did not get set-aside deduction).

234. I.R.C. § 645 and trusts that make the election are discussed below in section 3:9.

235. *United States v. MacIntyre*, No. H-10-2812, 2012 WL 2403491 (S.D. Tex. June 25, 2012).

236. *Id.* at *6.

237. The court noted that the estate and trust filed “joint federal income tax returns.” To do this, the estate and trust most likely had a section 645 election in place. For a discussion of the section 645 election, see section 3:8, *infra*.

Although estates are permitted a charitable set-aside deduction, if estate administration is unduly prolonged, the estate can be considered terminated and the set-aside deduction lost.²³⁸ For example, in *Estate of Berger v. Commissioner*,²³⁹ no charitable deductions were allowed under section 642(c) for income set aside for a charity but not paid. The court ruled that the estate administration was unduly prolonged, and, therefore, treated as ended. For federal income tax purposes, the terminated estate was considered a trust, for which no set-aside deduction is permitted except in the limited circumstances.

In addition to the set-aside rule, section 642(c)(1) provides for an election to treat a charitable contribution as “paid” during a year if actual payment is made within one year thereafter and paid from the prior year’s gross income, and apparently regardless of whether the obligation was accrued in the earlier year.²⁴⁰ Moreover, the regulations permit a deduction for amounts paid during a tax year for income received in a prior year, but only if no deduction was allowed in any prior year.²⁴¹ For example in Revenue Ruling 79-223,²⁴² a “ten-year-one-month” trust (often called a Clifford trust) provided that all of the ordinary income was paid to a charity and then the principal reverted to grantor at the end of the term. The Service ruled that an income tax charitable deduction was allowed if the ordinary income was paid to the charity during the year or in the next tax year.²⁴³ In Private Letter Ruling 200626021, the Service permitted a trust to make a late section 642(c)(1) election pursuant to Treasury Regulations sections 301.9100-1 and 301.9100-3.²⁴⁴ No deduction for unrelated business income was allowed, however.²⁴⁵

The mere fact that some part or all of the gross income has been used, paid, or set aside for specified organizations or purposes is not sufficient to justify the deduction, however. The payment must be “pursuant to the terms of the governing instrument.”²⁴⁶ The

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238. See Treas. Reg. § 1.641(b)-3(a) for a discussion of when estates may be deemed terminated.
239. *Estate of Berger v. Comm’r*, T.C. Memo. 1990-554.
240. I.R.C. § 642(c)(1).
241. Treas. Reg. § 1.642(c)-1(a)(1).
242. Rev. Rul. 79-223, 1979-2 C.B. 254.
243. The trust qualified under I.R.C. § 673 before it was amended in 1986. As a result, the ordinary income of the trust was not taxable to the grantor, but the capital gains that were allocable to corpus were.
244. See also Priv. Ltr. Ruls. 201202019, 201132005, 201023015, 200905027, 200952034. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
245. See I.R.C. § 681; Treas. Reg. § 1.681(a)-1.
246. *Estate of Tyler v. Comm’r*, 9 B.T.A. 255 (1927).

leading Supreme Court case on this issue, *Old Colony Trust Co. v. Commissioner*,²⁴⁷ defined “pursuant to . . . as ‘acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according.’”²⁴⁸ In *Old Colony*, the Supreme Court reversed a lower court decision, which held that the distributions were not made “pursuant to” the governing instrument because the trustees were merely given discretion to pay income to charity. According to the Supreme Court, the cited definition supports the conclusion that mere authorization satisfies section 642(c)’s “pursuant to” requirement and that, therefore, language definitively directing charitable distributions is not mandatory.

The Court’s broad holding, however, seems to have been partially limited by more recent lower court opinions. The Second Circuit, in *Ernest & Mary Hayward Weir Foundation v. United States*,²⁴⁹ affirming based on the district court’s opinion,²⁵⁰ held that an unrestricted testamentary power of appointment, granted by the terms of the taxpayer trust to the income beneficiary, did not constitute sufficient charitable intent for distributions of income to charity to qualify for a section 642(c) deduction. The Service originally had rejected the deduction because the exercise of the power of appointment in favor of charity was not “pursuant to” the governing instrument as “no mention of charitable contribution was made in the original governing instrument.”²⁵¹ The district court reasoned that “the instrument must be shown to possess some positive charitable intent or purpose of the settlor—not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty.”²⁵²

The Tax Court in *Trust of John Walker v. Commissioner*²⁵³ seems to most limit *Old Colony* on this issue. In this decision, the decedent’s will devised one part of the remainder of a trust in further trust for one of the decedent’s children. The portion held in further trust provided that if the child died without issue, the child was granted a testamentary special power to appoint the assets of the trust among lineal heirs of the decedent or certain charitable institutions. He exercised the power in favor of a new trust providing one-third of

247. *Old Colony Trust Co. v. Comm’r*, 301 U.S. 379 (1937).

248. *Id.* at 383 (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY (unabridged 2d ed. 1935)).

249. *Ernest & Mary Hayward Weir Found. v. United States*, 508 F.2d 894 (2d Cir. 1974).

250. *Ernest & Mary Hayward Weir Found. v. United States*, 362 F. Supp. 928, 936 (S.D.N.Y. 1973), *aff’d*, 508 F.2d 894 (2d Cir. 1974).

251. *Id.* at 930.

252. *Id.* at 939.

253. *Trust of John Walker v. Comm’r*, 30 T.C. 278 (1958). *See also* *Fid. Trust Co. v. United States*, 253 F.2d 407 (3d Cir. 1958) (involving the same trust and the same issue for a different tax year).

its income to his sister (the original decedent's daughter) for life and two-thirds of its income to various charities, with the entire corpus going to charity after his sister's death. The Tax Court held that the decedent's trust was not entitled to an income tax charitable deduction because the son "had the power at any time during his life . . . to appoint his share of the corpus of [the decedent's] estate entirely to the lineal descendants of [the decedent] to the exclusion of any charity or he had the power to appoint partly to one and partly to another, with no designation by [the decedent] as to the share to be given to either."²⁵⁴

More recently, in *Brownstone v. United States*,²⁵⁵ the decedent's will created a testamentary marital deduction trust. The decedent's surviving spouse exercised a general testamentary power of appointment over the trust's corpus in favor of her estate. Her will directed that her estate, after paying expenses and making certain other bequests, pay the residue to eight charitable organizations. The trustee of the marital trust attempted to take a section 642(c) deduction for income paid to the spouse's estate because the trust's income eventually wound up in the hands of charity. The distribution did not occur in the year in which the income was earned and a deduction claimed, but occurred late in the following year.²⁵⁶

The Second Circuit held that only one document, in this case the decedent's will that created the marital trust, may be considered the "governing instrument" for purposes of allowing a deduction to the trust under section 642(c). According to the Second Circuit, because the language of section 642(c) specifically refers to "the" governing instrument, there may only be one; and the court concluded that the charitable distribution was not "pursuant to" it, because the decedent's will expressed no preference as to whether and how the power of appointment should be exercised.

In *Williams v. United States*,²⁵⁷ a decision somewhat similar to *Brownstone*, the U.S. District Court for the Northern District of California reached an analogous result. In that case, the testator left his entire estate to his surviving spouse, who died while the decedent's estate was still being administered. The spouse's will created a residual trust for charity and provided that all income earned by her estate during the period of administration, not used for taxes or costs, would go to the residual charitable trust. The executrix of the decedent's estate argued that, upon the wife's death, all income accrued to the decedent's estate

254. *Trust of John Walker*, 30 T.C. at 283.

255. *Brownstone v. United States*, 465 F.3d 525 (2d Cir. 2006).

256. A deduction in the prior year is permitted if the trustee so elects. See I.R.C. § 642(c)(1); Treas. Reg. §1.642(c)-1(b); discussion at notes 240–41, *supra*, and accompanying text.

257. *Williams v. United States*, 158 F. Supp. 227 (1957), *aff'd*, 251 F.2d 847 (9th Cir. 1958). See also *Marquis v. United States*, 173 F. Supp. 616 (Ct. Cl. 1959).

was “irrevocably committed” to charity and, as a result, the income earned should be deductible under the predecessor of section 642(c).²⁵⁸ The court denied the deduction, stating that the statute “plainly contemplates that the contribution must be the result of a charitable intent expressed in the will.”²⁵⁹ Besides courts, the Service has considered the availability of a section 642(c) deduction in similar circumstances.²⁶⁰

A section 642(c) deduction has been denied in situations that appear somewhat analogous to *Brownstone*. In *Estate of O’Connor v. Commissioner*,²⁶¹ a decedent’s surviving spouse elected to withdraw all assets of a marital trust shortly after the decedent died and then assigned her rights in the trust to charity. The Tax Court determined that the marital deduction trust was not recognized as a tax entity because the spouse had the right to withdraw all of the trust corpus and because of the assignment the charity had the right to the trust property.²⁶² The court did not permit a section 642(c) income tax deduction for distributions to the assignee charity. Other cases have held similarly.²⁶³

Some trusts have claimed a section 661 distribution deduction when a section 642(c) deduction is not available for a distribution to charity. In *Mott v. United States*,²⁶⁴ the Court of Claims held that section 642(c) is the exclusive deduction for distributions to charity and validated Treasury Regulation section 1.663(a)-2 that provides in part that section 642(c) is the sole basis for a deduction for a distribution of income to a charity. *O’Connor*, discussed above, followed *Mott* and rejected the taxpayer’s position that a section 661 deduction is permitted for distributions to a charity when section 642(c) is not available. The denial of the section 661 deduction for a distribution to charity in section 651 does not refer to section 651. Nevertheless, Technical Advice Memorandum 8738007 held that neither a section 642(c) nor a section 651(a) deduction is permitted

258. *Williams* concerned section 162(a) of the 1939 Code. Section 642(c) replaced section 162(a) when the Internal Revenue Code of 1954 was enacted. See S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.A.N. 4621, 4982 (“This provision [section 642] is comparable to section 162(a) of the 1939 Code.”).

259. *Williams*, 158 F. Supp. at 228.

260. See Gen. Couns. Mem. 34,277 (1970). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

261. *Estate of O’Connor v. Comm’r*, 69 T.C. 165 (1977).

262. The court determined that the effect of section 678 was to cause the trust not to be recognized for tax purposes.

263. For additional discussion of assigning income interests to charity, see note 291, *infra*.

264. *Mott v. United States*, 462 F.2d 512 (Ct. Cl.), cert. denied, 409 U.S. 1108 (1972).

for income distributed to charity pursuant to a valid assignment of income to charity by the income beneficiary.²⁶⁵

Similarly, in *United States Trust Co. v. Internal Revenue Service*,²⁶⁶ the court held that no section 661 deduction is available for a distribution to a charity that also qualified for an estate tax charitable deduction. Both *Mott* and *United States Trust Co.* are distinguishable when the amounts distributed to charity are not claimed as estate tax charitable deductions. Unfortunately, dicta in both cases does not seem to limit the denial of an income tax deduction to instances in which an estate tax deduction is claimed for the same distribution to charity.

Brownstone provides that the original trust is not entitled to a section 642(c) deduction and *Mott* provides that no section 661 deduction is available for a distribution to charity. Nevertheless, *Brownstone* does not address the issue of whether the original trust is entitled to a section 661 distribution deduction if timely distributions are made to a new trust (or an estate) that is not a qualified charity. In this circumstance, the original trust should be entitled to a section 661 distribution deduction so long as the new entity is not the qualified charity; that is the basic tenet of section 661 and no authority provides otherwise. Moreover, the cases discussed above are not instructive as to whether a section 642(c) deduction may be taken by a transferee trust or estate. The income tax charitable deduction status of the new trust created by a powerholder is easily distinguished from cases limiting the ruling in *Old Colony*. The new trust can expressly direct payments of income to charity. The language of the new trust will express a charitable intent. The new trust may contain an "indication" of "positive charitable intent," and the language can show sufficient "charitable impulses" of the grantor of the new trust as the courts seem to require. As such, it appears that charitable distributions of income from the new trust, in conformance with the language of that trust agreement, would be considered to be "pursuant to" the terms of the governing instrument.²⁶⁷

265. I.R.S. Tech. Adv. Mem. 8738007 (1987); *see also* I.R.S. Tech. Adv. Mem. 8446007 (1984); Gen. Couns. Mem. 39,306 (1984). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

266. *U.S. Trust Co. v. Internal Revenue Serv.*, 803 F.2d 1363 (5th Cir. 1986).

267. *See* Rev. Rul. 2003-123, 2003-2 C.B. 1200 (stating that a distribution is made "pursuant to the terms of the Trust's governing instrument" where the governing instrument "authorizes the trustee to make contributions to charity, including contributions of [the trust's] gross income.").

General Counsel Memorandum 34,277²⁶⁸ provides an interpretation of section 642(c)'s application in the following hypothetical:

Assume Trust A has \$100,000 of trust income accumulated for charity . . . which it must pay to trust B which can only pay this income to charity. Section 642(c) says Trust A is allowed a deduction for the amount of the trust income destined to Trust B. Assume arguendo that it is incumbent on Trust B to consider this \$100,000 as gross income since no tax has been paid thereon. Then when Trust B distributes the \$100,000 to charity it also is entitled to \$100,000 section 642(c) deduction and this would offset its \$100,000 of gross income. Accordingly, no tax benefit results from this double deduction treatment and funds which are irrevocably destined for charity are not subjected to tax. This would seem to conform to the basic premise that such funds should not be taxed.

This analysis strongly suggests that the Service is willing to treat funds passing through multiple trusts separately at each trust.

When the power creating the charitable gift is a special power of appointment and the charity is a direct beneficiary, a possible alternative argument exists to support a charitable income tax deduction. A special power of appointment, as is sometimes found in Qualified Terminable Interest Property (QTIP) marital deduction trusts, "by-pass" or "credit shelter" trusts, in trusts that permit an independent trustee to make changes, and other trusts as well, is arguably different from general powers of appointment because it is usually held that a special power of appointment "fills in the blank" of the document that creates that power.²⁶⁹

The Service has acknowledged this view of the law. In General Counsel Memorandum 34,277, the Service specifically discussed *Trust of John Walker* and the relation-back nature of a power of appointment and noted that the Tax Court had "relied too heavily . . . on a misconception of [state] law."²⁷⁰ The Service states in the

268. Gen. Couns. Mem. 34,277 (1970). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

269. See S. Alan Medlin, *A Primer on Powers*, 2 HOFSTRA PROP. L.J. 165, 173 (1988); see also *In re Estate of Stephens*, 268 N.Y.S.2d 769 (N.Y. Sur. Ct. 1966) (holding that with a special power of appointment there is "relation back" to the instrument that created the power, while general powers of appointment do not "relate back"); *Second Nat'l Bank of New Haven v. Harris Trust & Sav. Bank*, 29 Conn. Supp. 275 (Conn. Super. Ct. 1971).

270. Gen. Couns. Mem. 34,277 (1970); see also Gen. Couns. Mem. 38,227 (1979), in which the Service considers Gen. Couns. Mem. 34,277 to have revoked the ruling in *Trust of John Walker*. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

Memorandum that “the exercised power of appointment is deemed to speak as part of the [original decedent’s] will.”²⁷¹ Moreover, the Service acknowledged that “as of the [surviving spouse’s] death . . . two trusts were created pursuant to the term of the [decedent’s] will.”²⁷² If such relation back occurs, the conclusion that there is only one “governing instrument” might not prevent a taxpayer from considering the exercise of appointment as part of the original instrument. Whether the Service continues to believe that *Trust of John Walker* is incorrectly decided is not certain. The Justice Department’s brief in *Brownstone* favorably cites the Tax Court’s opinion and does not mention General Counsel Memorandum 34,277.²⁷³

In two Private Letter Rulings, the Service has approved section 642(c) deductions for income of trusts that is paid to charities pursuant to the exercise of special powers of appointment.²⁷⁴ In both rulings, however, the special powers were exercisable only in favor of charities and not potentially other non-charitable beneficiaries as was involved in *Trust of John Walker*. Moreover, the powers in both rulings were *inter vivos* rather than testamentary powers, although that would not seem to make any difference.

General Counsel Memorandum 34,277 does not distinguish between special powers of appointment and general powers of appointment. *Trust of John Walker*,²⁷⁵ discussed in the General Counsel Memorandum, involved the exercise of a special power of appointment. *Weir Foundation* and *Brownstone* concerned general powers of appointment. State law generally distinguishes general and special powers when applying the relation-back doctrine.²⁷⁶ Whether the Service would assert that a tax difference exists between general powers and special powers for purposes of section 642(c) is not known. The taxpayer’s briefs in *Brownstone* did not raise this argument.

A satisfactory resolution of the “pursuant to” requirement for trusts is problematic. When the direction to pay over income to charity, and not to another entity, is made by the exercise of a power of appointment, it seems that a section 642(c) deduction is not available if *Brownstone* and the other authorities cited above correctly interpret the law. The relation-back nature of a power of appointment might

271. Gen. Couns. Mem. 34,277.

272. *Id.*

273. Brief of Defendant-Appellee at 26–30, *Brownstone v. United States* (2d Cir. 2006) (No. 04-4061-cv).

274. *See* Priv. Ltr. Ruls. 201225004, 200906008, 201225004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

275. *Trust of John Walker v. Comm’r*, 30 T.C. 278 (1958).

276. *See* *Medlin*, *supra* note 269.

support a deduction based on the Service's view found in General Counsel Memorandum 34,277, when the power is a special power of appointment, but whether it is applicable to general powers of appointment is less certain.

An argument might be made that a distribution to charity might qualify for a distribution deduction under section 661 when section 642(c) is not available, but there is substantial authority against this position. Nevertheless, *Mott* and *United States Trust Company* are distinguishable when the amounts distributed to charity are not claimed as estate tax charitable deductions.

In some situations there may be an alternative argument to avoid the income taxes on gross income paid to charity. If the only beneficiary of the trust after the power is exercised is charity, the trust may be considered a charitable trust and exempt from income taxes.²⁷⁷ Thus, it is not necessary to qualify under section 642(c) for a charitable income tax deduction with respect to income it earned (other than unrelated business income defined in section 512). Of course, in most instances, the trustee would need to apply for tax exempt status to be exempt from income taxes.

When a power of appointment is exercised in favor of another trust or an estate and the transferee entity provides for distributions of income to charity, a distribution deduction should be available for the transferor trust, so long as the transferee is not a qualified charity and the distribution is timely made. The question will then become whether the transferee is entitled to a charitable deduction, but normal rules should apply and support a section 642(c) deduction.

In *Hunt v. United States*,²⁷⁸ pre-1970 trusts had individuals as income beneficiaries and a charity as the remainder beneficiary. The trustee had sole discretion to determine what was income and what was corpus. Although the trustee apparently did not consciously exercise the power and, as a result, capital gain was allocated to corpus, no charitable deduction was allowed because the court determined that capital gains were not permanently side aside for charity.

277. A tax-exempt charitable entity is taxed to the extent it has unrelated business taxable income under I.R.C. § 512; see *infra* notes 327–28 and accompanying text.

278. *Hunt v. United States*, 93 A.F.T.R.2d (RIA) 351 (D.N.H. 2003). See also Priv. Ltr. Ruls. 5901224600A, 5901224720A (similar as to I.R.C. § 642(c) deduction where “genuine contest”); Priv. Ltr. Rul. 9037004 (charitable deduction under I.R.C. § 642(c) allowed for payment due charity pursuant to settlement agreement even for years prior to settlement where it takes the place of the will and relates back to testator’s death). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent..

Because *Hunt* involved pre-1970 trusts, a charitable set-aside deduction was possible.²⁷⁹ For trusts created after 1969, there is no question that a charitable set-aside deduction is not allowed, although one might be allowed for an estate, but not on these facts. For example, if an estate is payable to a trust that provides for a qualifying gift to charity, the charitable deduction should be allowed.

In *Crown v. Commissioner*,²⁸⁰ no section 642(c) deduction was allowed for income in excess of an annuity paid to a charity, because the excess income was not paid “pursuant to the terms of the governing instrument.” The court determined that the trustees lacked the authority under the instrument to pay the excess to the charity.

The phrase “permanently set aside” has been interpreted to allow a deduction if the income will ultimately pass to certain exempt entities (for example, if the charities are remainder beneficiaries), although in fact none of the income has been paid or credited, and no direct action has been taken to set it aside during the taxable year.²⁸¹ This rule is applicable to estates but not trusts. The fact that under local law the taxable gross income thus received by a charitable remainder trust as corpus will not be distributable to the current income beneficiaries, may enable major tax savings in funding a charitable remainder trust.²⁸² However, the regulations deny a section 642(c) deduction for amounts of gross income set aside for a charitable remainder trust described in section 664(d) (other than perhaps for an income-only unitrust described in section 664(d)(3)) because of the possibility of invasion of corpus.²⁸³ Nevertheless, a

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279. In Rev. Rul. 73-95, 1973-1 C.B. 322, the Service ruled that a charitable set-aside was not permitted for a pre-1970 trust if the trustee has discretion on the allocation of capital gain to income or principal; I.R.S. Tech. Adv. Mem. 9714001 (similar to Rev. Rul. 73-95). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
280. *Crown v. Comm’r*, 8 F.3d 571 (7th Cir. 1993).
281. *E.g.*, *Bowers v. Slocum*, 20 F.2d 350 (2d Cir. 1927); *Sence v. United States*, 394 F.2d 842 (Ct. Cl. 1968) (trustee had not paid proper amount although governing instrument made it mandatory); *Middleton v. United States*, 99 F. Supp. 801 (E.D. Pa. 1951).
282. *See United States v. Bank of Am. Nat’l Trust & Sav. Ass’n*, 326 F.2d 51, 54 (9th Cir. 1963); Trautman, *The Income Taxation of Estate Distributions: A Need for Reform*, 44 IND. L.J. 397, 406–08 (1969). *See* Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents’ Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1 (1984).
283. Treas. Reg. § 1.642(c)-2(d). The treatment of a distribution to a charitable remainder trust is governed by the rules of subchapter J other than I.R.C. § 664. Treas. Reg. § 1.664-1(a)(5)(iii). *See* I.R.S. Tech. Adv. Mem. 8810006 (only a distributions deduction under I.R.C. § 661 and no charitable deduction with I.R.C. § 642(c) allowed for distributions by estate to residuary charitable remainder trust). Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110(k)(3). *See also* chapter 7.

distribution deduction may be allowed under section 661, resulting in a shift of income from the estate to the trust, which is tax exempt.²⁸⁴

An amount paid in settlement of a dispute can be deemed paid “pursuant to” the instrument.²⁸⁵ For example in *Emanuelson v. United States*,²⁸⁶ the court ruled that a settlement that provided for a portion of the decedent’s residuary estate to pass to charity, including a share of income, qualified for an income tax charitable deduction for amounts paid pursuant to the decedent’s will. In Private Letter Ruling 9044047,²⁸⁷ a section 642(c) deduction was allowed where a charity received a fractional share of two trusts as the result of a settlement. The local court found that the distributions were in accordance with the trust agreement. The Service ruled that the settlement was paid pursuant to the terms of the governing instruments.²⁸⁸ This will not necessarily be the case in all events.²⁸⁹

For example, in Chief Counsel Advice 200848020,²⁹⁰ the Service denied an income tax charitable deduction for amounts paid to charity when the trust was not modified “to resolve a conflict in the Trust,” but rather to “qualify as a designated beneficiary under section 401(a)(9).”

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284. Although not completely certain, an estate’s DNI cannot constitute unrelated business income that would be taxable income to charitable remainder trusts.
285. Estate of Wright v. United States, 677 F.2d 53 (9th Cir. 1982). *But see* Genesee Merchs. Bank & Trust Co. (Estate of Pansy Lee Reeder) v. United States, 37 A.F.T.R.2d 76-747, 76-1 USTC ¶ 9212 (E.D. Mich. 1976), in which an income tax charitable deduction was disallowed for tax years before the settlement.
286. Emanuelson v. United States, 159 F. Supp. 34 (D. Conn. 1958); Middleton v. United States, 99 F. Supp. 801 (E.D. Pa. 1951) (distribution to a charitable organization under a compromise agreement was pursuant to terms of settlor’s will); Rev. Rul. 59-15, 1959-1 C.B. 164 (settlement agreement arising from a will contest qualifies as a governing instrument); *cf.* Harte v. United States, 252 F.2d 259 (2d Cir. 1958); Lambert Tree Trust Estate v. Comm’r, 38 T.C. 392 (1962).
287. Priv. Ltr. Rul. 9044047. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
288. *See also* Priv. Ltr. Ruls. 5901224600A, 5901224720A (similar as to section 642(c) deduction where “genuine contest”); Priv. Ltr. Rul. 9037004 (charitable deduction under I.R.C. § 642(c) allowed for payment due charity pursuant to settlement agreement even for years prior to settlement where it takes the place of the will and relates back to testator’s death). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
289. *See, e.g.*, John Allan Love Charitable Found. v. United States, 710 F.2d 1316 (8th Cir. 1983).
290. *See* Chief Couns. Adv. 2008480209. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. *See also* Priv. Ltr. Rul. 201438014. This Private Letter Ruling is discussed in Chapter 2, at note 141.

The “pursuant to” requirement has been applied to deny a section 642(c) deduction where a surviving spouse assigned her interest in a marital trust to a charity.²⁹¹ The decedent’s will did not provide for the charitable gift. Moreover, the tax court ruled that the decedent’s estate was not permitted a distribution deduction under section 661 for money due the marital trust but assigned to charity because as a result of the assignment the marital trust was no longer recognized. No distribution deduction is allowed by section 661 for a distribution to a charity.

When income is permanently set aside for charity, it is not necessary for the charitable entity to be in existence in the taxable year in which the deduction is claimed.²⁹² In *Arthur Jordan Foundation v. Commissioner*,²⁹³ a deduction was permitted for income that was retained at least temporarily as part of the investment fund for charity. The *Arthur Jordan Foundation* holding was distinguished in *John Danz Charitable Trust v. Commissioner*,²⁹⁴ and a deduction was not permitted where the “ultimate destination” was charity, but the funds could have been long retained and devoted to speculative commercial pursuits. Another distinction exists “between cases where the provisions of the instrument itself render uncertain whether the charitable donees will actually take, and cases where there is no uncertainty under the provisions of the instrument that net income must be used for charitable purposes, but valid claims and charges against the trust render uncertain for the time being the exact amount of the net income which is committed to charitable purposes.”²⁹⁵

In contrast to the rule governing an individual’s charitable donations, the trust’s or estate’s charitable distributions must be from gross income to be deductible.²⁹⁶ However, it is not necessary that these items constitute trust income rather than corpus in the trust-accounting

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291. Estate of O’Connor, 69 T.C. 165 (1977). See also I.R.S. Tech. Adv. Mem. 8446007 (ruling the same); I.R.S. Tech. Adv. Mem. 8604080 (providing relief from retroactive application of I.R.S. Tech. Adv. Mem. 8446007); Gen. Couns. Mem. 39,306 (agreeing with I.R.S. Tech. Adv. Mem. 8446007). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
292. Potter v. Bowers, 89 F.2d 687 (2d Cir. 1937); Bruckner v. Comm’r, 20 B.T.A. 419 (1930). See Comm’r v. Upjohn’s Estate, 124 F.2d 73 (6th Cir. 1941).
293. Arthur Jordan Found. v. Comm’r, 210 F.2d 885 (7th Cir. 1954), *aff’g* 12 T.C.M. (CCH) 109 (1953).
294. John Danz Charitable Trust v. Comm’r, 231 F.2d 673 (9th Cir. 1955), *aff’g* 18 T.C. 454 (1952), *cert. denied*, 352 U.S. 828 (1956) (also dealing with the contention that the entire trust was tax exempt).
295. Comm’r v. Beeghley Fund, 310 F.2d 756, 761 (6th Cir. 1962).
296. I.R.C. § 642(c); Treas. Reg. §§ 1.642(c)-1, -2. Accordingly, references in I.R.C. § 662(b) (last sentence), and in H.R. REP. NO. 83-1337, at A201; S. REP. NO.

sense, despite some occasional tendency to require at least an indication that the charity is to be a beneficiary of income.²⁹⁷ For example, if receipts of an IRA payable to an estate must be paid over to charity, a charitable income tax deduction is permitted even though the IRA is fiduciary accounting principal.²⁹⁸

Also, it is probably sufficient if the distribution is charged to items of gross income, even if not actually paid from the particular year's receipts.²⁹⁹ However, a distribution of appreciated stock was held not deductible, because the shares constitute corpus and are not items of gross income, even if under the instrument the distribution is chargeable to trust-accounting income.³⁰⁰ In Chief Counsel Advice 201042023, the Service ruled that a property bought with accumulated

83-1622, at 350, to charitable deductions for amounts paid from other than income seem to refer only to items paid from gross income that do not constitute income in the trust-accounting sense. See I.R.C. § 643(b); Treas. Reg. § 1.662(b)-2 (next-to-last sentence of first paragraph). On the other hand, it must be conceded that the above Committee Reports and Treas. Reg. § 1.662(b)-2 example (1), may imply that a charitable deduction is permissible for a distribution to charity of accumulated income.

297. Treas. Reg. § 1.642(c)-3 (example of deduction for capital gains allocable to corpus where remainder is set aside for charitable purposes); Estate of Clymer v. Comm'r, 221 F.2d 680 (3d Cir. 1955); Casco Bank & Trust Co. v. United States, 76-1 U.S. Tax Cas. (CCH) ¶ 9102 (D. Me. 1975) (estate corpus distribution constituting taxable income to trust); Emanuelson v. United States, 159 F. Supp. 34 (D. Conn. 1958); cf. United States v. Bank of Am. Nat'l Trust & Sav. Ass'n, 326 F.2d 51 (9th Cir. 1963). *But cf.* Estate of Huesman v. Comm'r, 16 T.C. 656 (1951), *aff'd*, 198 F.2d 133 (9th Cir. 1952); I.T. 1966, 3-1 C.B. 215 (1924); Wellman v. Welch, 21 F. Supp. 978 (D. Mass. 1938), *aff'd*, 99 F.2d 75 (1st Cir. 1938); see also Estate of Freund v. Comm'r, 303 F.2d 30 (2d Cir. 1962) (not even paid to charity, so nondeductible, where partnership income that had been distributed to decedent before the death was taxed, as income in respect of decedent, to estate whose remainder would go to charity); Estate of Esposito v. Comm'r, 40 T.C. 459 (1963), *acq.* 1964-1 C.B. (pt. 1) 4 (same as to consent dividend); Priv. Ltr. Rul. 9037004 (to get set-aside deduction estate must show under settlement agreement, which relates back to death, it had gross income in fact set aside for charity); Estate of Holdeen v. Comm'r, T.C. Memo. 1975-29 (charitable deduction reduced to reflect settlement with heir). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
298. Priv. Ltr. Ruls. 200537019, 200336020, 200221011. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
299. Old Colony Trust Co. v. Comm'r, 301 U.S. 379 (1937). *But cf.* W.K. Frank Trust of 1931 v. Comm'r, 145 F.2d 411 (3d Cir. 1944); Freund v. Comm'r, 303 F.2d 30 (2d Cir. 1962); Estate of Esposito v. Comm'r, 40 T.C. 459 (1963), *acq.* 1964-1 C.B. (pt. 1) 4; Sid W. Richardson Found. v. United States, 306 F. Supp. 755 (N.D. Tex. 1969), *aff'd*, 430 F.2d 710 (5th Cir. 1970), *cert. denied*, 401 U.S. 1009 (1971).
300. W.K. Frank Trust of 1931 v. Comm'r, 145 F.2d 411 (3d Cir. 1944).

income of a trust was deductible under section 642(c) when distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property.³⁰¹ A distribution to a charity made from the gross income of an estate is deductible despite a provision in the will that the payment may be made from corpus if income is insufficient.³⁰²

A charitable income tax deduction is problematic when an estate or trust with charitable beneficiaries must report gross income that is not accompanied by a cash receipt. There is no cash to distribute to or set aside for charity. This may occur when a trust owns an interest in a pass-through entity such as a partnership or an S corporation that does not make cash distributions.

In *Estate of Freund v. Commissioner*,³⁰³ the decedent, a partner in a New York City law firm, left his residuary estate to charity. During the year in which the decedent died, the decedent's share of partnership income for the calendar year was \$35,000³⁰⁴ and the estate reported this amount of gross income, although the estate received only \$12,000—the balance of cash due after taking into account the cash previously distributed during the decedent's lifetime. The estate reported the entire \$35,000 of income and claimed a \$35,000 section 642(c) charitable deduction. The Court of Appeals for the Second Circuit allowed only a portion of the deduction. It held that while the estate must report \$35,000 of gross income,³⁰⁵ \$23,000 of the income was never actually received by the decedent's estate, was not actually included in the residuary estate, would not ultimately ever go to charity, and therefore could not be deducted.

In *Sid W. Richardson Foundation v. United States*,³⁰⁶ the estate owned all stock of an S corporation. The estate included all taxable income of the S corporation in its own gross income. During the years

301. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

302. *Estate of Bedford v. Comm'r*, 39 B.T.A. 1039 (1939), *nonacq.* 1939-2 C.B. 42.

303. *Estate of Freund v. Comm'r*, 303 F.2d 30 (2d Cir. 1962), *aff'g* 35 T.C. 629 (1961).

304. Before 1997, the taxable year of a partnership with respect to any partner did not close upon the death of a partner. The Code has been amended to change that result. See I.R.C. § 706(c)(2)(A); see also WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, 12-4 (4th ed. 2007).

305. Under current partnership tax rules (I.R.C. § 706(c)(2)), the income of the partnership earned before the decedent died would be included on the decedent's final income tax return, but § 706(c)(2) was not the law at the time Freund died.

306. *Sid W. Richardson Found. v. United States*, 430 F.2d 710 (5th Cir. 1970), *aff'g* 306 F. Supp. 755 (N.D. Tex. 1969).

at issue, the S corporation reported income to the estate while distributing nothing to it. The estate took deductions under section 642(c) for all that income. The Fifth Circuit disallowed the deduction on two grounds: "First, the undistributed income of [the S corporation] was never subject to the charitable provisions of the Will. Second, the amounts in question were not paid or permanently set aside or otherwise properly designated for charitable purposes."³⁰⁷

The outcome in *Richardson* might have been different if other funds held by the estate equal to the amount of the phantom income had actually been distributed to the charity. The court's grounds for denying a deduction would seem not to apply. In *Freund*, it does not seem likely that an alternative cash distribution was possible.

The Treasury Department issued final regulations in the spring of 2012 for section 642(c) concerning provisions in trusts or wills or local law that provide the tax character of the amounts paid to a charitable beneficiary of the trust or estate by designating the source of the income distributed.³⁰⁸ Such a so-called ordering provision might, for example, provide that income distributions to a charity are deemed to be paid first out of ordinary income of a trust before being deemed paid out of other types of income, such as long-term capital gains or tax-exempt income. The purpose of such a provision is to reduce the tax liability of an estate or a trust, or its beneficiaries, by leaving the estate or the trust, or its beneficiaries, taxable on classes of income that are taxed at lower rates or that are not taxable.

The regulations provide that a specific ordering provision must have "economic effect" independent of the income tax consequences. If the ordering in the governing instrument or local law does not have an independent economic effect, the types of income distributed to a charity will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes.³⁰⁹ Examples 1 and 2 of regulations sections 1.662(b)-2 and 1.662(c)-4(e) illustrate how the character of an amount paid to a charity, deductible under section 642(c), is determined when the ordering provision is ignored.³¹⁰

307. *Id.* at 712. See also *Estate of Esposito v. Comm'r*, 40 T.C. 459 (1963), *acq.* 1964-2 C.B. 3, in which the residue of the decedent's estate passed to charitable organizations. An asset of the estate was a personal holding company. To avoid an additional tax under section 541 on its undistributed income, the estate as a shareholder of the personal holding company consented to be treated as though it had received a dividend and took a set aside charitable deduction under section 642(c). The U.S. Tax Court disallowed the deduction because the income was not set aside for charity.

308. T.D. 9582, *Treas. Reg.* §§ 1.642(c)-3, 1.643(a)-5.

309. *Treas. Reg.* § 1.642(c)-3(b)(2).

310. *Treas. Reg.* § 1.643(a)-5(b).

The import of the regulation is obvious when applied to charitable lead trusts (CLTs). The regulations contain the following example:

Example 1. A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of \$10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the \$10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.³¹¹

The regulations provide also an example of when an ordering provision will have an independent economic effect.

Example 2. A trust instrument provides that 100% of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.³¹²

A provision of a trust providing that a charity is to receive the greater of a specified amount of the trust's ordinary income might satisfy the regulation, but this is likely only when the trust's ordinary income is the

311. Treas. Reg. § 1.642(c)-3(b)(2), ex. 1.

312. Treas. Reg. § 1.642(c)-3(b)(2), ex. 2.

higher amount, or at least has the potential to be higher. A “higher of” type of payment is permitted by the guidance for CLTs.³¹³

The charitable distribution must be out of income that is taxable if it is to be considered to be out of gross income, as required by section 642(c). In determining whether distributed trust income includes tax-free items not included in gross income, the governing instrument apparently may control the make-up of charitable distributions; otherwise charitable distributions are deemed to consist of the proportionate amounts of each item entering trust income, appropriately reduced by portions of deductions.³¹⁴ If capital gains are a part of the distribution, the charitable deduction is adjusted by reason of the special deduction allowed for capital gain.³¹⁵

Distributions from principal that are not gross income are not deductible under section 642(c). Estates have argued that when a charity is a beneficiary and a distribution is out of principal, a distribution deduction is available under section 661 because a section 642(c) deduction is not allowed.³¹⁶ Section 663(a)(2) denies a distribution deduction for charitable gifts of income that qualify under section 642(c): this prevents a double income deduction.³¹⁷ Courts have not been receptive to the taxpayer’s theory, but have noted that estate tax deduction is available for the devise.³¹⁸

313. See, e.g. Rev. Proc. 2008-45, § 5.02(7), 2008-2 C.B. 224.

314. Treas. Reg. § 1.642(c)-2; H.R. REP. NO. 83-1337, at A193, S. REP. NO. 83-1622, at 342; see I.R.C. § 643(a) (last sentence); Treas. Reg. § 1.662(b)-2. See, however, Priv. Ltr. Rul. 8940055 (Service refuses to respect “ordering” of classes of income instrument directs to be used in making annuity payments to charity from so-called charitable lead trust); Priv. Ltr. Rul. 9233038 (same). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

315. Treas. Reg. § 1.642(c)-3; I.R.C. § 1202. See also *United States v. Benedict*, 338 U.S. 692 (1950). However, the long-term capital gains deduction has been repealed for years after 1986.

316. *Mott v. United States*, 462 F.2d 512 (Ct. Cl.), cert. denied, 409 U.S. 1108 (1972); *U.S. Trust Co. v. Internal Revenue Serv.*, 803 F.2d 1363 (5th Cir. 1986); *Crestar Bank v. Internal Revenue Serv.*, 47 F. Supp. 2d 670 (E.D. Va. 1999).

317. *Statler Trust v. Comm’r*, 361 F.2d 128, 131–32 (2d Cir. 1966), referring to legislative history and emphasizing that the function of the section is to prevent double deductions. *Estate of O’Connor v. Comm’r*, 69 T.C. 165 (1977) (holding Treas. Reg. § 1.663(a)-2 valid); *Pullen v. United States*, 80-1 U.S. Tax Cas. (CCH) ¶ 9105 (D. Neb.), aff’d without opinion (8th Cir. 1980); *United Cal. Bank v. United States*, 439 U.S. 180 (1978); Rev. Rul. 68-667, 1968-2 C.B. 289.

318. *U.S. Trust Co. v. Internal Revenue Serv.*, 803 F.2d 1363 (5th Cir. 1986); *Pullen v. United States*, 80-1 U.S. Tax Cas. (CCH) ¶ 9105 (D. Neb.), aff’d without opinion (8th Cir. 1980).

When a trust or estate is an owner of an entity such as a partnership, the issue may arise as to whether the trust may deduct its share of a charitable contribution made by the partnership if the trust instrument does not authorize charitable gifts of income. In Revenue Ruling 2004-5,³¹⁹ the Service ruled that a trust was allowed a deduction under section 642(c) for the trust's distributive share of a charitable contribution made by the partnership from the partnership's gross income even though the governing instrument of the trust neither authorized nor directed the trustee to make distributions to charity. It seemed important in the ruling that the partnership made the charitable contribution from its gross income.

In Revenue Ruling 2003-123,³²⁰ a trust was not allowed an income tax deduction under section 642(c) for the transfer of a qualified conservation easement described in section 170(h). The trust instrument permitted the grant of the easement to charity, but it was not made from the trust's gross income. This result was confirmed in *Goldsby v. Commissioner*,³²¹ in which the Tax Court held that a conservation easement was not deductible when it was not made from income.

The rules concerning trusts that own stock of S corporations vary. The regulations for the S portion of an ESBT described in section 1361 provide that if an S corporation makes a charitable gift from gross income, the contribution will be deemed to satisfy the rules of section 642(c), but the limitation of section 681 regarding unrelated business income still applies.³²² This may mean that the charitable deduction may be lost if the charitable gift is not from gross income.

If a trust is a qualified shareholder of S corporation stock because of a Qualified Subchapter S Trust (QSST) election, the charitable deduction may pass through to the individual who has elected to be treated as the owner of the S shares held by the trust. The QSST election makes the trust beneficiary a section 678 deemed grantor of the trust

319. Rev. Rul. 2004-5, 2004-1 C.B. 295. *See also* Chief Couns. Adv. 200928029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

320. Rev. Rul. 2003-123, 2003-2 C.B. 1200. *See also* Chief Couns. Adv. 200928029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

321. *Goldsby v. Comm'r*, T.C. Memo. 2006-274. The Tax Court found that the trust was a grantor trust as to income, but not as to principal. Thus, when the taxpayer did not prove the contribution was from income no charitable deduction was allowed. The court in footnote 3 entertained the idea, but did not rule, that if the trust was a grantor trust as to principal, the beneficiary might have been entitled to the deduction.

322. Treas. Reg. § 1.641(c)-1(d)(2)(ii).

and as a result the income and deductions of the trust are reportable on the beneficiary's personal return. If this analysis is correct, a trust that can qualify as a QSST might be able to secure a charitable deduction for a gift of principal by transferring property to an S corporation if the S corporation makes a charitable contribution. Of course, a trustee who considers this must evaluate the fiduciary issues surrounding a gift of principal when the gift may be inconsistent with the settlor's intent. In a footnote in *Goldsby v. Commissioner*,³²³ the Tax Court entertained the idea that if the trust was a grantor trust as to both income and principal, the beneficiary might have been entitled to the pass-through charitable deduction, but did not rule on the question.

In Revenue Ruling 78-24,³²⁴ the Service ruled that the section 642(c) deduction for capital gains incurred in trust's year of termination is limited to the lesser of the capital gain (properly adjusted) or the amount actually paid to the charitable remainderman. In the ruling, capital gains were realized when a terminating trust sold assets to meet a requirement of its governing instrument that it make a payment of a specified amount to a noncharitable trust, and the remainder was payable to a charitable organization. However, in Revenue Ruling 83-75,³²⁵ a trust was permitted to take a section 642(c) deduction for gain, properly adjusted, recognized on an in-kind distribution of an asset in satisfaction of charity's right to an annuity.³²⁶

Under the particularized limitations for trusts, no deduction is allowed under section 642(c) to the extent it is allocable to unrelated business income for the year.³²⁷ This limitation is not applicable to estates.³²⁸ A trust's unrelated business taxable income is the amount that would be unrelated business income under section 512 if the trust were exempt from taxation under section 501(a) by reason of section 501(c)(3). This has the effect of placing the section 170 limitations for individuals (that is, 20% to 50% of the taxpayer's contribution base) on the trust to the extent that the deduction is allocable to the unrelated business income.

323. *Goldsby v. Comm'r*, T.C. Memo. 2006-274, n.3. The Tax Court found that the trust was a grantor trust as to income, but not as to principal. Thus, when the taxpayer did not prove the contribution was from income no charitable deduction was allowed.

324. Rev. Rul. 78-24, 1978-1 C.B. 196.

325. Rev. Rul. 83-75, 1983-1 C.B. 114.

326. *See also* Priv. Ltr. Rul. 9044047. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

327. I.R.C. § 681(a); Treas. Reg. § 1.681(a)-1. *See also* I.R.C. § 512(a)(1), (b)(11); Rev. Rul. 79-223, 1979-2 C.B. 254.

328. I.R.C. § 642(c)(4), last sentence, limits the disallowance to trust, whereas the remainder of subsection (c)(4) is applicable estates and trusts.

The section 642(c) deduction is disallowed for payments to private foundations and certain charitable and split-interest trusts treated as private foundations under section 4947, if the recipient's governing instrument does not contain certain requirements and prohibitions.³²⁹ Also, the deduction will be disallowed for certain transfers to certain foreign foundations that engage in or have engaged in certain prohibited transactions.³³⁰

[K] Credits Against Tax

Tax credits directly reduce tax liability rather than reduce taxable income as deductions may. Credits against the income tax consist of refundable and nonrefundable credits.³³¹ Generally, an estate or trust is entitled to the same credits as those of an individual. However, unused tax credits of a decedent do not appear to be available to the decedent's estate. The decedent and the estate are different taxpayers and the Code has no provision permitting the estate, as the successor to the decedent, to claim the unused tax credits of the decedent.

For individuals, refundable credits include the credit for taxes withheld from salary or wages,³³² the earned income credit available to certain individuals who have qualifying children and earned income,³³³ the credit for tax withheld at the source of nonresident aliens and foreign corporations,³³⁴ the credit for federal excise taxes on gasoline and special fuels in some cases,³³⁵ and the credit for capital gains tax paid by a regulated investment company (a mutual fund).³³⁶ Although the Code does not contain any specific rules about how or when these refundable credits apply to estates and trusts, it seems as though all are available to an estate or trust except for the earned income and withholding on wages and salary credits.³³⁷ An estate or trust may be entitled to a credit for back-up withholding under

329. I.R.C. §§ 681(b), 508(d), 508(e).

330. I.R.C. §§ 681(b), 4948(c)(4).

331. A refundable tax credit is one that will result in a cash refund to a taxpayer who does not use it to offset a tax liability; a non-refundable credit is a tax credit that is wasted if it does not offset a current tax liability.

332. I.R.C. § 31.

333. I.R.C. § 32.

334. I.R.C. § 33.

335. I.R.C. § 34.

336. I.R.C. § 852(b)(3)(D)(ii).

337. For withholding on wages and salary, see Tech. Adv. Mem. 200644018, which concludes that neither sections 31(a) or 643(d) apply to the withholding credit under section 31(a), unless the trust is a grantor trust. Also the instructions for Form 1041 state that withheld income tax (other than backup withholding) does not pass through to beneficiaries. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

section 3406. Note that the allocation of the credit to the beneficiary is treated as though an amount equal to that credit has been paid to him by the estate or trust.³³⁸

Some of the non-refundable credits are personal credits that are not available to estates and trusts. These include the child and the dependent care credit which applies to certain gainfully employed persons,³³⁹ and the elderly or permanently and totally disabled credit.³⁴⁰ The interest on certain home mortgages credit³⁴¹ is available only for an indebtedness on a home owned by a trust and used by a trust beneficiary having a current interest in the trust and that constitutes qualified residential indebtedness.³⁴²

Other non-refundable credits appear to be available to estates and trusts. These include the foreign tax credit,³⁴³ the alternative fuels credit,³⁴⁴ the qualified electric vehicles credit,³⁴⁵ the credit for prior minimum tax,³⁴⁶ and the business-related credit,³⁴⁷ which in turn is comprised of several credits, including the investment credit under section 46.

Section 52(d) provides that the section 51 work opportunity credit is shared between the estate or trust and the beneficiaries on the basis of the income that is allocable to each.³⁴⁸ Section 41(f)(2)(A) provides that the section 41 credit for increasing research activities is apportioned using rules similar to section 52(d);³⁴⁹ section 45K(d)(8) provides that the section 45K credit for producing fuel from a non-conventional source is apportioned using rules similar to section 52(d); and the section 40A credit for biodiesel and renewable diesel is apportioned using rules similar to section 52(d). Section 42(i)(6) provides that the section 42 low-income housing credit is shared between the entities and the beneficiaries on the basis of the income that has passed to the beneficiaries. This is the same statutory scheme as section 52(d), but section 52(d) is not referenced. Similarly, the regulations for the investment credit under section 46 provide

338. See I.R.C. §§ 3406(h)(10), 643(d).

339. I.R.C. § 21.

340. I.R.C. § 22.

341. I.R.C. § 25.

342. I.R.C. § 163(h)(4)(D).

343. I.R.C. § 27.

344. I.R.C. § 45K.

345. I.R.C. § 30.

346. I.R.C. § 53.

347. I.R.C. § 38.

348. See I.R.C. § 52(d). This section refers to credits in "this subpart." The applicable subpart is G and the only credit covered is the section 51 work opportunity credit.

349. See also Treas. Reg. § 1.41-7(a)(2).

for an apportionment between the estate or trust and the beneficiary.³⁵⁰ Guidance is provided also for apportioning the foreign tax credit allowed under section 901.³⁵¹

The Code does not provide specific rules about how many of the other credits are to be apportioned between an estate or trust and the beneficiaries. It seems that they might be apportioned as the credits under sections 52, 45K, 46, 42, 41, and 40A are apportioned—that is, as accounting income is apportioned between them.³⁵² Nevertheless, a more appropriate method might be to apportion each credit between the fiduciary and the beneficiaries based upon how the income of the activity that gave rise to the credit is apportioned between them. For example, the credit for capital gain taxes paid by a regulated investment company might more appropriately be apportioned to the fiduciary rather than the beneficiary in those cases in which the capital gain is not attributed to the beneficiary, which is the more common scenario.

At the time an estate or trust closes, the unused credits of an estate or trust probably are not available to the beneficiaries of the estate or trust under the authority of section 642(h) as do most deductions in excess of income and to unused capital-loss and net-operating carryovers.³⁵³ Without statutory authority to support the use of excess credits by the beneficiaries, the credits probably are not unavailable to the beneficiaries, except as generally available under the rules discussed above.³⁵⁴

The \$25,000 threshold amount specified in section 38 (relating to the limitation of the general business credit under that section) is reduced proportionately for an estate or trust to the extent that its

350. Treas. Reg. § 1.48-6(a).

351. I.R.C. §§ 642(a), 901(b)(5); Treas. Reg. § 1.642(a)(2)-1.

352. See I.R.C. § 48(f), as in effect before the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508. I.R.C. § 50(d)(6) directs that rules similar to those contained in I.R.C. § 48(f), as in effect prior to its repeal by that Act, are to continue to apply.

353. See section 3:9, *infra*, for a full discussion of section 642(h) and when excess deductions are available to estate and trust beneficiaries.

354. The legislative history of section 642(h) discusses only excess deductions and carryovers. It provides:

(b) Subsection (h) of section 642 appeared in substance in the House bill as section 662 (d), relating to excess deductions on termination available to beneficiaries. Under this provision, unused loss carryovers and deductions in excess of gross income in the year of termination of the estate or trust are made available to the remainderman to whom the property is distributed. Under existing law, these unused carryovers and excess deductions are wasted when the estate or trust terminates.

income is allocated to its beneficiaries,³⁵⁵ and any beneficiary to whom any investment is apportioned is treated as the taxpayer for that investment and the property does not lose its character as an investment in new or used “section 38 property.” The \$25,000 credit limit (plus the percentage limit) under section 38(c)(1) is reduced for an estate or trust to an amount that bears the same ratio to \$25,000 as the amount of the qualified investment allocated to the estate or trust bears to the entire amount of the qualified investment.³⁵⁶

Upon election by the trustee, estimated payments of tax made by a trust may be treated as a payment made by the trust’s beneficiary. In addition, upon election by the personal representative, estimated payments of tax made by an estate may be treated as estimated tax payments of the estate’s beneficiary, but only for the taxable year reasonably expected to be its last.³⁵⁷ This election is discussed in greater detail in section 3:8.

In *Estate of Good v. United States*³⁵⁸ the district court held that an estate is entitled to the credit available under section 1341 when a decedent’s estate repays an amount previously reported in income by the decedent.³⁵⁹ Initially, the Service announced it would not follow the result in *Good*,³⁶⁰ but subsequently reversed itself when another district court³⁶¹ ruled for the taxpayer on this issue.³⁶²

The district court’s decision in *Good* (and the district court’s decision in *Nalty*^{362.1}) and the Service’s agreement with those decisions in Revenue Ruling 77-322 are subject to the Eleventh Circuit’s opinion in *Batchelor-Robjohns*,^{362.2} which affirmed the district court’s ruling that section 642(g) prevented the estate from claiming an estate tax deduction and an income tax deduction. The *Batchelor-Robjohns* court concluded that payments could not be estate tax deductions and income tax deductions unless deductible under sections 162, 163, 164, 212, or 611 or a credit specified in section 27. The taxpayer argued that payment was within the mitigation provisions of section 1341 and, therefore, deductible. The Eleventh Circuit concluded that

355. I.R.C. § 38(c)(5)(D). See *Brown v. Comm’r*, 75 T.C. 172 (1980) (trust beneficiaries, as transferees of beneficial interests in trusts, not required to recapture investment credits taken by trusts; rather, trusts should have recaptured upon termination).

356. I.R.C. § 38(c)(5)(D).

357. I.R.C. § 643(g).

358. *Estate of Good v. United States*, 208 F. Supp. 521 (E.D. Mich. 1962).

359. A discussion of section 1341 is beyond the scope of this book.

360. Rev. Rul. 67-355, 1967-2 C.B. 296.

361. *Nalty v. United States*, Civ. No. 73-1574 (E.D. La. Apr. 16, 1975).

362. Rev. Rul. 77-322, 1977-2 C.B. 314.

362.1. See note 361, *supra*.

362.2. *Batchelor-Robjohns v. United States*, 788 F.3d 1280 (11th Cir. 2015).

section 1341 applied only if a deduction (or credit) is allowable under another section of the code, which it was not in the case because of section 642(g). For a further discussion of section 642(g) see section 2:3.3, which more fully considers section 691(b).

Similar to this—although not a tax credit—is an adjustment allowable by section 1311 and applicable to trusts or estates and their beneficiaries, legatees, or heirs, for double inclusions in or exclusions from income or double allowance or disallowance of deductions.³⁶³

[L] Section 1031 Like-Kind Exchanges

Trusts, like other taxpayers, may enter into like-kind exchanges. No special rules apply. Nevertheless, under section 1031(f) special rules do apply to non-recognition exchanges between related parties if there is a subsequent disposition of the exchanged property within two years of the initial exchange. For this purpose, section 1031(f) incorporates the definition of related person provided for in section 267(b), which includes certain trusts, grantors, and beneficiaries. When a like-kind exchange is contemplated, the related party rules should be closely studied.

Among the rules of section 1031 is the requirement that the taxpayer hold the property received in the exchange for use in a trade or business or for investment immediately after the exchange. In Private Letter Ruling 200521002,³⁶⁴ a trust nearing its termination date sought and received a court order regarding the distribution of trust assets upon termination. This plan included the distribution of some of its real estate to a single-member LLC, which would be distributed to the beneficiaries of the trust upon termination of the trust. On a different date, the trust entered into an exchange agreement for a parcel of real estate owned by the trust. That exchange occurred before the proposed transfer of the replacement property to the LLC. In the ruling, the trust requested a ruling as to whether the transfer of the property received in the exchange to the LLC and the subsequent distribution of the LLC on termination of the trust jeopardized the section 1031 exchange. The Service ruled that the termination of the trust, as approved by the probate court, was an independent event that did not disqualify the section 1031 transaction.³⁶⁵ The private ruling distinguished two revenue rulings, one which involved a section 1031 exchange followed by a section 351

363. I.R.C. § 1312(5).

364. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

365. See also Priv. Ltr. Rul. 8126070. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

contribution to a corporation,³⁶⁶ and another involving a liquidation of a corporation followed by a section 1031 exchange of the property received from the corporation.³⁶⁷

[M] Section 199 Deduction for Income Attributable to Domestic Production Activities

The American Jobs Creation Act of 2004³⁶⁸ added section 199 to permit a deduction related to qualified production activities income (QPAI), and the Tax Increase Prevention and Reconciliation Act of 2005 amended section 199.³⁶⁹ Final regulations issued in 2006 provide complex rules for the determination of the section 199 deduction for trusts that are not grantor trusts.³⁷⁰ Generally, the computations under section 199 are based on the portion of the trust's or estate's distributable net income that is deemed distributed to the beneficiaries.³⁷¹ For tax years beginning on or before May 17, 2006, the regulations provide that to the extent DNI is not distributed, or if the trust or estate has no DNI, the section 199 deduction may be claimed by the estate or trust to the extent of its share of QPAI.³⁷²

In October 2006, the Treasury issued Temporary Regulations section 1.199-5T for tax years beginning after May 17, 2006.³⁷³ Under the temporary regulations non-grantor trusts and estates determined QPAI and W-2 wage expenses at the entity level for both itself and its beneficiaries. The allocation of these between the entity and its beneficiaries is based on relative portion of DNI distributed or required to be distributed and DNI retained by the estate or trust.³⁷⁴ For entities that have no DNI, the entire QPAI and W-2 wages are allocated to the entity.³⁷⁵

In addition, the temporary regulation provides guidance for the allocation of directly related and non-directly related expenses among classes of income, including depreciation and depletion, as well as expenses coming from other pass-through entities.³⁷⁶ Moreover,

366. Rev. Rul. 75-292, 1975-2 C.B. 333.

367. Rev. Rul. 77-337, 1977-2 C.B. 305.

368. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

369. The Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (2005).

370. Treas. Reg. § 1.199-9(e). See chapter 5 for a discussion of when the trust is a grantor trust.

371. *Id.*

372. *Id.*

373. Treas. Reg. § 1.199-5T. The regulations are effective as of October 19, 2006.

374. Temp. Treas. Reg. § 1.199-5T(e)(2).

375. *Id.*

376. Temp. Treas. Reg. § 1.199-5T(e)(1). For a general discussion of allocating expenses between various classes of income when a portion of income is exempt from taxation, see section 3:2.1[I].

the temporary regulation contains a lengthy example of how the section 199 rules apply including how they apply to a trust that is a partner in a partnership with qualifying expenses.³⁷⁷

For grantor trusts, the QPAI and W-2 wage limitation is computed as though the activities had occurred directly.³⁷⁸

[N] Disposition of Installment Obligations

Section 453B provides that the disposition of an installment obligation triggers the recognition of income with the transfer. An exception exists for the disposition of some installment obligations that are section 691 items of income in respect to a decedent (IRD).³⁷⁹ A general discussion of section 453B is beyond the scope of this book, but a few situations should be noted. In *Shannon v. Commissioner*,³⁸⁰ the Tax Court held that an estate that distributed installment notes to its beneficiaries triggered the recognition of gain as a disposition of an installment obligation. The notes transferred were received by the estate in exchange for property the estate sold. Thus, the notes were not section 691 IRD. The Service has ruled similarly in Revenue Ruling 55-159.³⁸¹

The transfer of an installment obligation by a trust similarly causes the recognition of income.³⁸² This is consistent with the rule that a gift of installment note is a taxable disposition.³⁸³ This rule is not applicable if the transferee-trust is a grantor trust.³⁸⁴

[O] Disposition of Real Property by a Nonresident Alien or a Foreign Corporation Owned Through an Estate or Trust

Section 897 provides that money or property received by a non-resident alien or a foreign corporation in exchange for some or all of the seller's interest in the estate or trust, to the extent of U.S. real property interests of the entity, is deemed "an amount received from

377. Temp. Treas. Reg. § 1.199-5T(e)(4).

378. Temp. Treas. Reg. § 1.199-5T(d).

379. See section 2:3.2, *supra*, for a discussion of the income in respect of a decedent exception to section 453B.

380. *Shannon v. Comm'r*, 29 T.C. 702 (1958). See also *Rogers v. Comm'r*, 143 F.2d 695 (2d Cir. 1944) (when an estate makes a similar distribution).

381. Rev. Rul. 55-159, 1955-1 C.B. 391.

382. *Legg v. Comm'r*, 496 F.2d 1179 (9th Cir. 1974). See also *Smith v. Comm'r*, 56 T.C. 263 (1972); Rev. Rul. 76-530, 1976-2 C.B. 132.

383. Rev. Rul. 79-371, 1979-2 C.B. 294.

384. Rev. Rul. 74-613, 1974-2 C.B. 153. See also *Flacco v. Comm'r*, T.C. Memo. 1985-393; Rev. Rul. 67-70, 1967-1 C.B. 106; Rev. Rul. 81-98, 1981-1 C.B. 40.

the sale or exchange in the United States of such property.”³⁸⁵ Executors and trustees of such trusts are subject to the withholding provisions of section 1445 with respect to certain dispositions of U.S. real estate.³⁸⁶ In addition, the percentage ownership of a trust’s or an estate’s foreign beneficiaries must be determined when U.S. real property is sold because the foreign beneficiary is taxable to the extent of the foreign beneficiary’s proportional interest.³⁸⁷

§ 3:2.2 Beneficiaries

When a trust’s or estate’s deductions, other than depreciation and depletion, exceed taxable income, there is no provision for the excess deductions to pass through to a beneficiary. For example, if a trust with unproductive property, that is, a trust with little or no income, pays a trustee’s fee, the amount of the fee in excess of income is not deductible by the trust’s beneficiaries. In the year a trust or estate terminates, it is possible that deductible expenses may exceed trust income. Section 642(h) provides that if the deductions for the final taxable year of the estate or trust are in excess of gross income, the excess will, under regulations, be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.³⁸⁸ Likewise, the beneficiaries are allowed in the final year any net-operating-loss carryover or capital-loss carryover of the estate or trust.³⁸⁹ The characterization of capital losses as short-term or long-term in the hands of the beneficiary is the same as it was for the trust, except if the beneficiary is a corporation, all capital losses are short-term.³⁹⁰

385. I.R.C. § 897(g). This rule is subject to the Treasury Department issuing regulations, which it has not yet done, although it has issued Treas. Reg. 1.897-7T, which provides guidance for partnerships under the authority of the same Code subsection.

386. I.R.C. § 1445(e).

387. Treas. Reg. §§ 1.897-1(e)(1), -1(e)(3).

388. *Westphal v. Comm’r*, 37 T.C. 340 (1961), *petition to review dismissed*, 317 F.2d 365 (8th Cir. 1963) (not terminated so long as a taxable entity under I.R.C. § 641). The separate-share rule of I.R.C. § 663(c) does not extend so as to make I.R.C. § 642(h) applicable merely upon termination of a separate share in the trust. Treas. Reg. § 1.663(c)-1(b)(3). *See* ESTATE TAX TECHNIQUES §§ 32.03[4]–32.04[3] (J. Lasser ed., 1989) (which states, in part, that the Service has indicated in a private ruling that the remainder beneficiary is entitled to deduct under I.R.C. § 642(h) the full amount by which the deductions for his separate share of the remainder exceed the income of his separate share); *Kitch v. Comm’r*, 104 T.C. 1 (1995), *aff’d*, 103 F.3d 104 (10th Cir. 1996) (beneficiaries of mother’s estate could not deduct loss in father’s estate where mother not beneficiary of father’s estate); *O’Bryan v. Comm’r*, 75 T.C. 304 (1980) (excess deductions computed without regard to charitable deduction under I.R.C. § 642(c) or personal exemption under I.R.C. § 642(b)).

389. I.R.C. § 642(h)(1).

390. Treas. Reg. § 1.642(h)-1(b).

The Tax Court in *Nemser v. Commissioner*,³⁹¹ held that a purchaser of interest in a testamentary trust was not a beneficiary succeeding to property of estate or trust under section 642(h).³⁹²

The excess deductions are allowed only in computing the beneficiary's taxable income, that is, the deductions are itemized deductions (and not adjustments to gross income). This means that the deductions may be subject to the rules of sections 67 and 68.³⁹³ Moreover, the excess deductions are taken into account in computing the beneficiary's tax preference items.³⁹⁴ The excess deductions are allowed only for the taxable year of the beneficiary in which or with which the estate or trust terminates.³⁹⁵

Excluded from the carryout of excess deductions rule is the trust or estate's personal exemption under section 642(b) and the charitable deduction under section 642(c). When the deductions in the final year include the personal exemption, a charitable deduction and other deductions, a question arises as to which deductions offset the income of the trust or estate and which deductions are the "excess." The Tax Court in *O'Bryan v. Commissioner*³⁹⁶ ruled that the charitable deduction is deemed the last deduction used to offset income of the estate or trust. This means that if the deductions do not exceed income without the charitable deduction, there is no excess to flow out under section 642(h), and if the other deductions exceed income, then the pass-out of excess deductions is limited to the amount the other deductions exceed income.

Involuntary-conversion benefits can also carry out to beneficiaries in the year of termination.³⁹⁷

When an estate terminates and pays over to a trust, the estate's excess deductions pass out to the trust. However, the excess deductions will not pass out to the trust's beneficiary unless the trust terminates as well.³⁹⁸

A trust's operating loss carryback permits the recomputation of the beneficiaries' income for the earlier year because the carryback affects distributable net income.³⁹⁹

391. *Nemser v. Comm'r*, 66 T.C. 780 (1976), *aff'd*, 556 F.2d 558 (2d Cir. 1977), *cert. denied*, 434 U.S. 855 (1979).

392. *See* Rev. Rul. 87-97, 1987-2 C.B. 155 (distributions of funds by perpetual care trust to cemetery corporation for care/maintenance of gravesites not deductible under I.R.C. § 651 or 661 because not made to corporation as beneficiary but as compensation for services).

393. *Treas. Reg.* § 1.642(h)-2(a).

394. *Id.*

395. *Id.*

396. *O'Bryan v. Comm'r*, 75 T.C. 304 (1980).

397. *Rev. Rul.* 58-407, 1958-2 C.B. 404.

398. *Rev. Rul.* 57-31, 1957-1 C.B. 201.

399. *Rev. Rul.* 61-20, 1961-1 C.B. 248.

The regulations contain rules for the allocation of these items to the succeeding beneficiaries, and they attempt to allocate them to the beneficiaries who bear the burden of the loss.⁴⁰⁰ An example in the regulations provides:

A decedent's will leaves \$100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only \$90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of \$5,000, and a capital loss carryover of \$15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of \$10,000, and since the total of the excess of deductions and the loss carryover is \$20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.⁴⁰¹

When a trust terminates, the issue has arisen of whether and how to allocate expenses to tax-exempt income and the application of the disallowance rule of section 265.⁴⁰² For example, in Revenue Ruling 77-466, the Service ruled that a reasonable part of some expenses paid in the year of termination must be disallowed under section 265 if the trust owned tax-exempt bonds at some time during the term of trust, even if the exempt bonds were not held in trust during its final year.⁴⁰³

On the termination of any portion (which, presumably, includes all) of an electing small business trust described in section 1361(e), the loss carryover or excess deductions referred to in section 642(h) are taken into account by the entire trust.⁴⁰⁴

400. Treas. Reg. §§ 1.642(h)-4, -5.

401. Treas. Reg. § 1.642(h)-4, ex.

402. See section 3:2.1[I] for a discussion of I.R.C. § 265.

403. Rev. Rul. 77-466, 1977-2 C.B. 83. *See also* Comm'r v. Wade, 155 F.2d 918 (2d Cir. 1946); *cf.* Whittemore v. United States, 383 F.2d 824 (8th Cir. 1967); Chapman & Strassler, *How to Reap the Fullest Tax Advantages from an Estate or Trust on Termination*, 5 EST. PLAN. 2, at n.15 (1978). *See also* Case v. United States, 66-2 U.S. Tax Cas. (CCH) ¶ 9764 (D. Wyo. 1966) (not finding unreasonable Commissioner's allocation of trustees' termination commissions on basis of ratio of value of tax-free assets to value of total corpus at time of termination and disallowance of executors' and attorneys' fees on the ratio of total claimed as deductions as value of tax-free assets disbursed or distributed plus accrued interest bears to total assets disbursed or distributed); Fabens v. Comm'r, 519 F.2d 1310 (1st Cir. 1975) (Commissioner's disallowance of trustees' termination commissions on ratio of tax-exempt income over life of trust to total income should have considered unrealized gains); Rev. Rul. 77-355, 1977-2 C.B. 82 (simple trust may not consider capital gains not included in distributable net income to allocate indirect expenses to tax-free income) (distinguishing Rev. Rul. 73-565, 1973-2 C.B. 90); Rev. Rul. 80-165, 1980-1 C.B. 134 (same as to tax-free dividend that reduces basis).

404. I.R.C. § 641(c)(4). Treas. Reg. § 1.641(c)-1(j) confirms the application of I.R.C. § 642(h) if the entire ESBT election terminates or is revoked and

In *L.P. Whitehead Foundation, Inc. v. United States*,⁴⁰⁵ the court held that a private foundation that was a remainder beneficiary of a trust could not use excess deductions in the year of termination in computing its excise tax liability under section 4940 on its net investment income.

§ 3:3 “Income” and “Distributable Net Income”

Subchapter J uses the word “income” in several different Code sections and with differing meanings. The root use of the word “income” appears in section 643(b), which defines “income,” when unmodified by words such as “taxable,” “distributable net,” “undistributed net,” or “gross,” to mean either income as defined in the governing document or under state law.

A second critical use of the word “income” is in the term “distributable net income” that is defined in section 643(a). The amount of income taxable to the beneficiaries of a trust or estate in any year is limited by that year’s “distributable net income,”⁴⁰⁶ even if the total distributions are greater: distributions in excess of “distributable net income” are generally not taxable.⁴⁰⁷ Moreover, a special deduction is permitted to an estate or trust for distributions to beneficiaries, but the amount of that deduction is limited by “distributable net income.”⁴⁰⁸ Distributable net income is commonly referred to as “DNI.”

Both of these concepts are discussed in detail below.

§ 3:3.1 “Income”

Section 643(b) provides that “income” when unmodified means “the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.”⁴⁰⁹ The 2004 regulations provide that “[t]rust provisions that depart fundamentally from *traditional principles of income and principal* will generally not be recognized” for such purposes.⁴¹⁰ The pre-2004 regulations provided that provisions in the governing instrument that “depart *fundamentally from concepts of local law* in the determination

raises a question if the rule is applicable if only a portion of the ESBT election terminates or is revoked. A partial termination might occur if the trust owns stock in more than one S corporation and disposes of the stock in one S corporation but retains stock in another S corporation.

405. *L.P. Whitehead Found. v. United States*, 606 F.2d 534, 539 (5th Cir. 1979).

406. I.R.C. §§ 652(a), 662(a).

407. I.R.C. §§ 652(a), 662(a). If the throwback rules apply, distributions in excess of DNI may be gross income to the recipient. For more discussion of the throwback rules, see section 3:6.

408. I.R.C. §§ 651(b), 661(c).

409. I.R.C. § 643(b).

410. Treas. Reg. § 1.643(b)-1 (2004) (emphasis added).

of what constitutes income are not recognized” for federal tax purposes.⁴¹¹ In essence, the word income means the estate’s or trust’s fiduciary accounting income.

Nevertheless, the Code provides a few special rules for distinguishing income and principal for section 643(b) purposes. For example, it permits a fiduciary in good faith to allocate taxable extraordinary dividends or taxable stock dividends to corpus under the terms of the governing instrument and applicable local law without those items being considered “income” for section 643(b) purposes.⁴¹² On the other hand, this deference to the document is not unfettered. The applicable regulations provide that if a trust directs that dividends and interest are principal, the trust will not be considered to be a trust that is required to distribute all of its accounting income.⁴¹³

Moreover, the Service and the courts have provided additional nuances. For example, in Revenue Ruling 90-82,⁴¹⁴ the Service ruled that a direction in a trust to pay the principal part of mortgage payments from accounting income departed fundamentally from local law where the state had adopted the Revised Uniform Income and Principal Act, which charges mortgage principal payments to corpus. On the other hand, in *Crisp v. United States*,⁴¹⁵ capital gains were treated as accounting income because the trust instrument authorized “net profits” to be distributed to an income beneficiary and because local law (Texas) looked to the trust to determine if capital gains were allocable to corpus. In addition, several private letter rulings concerning the determination of trust accounting income of a net income charitable remainder trust⁴¹⁶ conclude that governing document provisions of a trust will not be regarded as fundamentally departing from local law if local law rules apply in determining income and corpus only in default of explicit provisions in the governing instrument.⁴¹⁷

The amount of accounting “income” under a will or trust instrument, as interpreted under local law, may differ considerably from taxable income. For example, capital gains of a trust generally

411. Treas. Reg. § 1.643(b)-1 (2003) (emphasis added).

412. Treas. Reg. § 1.643(b)-1.

413. *Id.* Whether a trust is required to distribute all of its accounting income has meaning for purposes of the I.R.C. § 642 personal exemption and the I.R.C. §§ 651 and 652 rules concerning simple trusts.

414. Rev. Rul. 90-82, 1990-2 C.B. 44.

415. *Crisp v. United States*, 34 Fed. Cl. 112 (1995).

416. A net income charitable remainder trust is a trust that distributes the lesser of its trust accounting income or the unitrust amount. *See* I.R.C. § 664(d)(3).

417. *See, e.g.,* Priv. Ltr. Ruls. 9511007, 9511029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

are added to accounting principal rather than to income.⁴¹⁸ In this case, the gain is not accounting income, but is still gross income and potentially taxable income. Items that are income in respect of a decedent,⁴¹⁹ such as payments on installment sale notes and IRA distributions, are other examples of gross income that may be allocated to fiduciary accounting principal.⁴²⁰ When a trust or estate receives tax-exempt income allocable to accounting income, the amount of fiduciary accounting income may exceed the taxable income of the trust or estate.

Tax deductions may cause accounting income to differ from taxable income, as well. For example, a portion or all of trustee's commissions may be chargeable to corpus,⁴²¹ but are fully deductible for tax purposes. Note that the Proposed Regulations section 1.67-4 requires the fiduciary to unbundle the commissions to identify the portion not within the exception of section 67(e) and thus subject to the general 2% disallowance rule of section 67.⁴²² In the case of a deductible expense chargeable to principal, the amount of fiduciary accounting income can exceed the trust's taxable income. On the other hand, to the extent that expenses such as investment adviser fees are not deductible because of section 67, accounting income may be less than taxable income.⁴²³

Example: A trust realizes \$5,000 of capital gain that is allocated to corpus and \$10,000 of ordinary income that is distributed to a beneficiary and it has a \$2,000 tax deduction (such as trustee's commissions) chargeable to corpus. Distributable net income will be \$8,000. \$2,000 of the \$10,000 that the beneficiary receives is tax-free. The capital gain will be taxable to the trust, while the benefit of the tax deduction has, in effect, been entirely allocated to beneficiary because it is used to determine DNI, which is the maximum amount of income the beneficiary must report.

Thus, the more deductible expenses are charged to corpus, the greater the after-tax income received currently by the beneficiaries will be, at the expense of principal. One of the chief criticisms that has been made of the 1954 Code in the trust area is that in such a case the

418. UNIFORM PRINCIPAL AND INCOME ACT § 404 (1997). *See* Appendix F.

419. Income in respect of a decedent is discussed in section 3:3.2[J].

420. UNIFORM PRINCIPAL AND INCOME ACT § 409 (1997). *See* Appendix F.

421. *See* UNIFORM PRINCIPAL AND INCOME ACT §§ 501-02 (1997), providing that Trustees are chargeable one-half to income and one-half to principal. *See* Appendix F.

422. Prop. Treas. Reg. § 1.67-4(c).

423. *See* section 3:2.1[G] for a discussion of I.R.C. § 67.

attempt to avoid wasted deductions has been carried too far, and the income beneficiaries are given the benefit of principal expenses even where enough taxable income is retained by the trust for the principal account to absorb the tax deductions.⁴²⁴

In response to many states adopting the 1997 Uniform Income and Principal Act with its power to adjust⁴²⁵ and the unitrust conversion option,⁴²⁶ the Treasury Department adopted new, final regulations defining “income,” that is, fiduciary accounting income for purposes of section 643(b) and other sections of the Code.⁴²⁷ Generally, the new regulations are effective January 2, 2004 and apply to tax years ending thereafter.⁴²⁸

The 2004 regulations provide that “[t]rust provisions that depart fundamentally from *traditional principles of income and principal* will generally not be recognized” for such purposes.⁴²⁹ The pre-2004 regulations provided that provisions in the governing-instrument that “depart *fundamentally from concepts of local law* in the determination of what constitutes income are not recognized” for federal tax purposes.⁴³⁰

424. See examples in Fillman, *Selections from Subchapter J*, 10 TAX L. REV. 453, 460 (1955); Soll, *Simple Trusts Under 1954 Code*, 94 TR. & EST. 916 (1956); *Mfrs. Hanover Trust Co. v. United States*, 312 F.2d 785 (Ct. Cl.), cert. denied, 375 U.S. 880 (1963) (justifying regulatory allocation of deductions against tax-free portion of distributable net income). See generally Miller & Yellon, *Give Trustee Power to Compensate for Tax Shifted by Discretionary Act*, 11 J. TAX’N 374 (1959). Under state law, the trustees might be required to adjust this distortion if it arises out of a discretion or option exercised by them, but perhaps not if it arises out of nonelective operation of law, as in the example of the text. See generally Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Worms*, 65 IOWA L. REV. 103 (1979); Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 INST. ON EST. PLAN. 1400 (1984).

425. UNIFORM PRINCIPAL AND INCOME ACT § 104 (1997). See Appendix F.

426. Some states permit a trust to convert to a unitrust payout. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 11-2.4.

427. T.D. 9102, 69 FR 12-01, 2004-1 C.B. 366. See generally Groppe, *Uniform Principal and Income Act Will Work Fundamental Changes in Estate and Trust Administration*, 74 N.Y.S.B.J., no. 1, Jan. 2002, at 8 (explanation of optional unitrust and power to adjust provisions as enacted in New York). Sloan, *Section 643 Regulations: Use of Non-Charitable Unitrusts and Other Issues Raised Under the Final Regulations, Valuation, Taxation & Planning: Techniques for Sophisticated Estates* (PLI Estates & Trusts, Course Handbook Ser. No. D-727, 2004); Hirschson, *Final § 643 Regulations Issue at Last, Permitting Total Return Investing*, N.Y.L.J., Mar. 1, 2004, Trusts and Estates Special Section 1; Blattmachr & Gans, *The Final “Income” Regulations: Their Meaning and Importance*, 103 TAX NOTES 891 (May 17, 2004).

428. T.D. 9102, 69 FR 12-01, 2004-1 C.B. 366.

429. Treas. Reg. § 1.643(b)-1 (2004) (emphasis added).

430. See Treas. Reg. § 1.643(b)-1 (2003) (emphasis added).

Note that the old regulations, unlike their replacements, contained no *generally* limitation. Thus, there may be a shift from the specific local law involved to some general traditional notion of income and principal. This may be true despite the fact that the preamble to the final regulations asserts that the Treasury Regulations “§ 1.643(b)-1 [has] always provided that the allocation to principal, under the terms of the governing instrument, of items that traditionally would be allocated to income will not be respected for purposes of section 643(b), and this position is maintained in the final regulations.”⁴³¹ The preamble mentions the standard of “traditional” three times. The 2004 regulations’ reliance on “traditional” notions of income and principal seem to suggest that the Service will focus on traditional default state rules. It is uncertain whether these rules will be general ones (for example, those recited in the *Restatement of Trusts*) or those of the particular jurisdiction involved (for example, California or New York). But unlike the prior regulations where the rule seems to have no exception (that is, departure from fundamental local law determination of income would not be respected in any case), the 2004 regulations by use of the word “generally” seem to imply some new or added flexibility.

The 2004 regulation rules, in contrast to the prior ones, set forth some of the consequences of having a provision for determining income and corpus that is not traditional. For example, the 2004 regulations state that if a trust defines ordinary dividends and interest as principal, it will not be treated as a trust that is required to distribute its income currently for purposes of determining its personal exemption under section 642(b) or for determining the tax treatment under section 651 for distributions by a simple trust.⁴³²

The 2004 regulations permit, within limitations, income to be defined by reference to a unitrust amount or to be adjusted pursuant to a power of adjustment.⁴³³ The regulations provide also that an allocation of amounts between income and corpus pursuant to applicable local law will be respected if local law provides a reasonable apportionment between the income and remainder beneficiaries of the total return for the year, including ordinary and tax-exempt income, capital gains and appreciation.⁴³⁴

The regulations specify that a state statute which provides that income is a unitrust amount of no less than 3% and no more than 5% of the trust’s fair market value is a reasonable apportionment of the trust’s total return.⁴³⁵ This seems to be a safe harbor and does not per

431. T.D. 9102, 69 FR 12-01, 2004-1 C.B. 366.

432. Treas. Reg. § 1.643(b)-1.

433. *Id.*

434. *Id.*

435. *Id.*

se foreclose a lower or higher unitrust percentage from being a reasonable apportionment. If rates of return fall off dramatically (as they did during the depression of the 1930s), a lower unitrust percentage probably would be more reasonable than 3%. Similarly, if fixed income returns of 20% per year or greater arise again (as they did in the late 1970s and early 1980s), a unitrust percentage in excess of 5% might be more reasonable than 5% would be. In fact, if the U.S. economy experiences high inflation in the future, a 5% unitrust payment to someone designated as the income beneficiary might be unreasonably and unfairly low. Perhaps, in such a case where the state statute (to fall under the regulatory safe harbor) provides for the trustee or the court to convert an income interest into a unitrust payment of between 3% and 5%, the trustee could “revert” to the traditional concept of income or, if permitted by state statute, convert to the equitable apportionment of receipts between income and corpus. Nevertheless, it seems that the regulations might better have acknowledged that a unitrust tied to the current interest rate published pursuant to section 7520 to measure income, annuity and remainder interests in certain cases is per se reasonable. In fact, considering that Congress prescribed in section 664 a minimum 5% unitrust payment from a charitable remainder trust, it seems odd that the new income regulations would make 5% the safe harbor maximum.

The regulations provide also that a state statute that permits the trustee to make adjustments between income and principal (that is, a power to adjust) to fulfill the trustee’s duty of impartiality between income and remainder beneficiaries is generally a reasonable apportionment of the trust’s total return (implying that it will be respected for tax purposes so that, after any adjustment, fiduciary accounting income will be income within the meaning of section 643(b)).⁴³⁶

It seems that this may be where the “generally” word comes into play, for the 2004 regulations go on to provide that an allocation of amounts between income and corpus pursuant to applicable local law will be respected if such local law provides a reasonable apportionment between the income and remainder beneficiaries of the total return for the year, including ordinary and tax-exempt income, capital gains and appreciation—in other words, a unitrust payment regime.⁴³⁷

Conversion to a unitrust or the exercise of a power to adjust, at least pursuant to a state statute (as opposed to judicial decision or

436. *Id.*

437. *Id.*

non-judicial settlement), will be respected whether or not the trust requires fiduciary accounting income to be distributed.⁴³⁸

The 2004 regulations create a safe harbor permitting a “switch” between methods of determining trust income authorized by state statute without triggering a recognition event for income tax purposes under section 1001 and further provide that such a switch will not be a taxable gift by the trust’s grantor or any of the trust’s beneficiaries.⁴³⁹ Similarly, changing the situs of a trust and its governing law so a different method of determining income applies will not be treated as an income recognition event or as causing the grantor or a beneficiary to have made a gift.⁴⁴⁰ The reference to gain is not explained but is likely attributable to an expansive reading of the Supreme Court’s decision in *Cottage Savings Ass’n v. Commissioner*.⁴⁴¹

The 2004 regulations provide, however, that a switch not authorized by state statute but valid under state law may constitute a recognition event under section 1001 or a taxable gift, depending upon the facts and circumstances.⁴⁴² The preamble to the regulations state that the no gain/no gift rule does not apply to switches between methods not specifically authorized by state statute. But the preamble acknowledges that other actions may constitute applicable state law, such as decisions by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under that state’s laws.⁴⁴³ However, the regulations themselves contain no such reasonable apportionment rule pursuant to state case law.

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438. *Id. See, e.g.*, Priv. Ltr. Rul. 200901030 (Issues 1–2) (exercise of power to adjust does not result in the recognition of income). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
439. Treas. Reg. § 1.643(b)-1 (fourth-to-last sentence). *See also* Priv. Ltr. Ruls. 201320009 (Issue 3), 200812018 (Issue 3). *See also* Priv. Ltr. Rul. 201516028. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
440. Treas. Reg. § 26.2601-1(b)(4)(i)(E), exs. 11 & 12. *See* Schaengold, *Taxation of a New York Statutory Unitrust*, 74 CPA J., no. 12, Dec. 2004, at 28.
441. *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991). Priv. Ltr. Rul. 200812018 (Issue 3) notes the potential application of *Cottage Savings* in this context. *See, e.g.*, Priv. Ltr. Rul. 200901030 (Issues 1–2) (exercise of power to adjust does not result in the recognition of income). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
442. Treas. Reg. § 1.643(b)-1.
443. *Cf. Comm’r v. Estate of Bosch*, 387 U.S. 456 (1967).

Apparently, the preamble simply means, as the regulations recite, that a switch other than pursuant to a specific state statute may or may not be a gain/gift recognition event depending upon the facts and circumstances involved. Indeed, if the statement in the preamble that allocations will be respected if made pursuant to a decision of the highest court of the state is correct (and incorporated in essence in the regulations), then presumably a switch pursuant to such a court decision should provide the same shield against gain and gift that a switch pursuant to a state statute produces.

Whether a trust is required to distribute all of its income is important for reasons other than the treatment of distributions under section 651 or the personal exemption under section 642(b). For example, to constitute a Qualified Subchapter S Trust (that is, an eligible shareholder of an S corporation), the trust must distribute all of its income.⁴⁴⁴ Also, depreciation experienced by a trust is allocated between the trust and the beneficiaries based upon the income allocated to each, although the regulations provide no example of such an effect for a trust other than one required to distribute its income currently.⁴⁴⁵

The consequences of having distributions governed by section 661 rather than section 651 can be significant to the beneficiaries in other ways. For example, if more than one beneficiary is entitled to the required distribution of income, generally, each will include in gross income a proportionate part of the trust's DNI. However, if the trustee makes a discretionary distribution of accounting principal, the allocation of DNI will be different if section 661 controls the allocation of DNI.

§ 3:3.2 "Distributable Net Income"

The term "distributable net income" is defined by section 643(a) as the taxable income of the estate or trust, computed with certain modifications. It serves three basic purposes in subchapter J: (1) generally, it establishes a top limit on the amount that is taxable to beneficiaries,⁴⁴⁶ (2) it determines the types of income that will flow through to the beneficiaries,⁴⁴⁷ and (3) it limits the special distribution deduction permitted an estate or trust.⁴⁴⁸

444. See section 8:6 for a discussion of QSSTs.

445. See I.R.C. § 167(d).

446. I.R.C. §§ 652, 662. If the throwback rules are applicable, DNI is not a limit on the amount of gross income a beneficiary may receive. See section 3:6 for a discussion of the throwback rules.

447. I.R.C. §§ 652, 662.

448. I.R.C. §§ 651(b), 661(c). The distribution deduction is discussed in detail in section 3:5.

Distributions in excess of this measure are in effect treated as tax-free distributions of principal: trust income not included in DNI is not taxed to a beneficiary.⁴⁴⁹ This does not mean that the estate or trust will not have taxable income, however. For example, capital gains normally are not part of distributable net income⁴⁵⁰ and, therefore, will not be deemed to be passed out to the income beneficiaries even if there are distributions in excess of distributable net income; rather, capital gains generally will be taxed to the estate or trust.⁴⁵¹

The computation of distributable net income begins with taxable income of the estate or trust and then is modified as follows:⁴⁵²

1. The distribution deduction is added back.⁴⁵³
2. The personal exemption is added back.⁴⁵⁴
3. Generally, capital gains not included in fiduciary accounting income are subtracted for domestic trusts and capital losses allowed as deductions are added back.⁴⁵⁵
4. Taxable extraordinary dividends or taxable stock dividends which the fiduciary in good faith allocates to fiduciary accounting principal are subtracted for purposes of simple trusts.⁴⁵⁶
5. Interest income that is tax-exempt under section 103, less related expenses, is added back.⁴⁵⁷
6. For foreign trusts, gross income from sources without the United States, less related expenses, are added back. Also, gross income for the estate or trust includes gross income from

449. The throwback rules, if applicable, may cause distributions in excess of DNI to be taxable income. *See* section 3:6.

450. Under certain circumstances, capital gains may be part of DNI. *See* section 3:3.2[C] for a discussion.

451. *But see* Rev. Rul. 71-335, 1971-2 C.B. 250. Although *Edward D. Rollert Residuary Trust v. Comm’r*, 752 F.2d 1128 (6th Cir. 1985), *aff’g* 80 T.C. 619 (1983), and other authorities indicate that I.R.C. § 691 overrides I.R.C. §§ 661 and 662, it seems relatively certain the distributable net income under I.R.C. § 643(a) includes income in respect of a decedent under I.R.C. § 691(a) that would otherwise be included in DNI (such distribution for an IRA as compared with capital gain allocated to corpus and not distributed). *See* Treas. Reg. § 1.663(c)-5, exs. 9 & 10.

452. I.R.C. § 643(a).

453. I.R.C. § 643(a)(1).

454. I.R.C. § 643(a)(2).

455. I.R.C. § 643(a)(3).

456. I.R.C. § 643(a)(4).

457. I.R.C. § 643(a)(5).

sources within the United States, but computed without regard to section 894 (related to income exempt by treaty). Moreover, the capital gains adjustment described in 3 above does not apply.⁴⁵⁸

7. A few other minor adjustments are possible.⁴⁵⁹

Each adjustment to taxable income is discussed in greater detail below.

[A] Distribution Deduction⁴⁶⁰

The distribution deduction provided for in section 651 or 661 is added to taxable income when computing DNI. This adjustment presents the fiduciary with a “catch-22” dilemma, as the amount of the distribution deduction can not be computed until DNI is determined. To solve the circular computation problem, a fiduciary must compute taxable income without a distribution deduction. Several regulation examples that include DNI computations take this approach.⁴⁶¹ Thus, a tentative taxable income is calculated without a distribution deduction; therefore, no distribution deduction needs to be added back to calculate DNI.

[B] Personal Exemption⁴⁶²

Similar to the distribution deduction, the personal exemption provided for in section 642(b) is added to taxable income when computing DNI. This prevents a beneficiary from potentially offsetting income with the entity’s personal exemption. This adjustment does not present the fiduciary with the same “catch-22” dilemma as the distribution deduction because the personal exemption is not interrelated with the computation of taxable income. Nevertheless, several regulation examples that include DNI computations add all items of taxable income and then reduce that sum by all allowable deductions other than the distribution deduction or the personal exemption.⁴⁶³ Thus, a tentative taxable income may be calculated without a personal exemption; and if computed in this manner the personal exemption does not need to be added back to determine DNI.

458. I.R.C. § 643(a)(6).

459. See section 3:3.2[H]–[K].

460. I.R.C. § 643(a)(1).

461. See, e.g., Treas. Reg. §§ 1.652(c)-4, 1.662(c)-4.

462. I.R.C. § 643(a)(2).

463. See, e.g., Treas. Reg. §§ 1.652(c)-4, 1.662(c)-4.

[C] Capital Gains and Losses⁴⁶⁴

Except for foreign trusts,⁴⁶⁵ capital gains will form part of DNI only if they are allocated to fiduciary accounting income: (1) by a mandatory direction under both local law *and*⁴⁶⁶ the governing instrument, or (2) pursuant to the reasonable and impartial exercise of discretion by the fiduciary to allocate capital gains to income or corpus under a power granted under local law or under the governing instrument (and if not prohibited by local law);⁴⁶⁷ and where (1) it is treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary,⁴⁶⁸ or (2) it is actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.⁴⁶⁹

Capital losses offset capital gains realized by a trust or estate and are excluded from distributable net income except to the extent that they are taken into account in determining the amount of capital gains distributed to any beneficiary during the year.⁴⁷⁰ Under the regulations, capital losses may pass out of an estate or trust to its beneficiaries only in certain circumstances.⁴⁷¹

464. I.R.C. § 643(a)(3).

465. I.R.C. § 643(a)(6)(C). Distributable net income of a foreign trust also includes any amount excludible under I.R.C. § 894 by treaty and income from foreign sources reduced by amounts that would be deductible in the absence of I.R.C. § 265.

466. It is not certain if the word "and" is actually intended to mean "or." The same phrasing, that is, "pursuant to the terms of the governing instrument and applicable local law," is contained in the 2004 regulations on when capital gain may be allocated to fiduciary accounting income and be respected for tax purposes. *See* Treas. Reg. § 1.643(b)-1 (second to last sentence). Example 1 to Treas. Reg. § 1.643(a)-3(e) is consistent with the condition insofar as it states that the allocation of capital gain to principal is pursuant to the terms of the governing instrument and applicable local law. However, at least two examples contained in that regulation seem inconsistent with the conjunctive (and) condition. *See* Treas. Reg. § 1.643(a)-3(e), exs. 4 & 11. Moreover, Rev. Rul. 85-116, 1985-2 C.B. 174, which held that if part of sale proceeds of unproductive assets allocated by state statute (apparently where the governing instrument was silent) was allocated to income, a proportionate part of capital gain realized on the sale is included in DNI, was not revoked or modified by the 2004 regulations.

467. If income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to such capital gain.

468. Treas. Reg. § 1.643(a)-3(b)(2).

469. Treas. Reg. § 1.643(a)-3(b)(3).

470. Treas. Reg. § 1.643(a)-3(d).

471. Treas. Reg. § 1.642(h)-1.

Deductible expenses attributable to capital gains do not offset capital gains for DNI calculation purposes but may reduce DNI.⁴⁷² For example, in Revenue Ruling 74-257,⁴⁷³ the Service ruled that state income taxes on capital gains were deductible and reduced DNI. This differs from the offset rule for expenses related to tax-exempt income and for foreign trusts.⁴⁷⁴

The regulations provide that if a charitable deduction is allowed under section 642(c) for capitals gains “paid, permanently set aside, or to be used for” charity, the capital gains are included in distributable net income.⁴⁷⁵ It is not clear whether or not capital gain allocated to corpus will be included in distributable net income in this instance if it is paid to a beneficiary as part of an exempt distribution under section 663(a)(1).⁴⁷⁶

In several private letter rulings, the Service has ruled that the short-term gain portion of ordinary dividends distributed by a mutual fund (a regulated investment company), is included in DNI. This represents an additional exception to the section 643(a)(3) rule that generally capital gains are not included in DNI.⁴⁷⁷ Whether these rulings are significant may depend on whether local law would include these short-term gains in fiduciary accounting income. If they are, then under the other rules governing the inclusion of capital gains in DNI, the result may be the same.

Under revised regulations issued in 2004, for a capital gain to be included in DNI because it is allocated to income, the allocation must be “pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law.”⁴⁷⁸ It is interesting that the regulations do not expressly provide that capital gain will be included in DNI

472. Rev. Rul. 74-257, 1974-1 C.B. 153.

473. *Id.*

474. I.R.C. § 643(a)(5).

475. Treas. Reg. § 1.643(a)-3(c).

476. *See* prior Treas. Reg. § 1.643(a)-3(d), exs. (3) & (6). Perhaps Example (3) is not deemed exempt because the sum of money is not specific or because taxable income is distributed, although trust income is not.

477. *See, e.g.,* Priv. Ltr. Rul. 9811036 (that portion of short-term capital gain that is treated as ordinary income of a regulated investment company [mutual fund] and included in gross income of trust that owned units in it forms part of DNI whether or not allocated to accounting income; trust required to pay beneficiary greater of income or annuity amount). *See also* Priv. Ltr. Rul. 9811037. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

478. Treas. Reg. § 1.643(a)-3(a).

if allocated to income under applicable local law and the governing instrument is silent. The regulations seem to require both a mandatory allocation by applicable local law as well as an allocation pursuant to the terms of the governing instrument. Indeed, it is not the conjunctive requirement (“and”) but rather the disjunctive (“or”) that is used where the allocation of capital gains to DNI is not required by either local law or the governing instrument but is by “a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).”⁴⁷⁹

It seems hard to think that capital gain allocated to income pursuant to a default state law rule (and the instrument is silent on the allocation) will not cause capital gains to be in DNI. For example in Revenue Ruling 85-116,⁴⁸⁰ the Service ruled that a proportionate part of capital gain realized would be allocated to income and thereby form part of DNI and be included in the income beneficiary’s gross income where local law treated a portion of the proceeds of sale of an unproductive asset as delayed income and thus distributable to the income beneficiary. Apparently, the governing instrument was silent on the matter of allocation of such proceeds and, therefore, default state law applied. Of course, Revenue Ruling 85-116 precedes in time the 2004 regulations.

Capital gains may be part of DNI as a result of an exercise of discretion by the fiduciary, but the discretion must be both “reasonable and impartial.”⁴⁸¹ It is difficult to conclude that an exercise of discretion is reasonable if it is not impartial. However, it seems it could be impartial but not reasonable. In any case, the use of the conjunctive “reasonable and impartial” in the capital-gains-in-DNI regulations might be contrasted with the new definition-of-income regulations. The latter regulation provides that when an allocation of receipts (and apparently not limited to proceeds of sale) between income and remainder beneficiaries will be respected for federal tax purposes: “a state statute that permits the trustee to make adjustments [that is, allocations] 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.”⁴⁸² In other words, this portion of the definition-of-income regulations suggests that an impartial allocation is per se reasonable. Nevertheless, the last part of the definition-of-income regulations echoes the rule contained in the capital-gains-in-DNI

479. *Id.*

480. Rev. Rul. 85-116, 1985-2 C.B. 174.

481. *Id.*

482. Treas. Reg. § 1.643(b)-1.

regulations that “an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or the governing instrument, if not prohibited by applicable local law.”⁴⁸³

Nevertheless, it is difficult to conclude that an allocation to income by both local law and instrument should be necessary for the capital gain to form part of DNI. Indeed, the regulations might better have provided a contrast of when an allocation solely pursuant to default state law (because the terms of the governing instrument are silent on the allocation) would not be respected or when an allocation required by the governing instrument would be respected if contrary to local law (or traditional notions of income and corpus).

Maybe the term “reasonable” is intended to invoke a federal standard of reasonableness as opposed to a local law one. Perhaps the trustee could impartially allocate gains to income, but the allocation would be unreasonable under federal tax law principles. Again, the definition-of-income regulations specify that an adjustment between income and corpus pursuant to the trustee’s duty of impartiality authorized under a state statute “generally” is a reasonable apportionment. This may be a slightly greater level of “blessing” of the allocation of gain than that provided under the DNI final regulations with respect to the allocation of capital gain to income. An example is the allocation of proceeds of sale, presumably including any realized capital gain, to the income beneficiary.

The allocation of capital gains to DNI also may occur if the gains are allocated to corpus but are either (1) treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary, or (2) actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary.⁴⁸⁴ Both of these rules may apply only if the capital gains are so treated or are so distributed (a) pursuant to the terms of the governing instrument and applicable local law, or (b) pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).⁴⁸⁵

Meaningful additional guidance is provided through the fourteen examples under the regulations that illustrate the foregoing principles

483. Treas. Reg. § 1.643(b)-1 (last sentence).

484. Treas. Reg. § 1.643(a)-3(b)(2)-(3).

485. Treas. Reg. § 1.643(a)-3(b).

of when a capital gain is allocated to DNI.⁴⁸⁶ The examples manifest that certain exercises of discretion by a trustee must be consistent. Unfortunately, it is unclear how these rules apply to personal representatives. For instance, a capital gain is included in DNI where it is allocated to corpus if it is treated consistently by the “fiduciary” (perhaps, including a personal representative) on the “trust’s” (with no mention of an estate’s) books, records and tax returns as part of a distribution to a beneficiary. Perhaps, the thought is that a personal representative cannot consistently treat gain as part of distributions to beneficiaries either because a personal representative does not usually make multiple distributions to a beneficiary or because the administration of an estate usually is too limited in time for the treatment to be consistent.⁴⁸⁷

In Example 1,⁴⁸⁸ the trustee makes a discretionary invasion of principal for the income beneficiary, allocates all capital gains from a sale during the year to corpus (the Example does not specify whether the trustee could allocate it to income), and does not exercise the discretionary power (apparently granted under the instrument) to deem discretionary distributions of corpus as being made from capital gains. Example 1 concludes that the capital gains are not included in DNI, but states that the trustee “must treat all discretionary distributions as not being made from any realized capital gains.” This latter statement is probably overbroad. For example, if the trust terminates, any capital gains would be part of DNI as they always are in the year of termination because the capital gains, in fact, are “actually distributed to the beneficiary” within the meaning of Treasury Regulations section 1.643(a)-3(b). That result is confirmed by Example 7,⁴⁸⁹ which is the same as Example (4) in the former final regulations. Thus, the statement probably should be interpreted to mean that the trustee cannot exercise the discretion to deem discretionary distributions as consisting of capital gain (although the gain may be in DNI for other reasons).

Example 2⁴⁹⁰ is the same as Example 1, except that the trustee intends to follow a regular practice of treating discretionary distributions of corpus as consisting first of net realized gains for the year and evidences that treatment by including the realized gain in DNI on the trust’s federal income tax return. The Example states that the trustee is given two discretionary powers: one to invade principal and the other to deem discretionary distributions as being made from capital gains. The Example states that “[t]his treatment of the capital

486. Treas. Reg. § 1.643(a)-3(e).

487. Treas. Reg. § 1.643(a)-3(b)(2).

488. Treas. Reg. § 1.643(a)-3(e).

489. *Id.*

490. *Id.*

gains is a reasonable exercise of [the t]rustee's discretion." It is interesting that the Example seems to assume that "deeming" the discretionary distribution as being made from capital gains falls under the regulatory language of Treasury Regulations section 1.643(a)-3(b) that the allocation of such gain is to corpus and is treated consistently by the fiduciary as part of the distribution to the beneficiary. The Example goes on to provide that in future years the trustee must treat all discretionary distributions as being made first from realized capital gains. Although not stated, it seems that it must be from gains realized that year. Thus, gains from a prior year and not previously deemed distributed could not be treated as funding the discretionary distribution until gains realized in the year the discretionary distribution is made are allocated to DNI. (An allocation of a prior year's capital gain to the distribution seems to have no practical tax effect as DNI consists only of taxable income of the current year.)⁴⁹¹ The Example indicates that if the trustee fails to treat discretionary distributions as being paid first from any net capital gains realized by the trust during a later year such gains nonetheless will be allocated to DNI. The Example involves "net" capital gain, which presumably means that it is the gain as offset by capital losses for the year.

Example 3⁴⁹² is the same as Example 2, except that the trustee intends to follow a regular practice of treating discretionary distributions of corpus as being paid from any net capital gains realized by the trust during the year from the sale of certain specified assets of a particular class of investments. The Example also states that this is a reasonable exercise of the trustee's discretion, even though there does not seem to be any express authorization in the governing instrument to do so. On the other hand, it does not seem as though such action is prohibited. In any case, perhaps, this means that the trustee, if authorized under the instrument or local law, could deem that discretionary distributions consist only of capital gains realized on the sale of assets to the extent the overall value of the trust exceeds its original value.

Example 4⁴⁹³ also is the same as Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by local law), capital gains are allocated to income. The Example concludes that such gains, accordingly, are part of DNI.

Example 5⁴⁹⁴ is the same as Example 1 as well, except that the trustee decides that discretionary distributions will be made only to

491. At one time, the allocation of capital gain to DNI that was not distributed could have a tax effect under the old "throwback rules." See subpart D of part 1 of subchapter J as in effect from 1970 to 1976.

492. Treas. Reg. § 1.643(a)-3(e).

493. *Id.*

494. *Id.*

the extent the trust has realized capital gains during the year. The Example concludes that the capital gains are included in the trust's DNI for the year because the trustee "will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary." It seems, although it is not certain, that the trustee is not being compelled to distribute in future years each year's realized capital gains. Rather, it seems that because the trustee has decided that distributions, if made at all, will be made only to the extent of realized capital gains, DNI includes gains in years in which the amount of discretionary distributions are made because the trustee has committed to limit such distributions by the amount of such gains. (The Example does not specify what occurs if the trustee later changes the discretionary distribution pattern by distributing, in a particular year, much more than realized gain.) It is not certain but it seems that a proportionate part of capital gains would be included in DNI if the trustee had determined that discretionary distributions would be made only to the extent of one half (or another fraction or, perhaps, a dollar amount) of realized capital gains during the year. In that case, the capital gains allocated to corpus would be "utilized by the fiduciary in determining the amount that is distributed" within the meaning of Treasury Regulations section 1.643(a)-3(b). There is, as stated, an indication that the trustee could decide year by year whether to make any discretionary distribution, and, as long as the trustee determines that amount of the year's discretionary distribution by the amount of realized capital gain, the gain will be included in DNI.

Example 6⁴⁹⁵ involves a trust that requires that a specific asset be sold after ten years and the sales proceeds distributed to the income beneficiary. The Example concludes that any gain realized on sale is included in DNI because the trustee "uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed" to the beneficiary. This Example is the same as Example (3) of the former regulations, except new Example 6 adds reasoning for its conclusion—that is, the capital gains are part of DNI because the trustee uses the amount of sales proceeds to determine the amount required to be distributed to the beneficiary. Old Example (3) contained no explanation, just the facts and the conclusion that the realized gains are part of DNI for the year of sale and distribution. It seems that the reasoning expressed in Example 6 for its conclusion may not be correct, however. Instead, it could be that the reason that DNI includes the gains from the sale is not because the trustee uses the amount of sales proceeds to determine the amount required to be distributed but rather because the gain is "actually

495. *Id.*

distributed to the beneficiary” within the meaning of Treasury Regulations section 1.643(a)-3(b). Moreover, even the reasoning expressed in Example 6 seems at odds with the regulation. The regulation does not say that the gain is included in DNI when the proceeds that may include the capital gains are used to determine “the amount that is . . . required to be distributed to a beneficiary.” Rather, the regulation says the gain is in DNI where the “Gains . . . are . . . [a]llocated to corpus but . . . utilized by the fiduciary in determining the amount that is required to be distributed to the beneficiary” (emphasis added). In any case, Example 6 seems to expand this regulatory rule where the proceeds of a capital gain are allocated to corpus, but the proceeds are used to determine the amount that is required to be distributed to the beneficiary.

Example 7⁴⁹⁶ has the same facts and conclusion as old Example (4). In the Example, the trust is to terminate when the beneficiary reaches age thirty-five. It is concluded that in that year all capital gains are included in DNI. Unlike old Example (4), new Example 7 provides reasoning for its conclusion: all capital gains are included in DNI because all trust assets, including all gains, are actually distributed to the beneficiary.

Example 8⁴⁹⁷ is the same as Example 7, except that the trustee must first distribute \$10,000 to another beneficiary before distributing the balance of the trust assets to its income beneficiary. The Example concludes that none of the DNI, including the gains realized in the year of termination, is allocated to the distribution to the beneficiary who receives the \$10,000 because that distribution is in satisfaction of a specific sum of money which under section 663(a)(1) cannot, in general, be deemed to consist of DNI. (That Example does not deal with a possible exception where the \$10,000 must be funded in whole or in part with capital gain because the trust has insufficient other corpus to fund it.)

Example 9⁴⁹⁸ also is the same as Example 7, except that one half of the principal is to be distributed to the beneficiary upon attaining age 35. To satisfy that obligation, the trustee sells one-half of the trust’s assets, at a gain, when the beneficiary reaches age 35 and distributes the sales proceeds to the beneficiary. The Example concludes that the capital gains realized upon that sale are included in DNI because all sales proceeds, including all the capital gain attributable to the sale, are actually distributed to the beneficiary.

Example 10⁴⁹⁹ is the same as Example 9, except that the trustee sells all the assets at a gain. The Example states that, if authorized by the governing instrument and the applicable state statute, the trustee

496. *Id.*

497. Treas. Reg. § 1.643(a)-3(e).

498. *Id.*

499. *Id.*

may determine to what extent capital gain is distributed to the beneficiary, although, at a minimum, the distribution must include at least the minimum amount of capital gain that in fact would be distributed and, at a maximum, the distribution must include no more than the lesser of the distribution or the capital gains realized by the sale. The Example indicates that the trustee evidences the amount of capital gains that the trustee determines (subject to the minimum and maximum stated above) to include in the distribution to the beneficiary by including that amount in DNI on the trust's federal income tax return. The Example goes on to state that if the trustee is not authorized by the governing instrument and the applicable state statutes to make that allocation, then one half of the capital gain attributable to the sale is included in DNI for the year of sale. As indicated above, it is uncertain what authority must be granted under the applicable state statutes so that the trustee can allocate the DNI in accordance with this Example. If state law provides that the governing instrument controls all distribution matters, then express authorization under the governing instrument should be sufficient. If the state statutes must expressly authorize a trustee to make such an allocation, then it seems that the ability to use the flexibility provided in Example 9 will be limited as few, if any, state statutes provide such explicit authority to trustees. Based upon that, it seems that a state statute providing that the governing instrument may allocate receipts (as opposed to capital gains) between beneficiaries as directed by the trustee should be sufficient under the Example.

Example 11⁵⁰⁰ involves a state statute that permits the trustee to elect to pay the income beneficiary a 4% unitrust amount in lieu of income. (This is similar to New York EPTL section 11-2.4.) The state statute provides that the unitrust amount shall be considered paid first from ordinary and tax-exempt income (both of which are automatically part of DNI under section 643(a)), then net short-term capital gain, then net long-term capital gain and then corpus. The governing instrument provides that the income beneficiary is to receive income as defined under the state statute. The trustee makes the election to pay the unitrust amount to the income beneficiary. The value of the trust is \$500,000, so the trustee distributes \$20,000 (that is, 4% of \$500,000) to the beneficiary in satisfaction of the unitrust amount. In that year, the trust has \$5,000 of dividend income and \$80,000 of net long-term capital gain. The Example states, which seems correct as far as the state statute is concerned, that \$15,000 of the gain is allocated to income pursuant to the "ordering" rule of the state statute and, therefore, concludes that the \$15,000 of gain is included in DNI. The Example suggests that allocation of gain

500. *Id.*

to income pursuant to state law is sufficient to cause it to be in DNI even if the instrument does not so specifically direct. This seems to clarify the issue discussed above under the basic rule set forth in Treasury Regulations section 1.643(a)-3(b) about when capital gain allocated to income will be considered to form part of DNI. Indeed, the Example supports the notion that allocation of capital gain to income simply pursuant to the terms of the governing instrument is sufficient to make it part of DNI, assuming state law does not prohibit that result. In any case, as discussed below, Example 12 implies that the result in Example 11 would be the same if the governing instrument (rather than a state statute) provided the ordering rule that is deemed to make up any unitrust payment.⁵⁰¹ Few, if any, state statutes contain the ordering rule set forth in Example 11.

Example 12⁵⁰² is the same as Example 11, except that neither the governing instrument nor a state statute provides an ordering rule for the tax character of the unitrust payment. Although the Example does not state whether the authority comes from the governing instrument, a state statute or both, it provides that the decision on determining the tax character is left to the discretion of the trustee. The Example states that the trustee intends to follow a regular practice of treating the unitrust amount as being comprised of corpus rather than capital gain to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. The Example states that the trustee will manifest the ordering rule decision by not including any capital gain in DNI, which would be reflected on the trust's federal income tax return including the K-1 forms sent to the beneficiary. The Example concludes that this treatment of not having the capital gains form part of DNI is a reasonable exercise of the trustee's discretion, but in future years the trustee must not allocate capital gains to income, implying perhaps that any attempt to do otherwise will be void as a matter of federal tax law.

Example 13⁵⁰³ is the same as Example 12, except that the trustee intends to follow a regular practice of treating the unitrust amount as being comprised of capital gain to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. This Example concludes that this treatment of having the capital gains form part of DNI is a reasonable exercise of the trustee's discretion, but in future

501. The Treasury rejected the suggestion that a trust should be treated as paying out its income for tax purposes if the governing instrument provided for the payment of a unitrust amount rather than having it provide for the payment of income and having the trustee elect to pay a unitrust amount pursuant to an authorization under a state statute (or, perhaps, under state case law that correctly reflects the state's common law of trusts). T.D. 9102, 69 FR 12-01, 2004-1 C.B. 366.

502. Treas. Reg. § 1.643(a)-3(e).

503. *Id.*

years the trustee must treat capital gain, if any, as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income.

Example 14⁵⁰⁴ in essence combines Examples 12 and 13. In Example 14, a corporate fiduciary, acting under governing instruments and state statutes that do not provide a tax character ordering rule for unitrust payments but leave the decision to the trustee, intends to treat consistently the unitrust amount as consisting of capital gain to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income for some trusts and treat the unitrust amount as consisting of corpus, and not capital gain, to the extent the unitrust amount exceeds ordinary and tax-exempt income for other trusts. The Example concludes that the trustee's decision with respect to each trust is a reasonable exercise of the trustee's discretion but that, in future years, the trustee must treat the capital gains consistently with the treatment in the prior years. This Example is important to those who serve as trustee of several trusts. However, trustees probably should make sure that they are in a position to be able to justify to their beneficiaries (and the local courts) why the trustee decided to include capital gain as part of the unitrust payment in one trust but not another.

Examples 12, 13, and 14 seem to add a new condition to Treasury Regulations section 1.643(a)-3(b) as to when capital gain allocated to income will be included in DNI. Unlike one of the situations where capital gain is allocated to corpus and the trustee must consistently treat such gain as forming part of DNI or not, Treasury Regulations section 1.643(a)-3(b) does not expressly direct that any allocation of gain to income must be consistent year after year in order for it to be (or not be) in DNI. It seems that if the allocation is mandated (such as in Example 11), then the allocation of capital gain to income and, therefore, to DNI, will apply. But if the allocation to income is discretionary, then the discretion must be exercised consistently as to a particular trust. The regulations do not specify the consequences of the trustee not exercising the discretion consistently. It seems that the likely consequence will be that the prior treatment will apply for tax purposes even if the trustee does not exercise the discretion consistently. For instance, a trustee decides to have the unitrust payments deemed to consist of realized capital gain to the extent the payments exceed the trust's ordinary and tax-exempt income and follows that practice, manifesting it by such treatment on the trust's federal income tax returns, consistently for years. A new trustee is appointed who decides not to follow the capital gain treatment of the prior trustee. It seems that the regulations will cause capital gain to be treated as part of DNI to the extent the prior trustee did.

504. *Id.*

The regulations do not specify what occurs if the trustee does not intend to treat consistently the make-up of a unitrust payment as consisting of capital gain. For instance, in the first year, the trustee decides not to have any part of the unitrust amount consist of capital gain but the trustee does not intend to follow that practice regularly. In other words, the trustee intends to decide year by year whether it is preferable to have capital gain form part of the unitrust payment or not. Where, unlike Example 11, state law is silent on the tax character make-up of the unitrust amount, but leaves the decision to the fiduciary, it is unclear what the result would be. Similarly, where both state statutes and the governing instrument are silent as to the tax character of the unitrust amount, the result is uncertain if the trustee does not intend to adopt a consistent treatment. Example (2) of the old regulations may provide an answer. In that Example, the trustee was required to pay the beneficiary an annuity of \$15,000 each year. The Example appears to conclude that even though the trustee has to sell an asset at a profit for \$10,000 to pay the annuity amount, no portion of the capital gain is included in DNI. The Example might have supported the conclusion that a unitrust amount will not be deemed to consist of capital gain unless a state statute (or possibly the governing instrument) provides otherwise, or the trustee is authorized to determine the extent to which it will be deemed to consist of such gain and the trustee intends to adopt a consistent treatment. But, old Example (2) has been eliminated and what that means is difficult to determine.

In some situations it is possible that a distribution in kind can itself give rise to capital gain or ordinary income.⁵⁰⁵ For example, the distribution of an appreciated asset made in satisfaction of a right to receive a specific dollar amount will result in the recognition of income.⁵⁰⁶ In addition, a "simple" trust is treated as having sold the property (with realization of gain or loss) for its fair market value on the date the trust distributes property in kind as part of its requirement

505. In some situations, I.R.C. § 1239 will cause realized capital gains to be recognized as ordinary income.

506. *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940); Rev. Rul. 66-207, 1966-2 C.B. 243 (even though value is insufficient to satisfy the pecuniary legacy); Rev. Rul. 82-4, 1982-1 C.B. 99 (similar); Rev. Rul. 67-74, 1967-1 C.B. 194; Rev. Rul. 60-87, 1960-1 C.B. 286; *cf.* Rev. Rul. 69-486, 1969-2 C.B. 159 (exchange taxable where remaindermen agree to non-pro rata distribution and no authority in instrument or local law for trustee otherwise to do so). *But cf.* Priv. Ltr. Rul. 9410030 (non-pro rata but fairly valued division of trust does not result in gain recognition); Priv. Ltr. Rul. 9324015 (similar); Priv. Ltr. Rul. 9830017 ("Present case is distinguishable from Rev. Rul. 69-486 because the proposed addition will be mostly pro rata and because the trustee is authorized under the trust documents to make non-pro rata distributions based upon fair market values."); Priv. Ltr. Rul. 200452004 (non-pro rata distribution to charity, as a residuary beneficiary, of individual retirement accounts and deferred annuity contracts does not

to distribute all income of such distribution.⁵⁰⁷ Gain or loss is realized by a “complex” trust or estate (or the other beneficiaries) by a distribution of non-cash assets in satisfaction of a right to a specific dollar amount or property other than that distributed or of income if required to be distributed currently.⁵⁰⁸ In addition, gain or loss is realized if the trustee or personal representative makes the election under section 643(e) to recognize gain or loss.⁵⁰⁹ However, the distribution does not necessarily cause the capital gain to be included in distributable net income.⁵¹⁰

[D] Capital Gains and Pooled Income Funds

A pooled income fund, defined in section 642(c)(5), is a trust that, among other conditions, is maintained by a charitable organization (such as a college) that is the trustee and the remainder beneficiary. It receives contributions from individuals and provides for one or more individuals to receive the income for life. A pooled income fund is not exempt from income taxation but is permitted a current income tax deduction for long-term capital gains set aside for charitable purposes pursuant to the terms of the governing instrument even if the income will not be paid for the charitable purpose until a later tax year.⁵¹¹ To qualify the capital gain must be allocated to corpus and not income for fiduciary accounting purposes.

The regulation⁵¹² that deals with the set-aside charitable deduction for pooled income funds defined in section 642(c)(5) was revised in

cause estate to recognize income where will, as interpreted by local court, allowed non-pro rata distributions). *See also* Priv. Ltr. Rul. 200920031. Neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).

507. Treas. Reg. § 1.651(a)-2(d).

508. Treas. Reg. § 1.661(a)-2(f). In several Private Letter Rulings (200804015, 200607015, 200544007, and 200552009), the Service ruled that when assets of a trust are transferred to new trusts as a result of “decanting” under state law, there is no recognition of gain by the transferor trust and the transferee trust or trusts will have the same basis and holding periods in the transferred assets. The Rulings discuss the non-application of *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991), in this situation. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

509. See section 3:5.6 for a discussion of I.R.C. § 643(e).

510. Rev. Rul. 68-392, 1968-2 C.B. 284. *Cf.* Tech. Adv. Mem. 8728001 (the portion of capital gain recognized by trust and allocated by the trustee to accounting income pursuant to express authority in governing instrument is includible in DNI even though, in absence of such authorization and its exercise, all the capital gain would be allocated under local (New York) law to principal where local law permits such a grant of authority to the trustee).

511. I.R.C. § 642(c).

512. Treas. Reg. § 1.642(c)-2(c).

2004. Revised Treasury Regulations section 1.642(c)-2(c) provides that no net long-term capital gain is considered permanently set aside for charitable purposes if, under the terms of the governing instrument and applicable local law, the trustee has the power (whether or not it is exercised) to satisfy a beneficiary's right to income by the payment of either a unitrust amount or any other amount that takes into account unrealized appreciation in the fund's assets. The purpose is to prevent funds for which the pooled income fund received an income tax charitable deduction (limited, as indicated above, to its long-term capital gain as opposed to other forms of income even if also set aside for charitable purposes) from being distributed to an individual income beneficiary. Similarly, no long-term capital gain is considered permanently set aside for charitable purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income to be distributed to the income beneficiaries. This seems to indicate that short-term capital gain may be distributed to the income beneficiaries, if constituting income of the pooled income fund, because a fund is not entitled to an income tax deduction for short-term capital gain set aside for charitable purposes. Overall, it means that the trustee may be permitted to make an equitable adjustment between income and corpus of receipts and disbursements but must be prohibited from converting a fund to a unitrust arrangement. Most pooled income funds will not prohibit such a conversion. Some state statutes may, but others may not.⁵¹³ In any case, a pooled income fund's long-term capital gain may be considered permanently set aside for charity if the governing instrument is amended or reformed to eliminate the conversion to a unitrust payment arrangement, provided payments have not yet been determined in a unitrust manner. To be a sufficient reformation, a judicial reformation proceeding must have been commenced, or a nonjudicial one that is valid under local law completed, nine months after the later of January 2, 2004 (that is, October 2, 2004), or the effective date of a state statute, applicable to the fund, authorizing the determination of payment by a unitrust method.⁵¹⁴

513. N.Y. EST. POWERS & TRUSTS LAW (EPTL) § 11-2.3(b)(5)(C)(iv) prohibits a fiduciary from exercising a "power to adjust" (that is, to allocate receipts between income and corpus in a manner that is equitable when the fiduciary is investing pursuant to the prudent investor standard) from any amount that is permanently set aside for charitable purposes unless the income therefrom is also permanently devoted to charitable purposes. Unfortunately, the words "otherwise allowed as a charitable deduction under Code Sec. 642(c)" are not in that statute begging the question of whether the power to adjust forecloses it from being regarded as so permanently set aside. Presumably, those words should be read into the EPTL.

514. Definition of Income for Trust Purposes, T.D. 9102, 69 Fed. Reg. 12, 2004-1 C.B. 366.

In addition to denying the income tax charitable deduction for long-term capital gain realized by a pooled income fund, in some cases, the 2004 regulations change the definition of “income” for purposes of a pooled income fund. Presumably, for a trust to become or remain a pooled income fund, the regulatory meaning must be used. Before the amendment, Treasury Regulations section 1.642(c)-5(a)(5)(i) provided that the “term ‘income’ has the same meaning as it does under section 643(b) and the regulations thereunder.” Now that the 2004 regulations have changed the meaning of income for purposes of that section, the meaning of income is changed by the 2004 regulations for purposes of pooled income funds, as well. Treasury Regulations section 1.642(c)-5(a)(5)(i) provides that although the meaning of income generally has the same meaning as under section 643(b) and its regulations,

income generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee’s power to adjust between income and principal to fulfill the trustee’s duty of impartiality, if the state statute both 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)-1.⁵¹⁵

However, to use the unitrust payment regime or to exercise the power to adjust, the trustee must allocate to corpus the proceeds from the sale or exchange of any assets contributed to the fund by the donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution or purchase. The apparent purpose of the requirement of allocating at least that portion of proceeds or a sale or exchange equal to the fair market value at the time of contribution or purchase is to preserve for the charitable remainder beneficiary the amount upon which the income and any gift tax deduction was based.

This rule seems to mean that a trust will constitute and be entitled to treatment under section 642(c)(5) only if the trustee, in fact, allocates such proceeds to corpus. Perhaps, that will be simple for the trustee of a pooled income fund to do. But it is uncertain that a trustee could do that if it adopts a unitrust payment regime and, to satisfy the unitrust amount in full, must use proceeds from the sale or exchange of an asset contributed to or purchased by the fund, including part of the fair market value of those assets on the date of their contribution or purchase. In such a case (that is, where the trustee has a duty under

515. Treas. Reg. § 1.642(c)-5(a)(5)(i).

state law to satisfy the unitrust amount but would be using part of the original fair market value) the trustee might seek court approval to make the allocation to corpus as required by the regulations.⁵¹⁶

[E] Taxable Extraordinary Dividends or Taxable Stock Dividends of Simple Trusts⁵¹⁷

Taxable extraordinary dividends or taxable stock dividends which the fiduciary allocates to fiduciary accounting principal under the terms of the governing instrument and applicable local law are subtracted for purposes of trusts which distribute current income only, that is, simple trusts. Taxable extraordinary dividends or taxable stock dividends are included in DNI for estates and complex trusts, however. If the throwback rules of section 665 apply, DNI is computed without the section 643(a)(4) adjustment.⁵¹⁸ Of course, corporate distributions that are not taxable and non-taxable stock dividends will not be part of DNI.⁵¹⁹ Whether these types of distributions are fiduciary accounting income or principal will not alter this result, because they are not gross income.

[F] Tax-Exempt Income Under Section 103, Less Related Expenses⁵²⁰

Interest income that is tax-exempt under section 103 is added to taxable income to calculate DNI, but this amount is first reduced by expenses allocable to tax-exempt income and which would be deductible but for the provisions of section 265 (relating to disallowance of certain deductions). The deduction is disallowed by section 265 on the proportion of exempt income included in DNI to the total income included in DNI (before reduction for expenses).⁵²¹

516. *Id.*

517. I.R.C. § 643(a)(4); *see also* Treas. Reg. §§ 1.643(a)-4, 1.643(d)-2.

518. Treas. Reg. § 1.643(a)-4; I.R.C. § 665(e) (both before and after 1976 amendments); Treas. Reg. §§ 1.665(e)-1(b), 1.665(e)-1A (treatment of such items in computation of distributable net income, even for "simple" trusts). *See* Blattmachr & Cavalieri, *Dividends and DNI*, 125 TR. & EST., Mar. 1986, at 20. A foreign trust which makes a loan described in I.R.C. § 643(i) of cash or marketable securities to its grantor or a trust beneficiary who is a U.S. person cannot be treated as a simple trust.

519. *See* Rev. Rul. 67-117, 1967-1 C.B. 161.

520. I.R.C. § 643(a)(5).

521. *See* Treas. Reg. §§ 1.652(c)-4, ex.; 1.661(c)-2; 1.662(c)-4; 1.643(d)-2(a). *But see* Treas. Reg. § 1.652(b)-3(b). The I.R.C. § 265 disallowance rule is discussed in section 3:2.1[I].

Example: Assume a trust has \$15,000 of tax-exempt income and \$15,000 of rental income and has directly related rental expenses of \$5,000 and trustee fees of \$4,000. The rents are not reduced by the directly related rental expenses for section 643(a)(5) purposes. The ratio in the example is \$15,000/\$30,000 times \$4,000 equals \$2,000. It is not \$15,000/\$25,000 times \$4,000 equals \$1,600.

The inclusion of net tax-exempt income assures that the character of income earned by the entity will flow out to the beneficiaries. When the amount of income a beneficiary must report is determined under section 652 or 662, the tax-exempt nature of the distribution will be retained, because only the taxable portion of DNI will be income.⁵²² Moreover, when the distributions deduction is computed, no deduction will be allowed for the tax-exempt portion of DNI.⁵²³

[G] Foreign Trust Adjustments⁵²⁴

For foreign trusts,⁵²⁵ gross income from sources without the United States, reduced by expenses allocable to the foreign source income and which would be deductible but for the provisions of section 265(a)(1) (relating to disallowance of certain deductions related to tax-exempt income) are added back. Also, gross income of a foreign estate or trust includes gross income from sources within the United States but computed without regard to section 894 (relating to income exempt under treaty). Moreover, the capital gains adjustment described in [C] above does not apply. Rather, for foreign trusts, capital gains, reduced by capital losses to the extent capital losses do not exceed capital gains, are included in DNI, that is, for foreign trusts there is no capital gain adjustment and a capital loss adjustment only if deductible losses exceed gains.

[H] Delegation of Authority to Issue Regulations⁵²⁶

The Treasury Department is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of sections 641–85.⁵²⁷ No regulations have been issued, however.

522. Treas. Reg. § 1.652(b)-1.

523. Treas. Reg. § 1.651(b)-1.

524. I.R.C. § 643(a)(6).

525. See section 6:3.

526. I.R.C. § 643(a)(7).

527. I.R.C. § 643(a)(7) was enacted in 1996 as a part of the significant revisions made to the foreign trust rules by the Small Business Job Protection Act of

Treasury Regulations section 1.70-12, the so-called anti-abuse partnership regulations are an example of regulations issued by the Treasury Department under similar authority.

[I] Charitable Deduction Modification to DNI

In addition to the section 643(a)(1)–(7) list of modifications, section 643(a) provides:

If the estate or trust is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) [tax-exempt income adjustment] and (6) [foreign trust adjustment] shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

This modification to DNI affects the character of income distributions and is discussed below in section 3:3.3.

[J] Income in Respect of a Decedent and DNI

Under section 691(c)(1)(B) and the regulations,⁵²⁸ DNI of an estate or trust is computed without any section 691(c) deduction for federal estate taxes paid. Therefore, if a section 691(c) deduction is claimed in computing taxable income, the amount of the deduction is an “add back.” Once the distribution deduction is calculated, the section 691(c) deduction is apportioned between the estate or trust and the beneficiaries.⁵²⁹

[K] Income of Electing Small Business Trust (ESBT)

Income of an S corporation which is attributed to a section 1361(e)(1) “electing small business trust” is taxed to the trust and does not form part of the trust’s distributable net income.⁵³⁰ For additional discussion of ESBTs and the taxation of ESBT, see section 8:7 in chapter 8.

1996 discussed in chapter 6. Although the regulation authority does not appear to be limited to foreign trust issues and the legislative history does not indicate any limitation, one might question whether the grant of authority is as broad as it appears.

528. Treas. Reg. § 1.691(c)-2(a)(2).

529. Treas. Reg. §§ 1.691(c)-1(a)(4), -2(d), ex. (4).

530. I.R.C. § 641(d). The electing small business trust is taxed on this income at the highest rates. This income includes any gain or loss from the disposition of stock in the S corporation. I.R.C. § 641(d)(2)(c)(ii).

§ 3:3.3 Character of Income Distributed

The second function of the defined term “distributable net income” is to establish the character of the income the beneficiaries of an estate or trust receive, that is, does the beneficiary receive rents, dividends, interest, foreign income, etc. The entity’s income items are treated as having the same character in the hands of the beneficiaries as they have in the hands of the trust or estate.⁵³¹ Thus, distributable net income may include tax-exempt income. This modification to taxable income to compute DNI does not increase the amount taxable to beneficiaries, however. Rather it assures that if, for example, a trust receives \$50,000 of taxable dividends, plus \$50,000 of tax-free interest, a distribution will be deemed to consist half of dividends and half of tax-free interest, unless the document or local law provides otherwise in a manner that the regulations recognize is sufficient to change the otherwise proportionate allocation.⁵³² The flipside of this rule is to limit the estate or trust’s distribution deduction under section 652 or section 662; the entity does not get a deduction for the distribution of tax-exempt items.⁵³³

The 1954 Code Committee Reports say:

In effect, the concept of distributable net income gives statutory expression to the principle underlying the taxation of estates and trusts, that is, that these separate taxable entities are only conduits through which income flows to the beneficiaries, except where income is accumulated by the estate or trust for future distribution. Since the distributable net income concept is used to determine the character of amounts distributed to a beneficiary, it is necessary to adjust the taxable income of the estate or trust by adding to it items of trust income which are not includible in the gross income of the estate or trust but which may, nevertheless, be available for distribution to the beneficiaries.⁵³⁴

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- 531. See I.R.S. Announcement 2004-11, 2004-1 C.B. 581 (an estate for its fiscal year beginning 2002 is permitted to “pass through” qualifying dividends to its beneficiaries received by the estate in 2003).
 - 532. Treas. Reg. § 1.652(b)-2.
 - 533. I.R.C. §§ 652(b), 662(b), 651(b), 661(c). See Hilker, *Gift Loans May Complicate Estate Administration Despite Pre-Death Benefits*, 67 J. TAX’N, Aug. 1987, at 98 (discussing possible impact under I.R.C. § 7872 of interest-free loans upon DNI and income in respect of a decedent).
 - 534. H.R. REP. NO. 83-1337, at A194 (1954); S. REP. NO. 83-1622, at 343 (1954); see also Treas. Reg. § 1.643(a)-0. No explanation is given for failure to include other similar exempt items, for example, income exempt under treaty. See Soll, *Simple Trusts Under 1954 Code*, 94 TR. & EST. 916, 917–18 (1956). Note that under I.R.C. § 643(a)(6)(B), gross income from sources within the United States is determined, for purposes of determining distributable net income of a foreign trust, without regard to I.R.C. § 894 (relating to income exempt under treaty).

Example: If a trust with one beneficiary is required to distribute all of its income, that is, a simple trust, has \$15,000 of real estate rental income, \$10,000 of taxable dividends and \$10,000 of tax-exempt interest income, but no expenses, fiduciary accounting income equals \$35,000 and DNI equals \$35,000. The DNI attributable to exempt income is \$10,000, which leaves the beneficiary with \$25,000 of gross income to report.

In the example, the amount of income that the beneficiaries must report has been computed without regard to the nature of that income. Under the regulations, the beneficiary receives each class of income received by the trust.⁵³⁵ Thus, the beneficiary has \$15,000 of rental income, \$10,000 of dividend income and \$10,000 of tax-exempt income.

For an estate or trust with multiple beneficiaries, the classes of income are shared proportionately, unless the governing instrument has a specific provision or local law provides for a different apportionment of the income and only if apportionment has an independent economic effect separate and apart from the tax effect.⁵³⁶ The regulations provide a simple example:

Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of \$10,000, taxable interest of \$10,000, and tax exempt interest of \$4,000. A will be deemed to have received \$5,000 of dividends, \$5,000 of taxable interest, and \$2,000 of tax exempt interest; B and C will each be deemed to have received \$2,500 of dividends, \$2,500 of taxable interest, and \$1,000 of tax exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.⁵³⁷

The tax treatment of various types of income received by a beneficiary "depends upon the beneficiary's status with respect to them not upon the status of the trust."⁵³⁸ The regulations provide an

535. Treas. Reg. § 1.652(b)-2.

536. *Id.*

537. Treas. Reg. § 1.652(b)-2(a).

538. Treas. Reg. § 1.652(b)-1.

example: “if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.”⁵³⁹

When a trust has deductions, the regulations provide rules to determine which type of income is reduced by the deductions.⁵⁴⁰ First, the expenses directly attributable to one type of income offset that income to determine the type of income received by the beneficiary.⁵⁴¹ Second, if DNI includes any income exempt from taxes, the expenses must be apportioned between the exempt income and the taxable income.⁵⁴² For purposes of making the allocation of deductions to exempt income, any item of income with directly attributable expenses is not reduced by those expenses for purposes of determining the disallowance fraction.⁵⁴³

The remainder of the expenses may be allocated by the fiduciary against any class of income irrespective of local law or provisions of the governing document.⁵⁴⁴ There is no provision for allocation of a portion of the deductions against items of gross income that do not enter into the computation of distributable net income.⁵⁴⁵

Finally, if expenses directly attributable to a class of income exceed that class of income, the excess deductions may be allocated against any other class of income, except that excess expenses attributable to exempt income may not be allocated to taxable income.⁵⁴⁶

Example: If a trust with one beneficiary that is required to distribute all of its income, has \$20,000 of real estate rental income, \$10,000 of taxable dividends and \$10,000 of tax-exempt interest income, and has \$5,000 of rental income expenses and miscellaneous expenses of \$4,000 (chargeable to income for fiduciary accounting

539. *Id.*

540. Treas. Reg. § 1.652(b)-3.

541. *See* Treas. Reg. § 1.652(b)-3(a).

542. Treas. Reg. § 1.652(b)-3(b) applies I.R.C. § 265 rules to disallow a deduction for expenses related to tax-exempt income.

543. *See* Treas. Reg. § 1.652(c)-4, ex.

544. *See* Treas. Reg. § 1.652(b)-3(b).

545. *See id.*; Rev. Rul. 74-257, 1974-1 C.B. 153 (state income tax paid on capital gains retained by trust may be freely allocated against items entering distributable net income); Rev. Rul. 77-355, 1977-2 C.B. 82; *see also* Tucker v. Comm’r, 322 F.2d 86 (2d Cir. 1963) (share against tax-exempt items is not reduced by claimed inclusion in allocation base of capital gain not entering distributable net income); Fabens v. Comm’r, 519 F.2d 1310 (1st Cir. 1975); Rev. Rul. 80-165, 1980-1 C.B. 134. *But see* Rev. Rul. 77-466, 1977-2 C.B. 83 (termination expenses of a trust may not be allocated solely on the basis of components of DNI in final year).

546. *See* Treas. Reg. § 1.652(b)-3(d).

purposes), fiduciary accounting income equals \$31,000 and DNI equals \$31,000. The DNI attributable to exempt income is \$9,000, which leaves the beneficiary with \$22,000 of taxable income to report.

In the example above, the class of income received by the beneficiary and the allocation of deductions might be as follows:

	Tax-Exempt Income	Rents	Dividends
	\$10,000	\$20,000	\$10,000
Directly Related Expense		\$5,000	
Non-Directly Related Expense Allocation	\$1,000	\$3,000	
NET	\$9,000	\$12,000	\$10,000

The allocation of the \$5,000 of rental expenses to rental income and the allocation of \$1,000 of other expenses to tax-exempt income is mandatory. The miscellaneous expenses not allocated to tax-exempt income may be allocated to either the rental income, the dividend income, or apportioned between them.

Thus, the \$3,000 of the miscellaneous expenses that were not allocated to tax-exempt income and disallowed by section 265 may be allocated all to the rental income to produce a net rental income of \$12,000 and dividend income of \$10,000. Alternatively, it may be apportioned all to the dividend income to produce a net of \$7,000 of dividend income and rents of \$15,000. Another choice may be to apportion the expense between the two types of income as the trustee elects. For example, an allocation of the \$3,000 expense on a 50/50 basis results in \$13,500 of rental income and \$8,500 of dividend income.

In all of the alternatives, the total amount received by the beneficiary is \$31,000 of DNI, of which \$22,000 is subject to income taxes.

For another example of the allocation of deductions, see Treasury Regulations section 1.652(c)-4(f).

A trustee's discretion to allocate deductions to or away from various classes of income can be important to the beneficiary. Most important, so long as the tax rate on qualified dividends is a maximum of 15%, an allocation of expenses away from dividends to other types of income, such as rents in the example, may reduce the beneficiary's tax liability.⁵⁴⁷ In addition, if DNI includes capital gains, the allocation of deductions away from capital gain income might permit a beneficiary to deduct capital losses generated outside of the trust or qualify more income for the special capital gains rates provided section 1(h).⁵⁴⁸ Alternatively, if the beneficiary is subject to the passive activity rules of section 469, the allocation of deductions to dividends rather than to rental income of the trust might permit the beneficiary to increase the amount of the passive activity loss deduction permitted by section 469.

The determination of the character of income received by a beneficiary of a simple trust is discussed above. The regulations provide a similar rule for complex trusts.⁵⁴⁹ Subject to the disallowance rule of section 265, the trustees of complex trusts are permitted to allocate deductions to various classes of income, subject to the same limitations that apply to simple trusts.⁵⁵⁰ The regulations provide a complex example that illustrates the trustee's discretion to allocate deductions.⁵⁵¹

An additional rule affects the allocation of deductions if a trust is entitled to a charitable deduction, that is, when it has a charitable beneficiary that is entitled to gross income pursuant to the terms of the governing instrument. Under section 643(a), last sentence, and the regulations,⁵⁵² the charity is deemed to receive a ratable share of each class of income, unless the governing instrument has a specific provision or local law provides for a different apportionment of the income. Thus, the amount of each class of income should be less than

547. Qualified dividends are described in I.R.C. § 1(h)(11). *See also* D. Schaengold, *Old Provision Can Lower Taxes for Trust Beneficiaries*, 74 CPA J., Feb. 2004, at 51.

548. I.R.C. § 1(h) provides various tax rates applicable to different types of capital gain income.

549. Treas. Reg. § 1.662(b)-1 provides that deductions that are used in the calculation of DNI are allocated in accordance with Treas. Reg. § 1.652(b)-1.

550. *See* Treas. Reg. § 1.652(b)-3(b).

551. Treas. Reg. § 1.662(c)-4(e).

552. Treas. Reg. § 1.662(b)-2.

without the charitable deduction and that might affect how much deduction is allocated to each class.

§ 3:4 “Simple” and “Complex” Trusts

In an attempt to provide less complex provisions for trusts not involving more than one type of distribution, the Code provides separate sections governing distributions by simple trusts⁵⁵³ and by complex trusts.⁵⁵⁴ A simple trust is a trust that provides that all of the accounting income is required to be distributed currently,⁵⁵⁵ even if the income that is required to be distributed currently is not actually distributed.⁵⁵⁶ A simple trust may not provide for charitable distributions in the particular year,⁵⁵⁷ and may not make distributions in excess of current accounting income.⁵⁵⁸ All other trusts and all estates are governed by the distributions rules for complex trusts.⁵⁵⁹ It is estimated that the majority of trusts qualify as “simple” ones. A foreign trust which makes a loan described in section 643(i) of cash or marketable securities to its grantor or a beneficiary who is a U.S. person cannot be treated as a simple trust.⁵⁶⁰ Despite the separate sections, the basic rules applicable to simple trusts are fundamentally the same as those for other trusts and estates.

It is possible for a trust to be a simple trust in one year and not a simple trust in another.⁵⁶¹ For example, in *Steingold v.*

553. I.R.C. §§ 651–52. The term “simple trust” is used in Treas. Reg. § 1.651(a)-1.

554. *Id.* The term “complex trust” is used in Treas. Reg. § 1.651(a)-1.

555. Treas. Reg. § 1.651(a)-2(a).

556. Treas. Reg. § 1.651(a)-2(b); H.R. REP. NO. 83-1337, at A196 (1954), S. REP. NO. 83-1622, at 345 (1954). The Committee Reports indicate that the instrument must provide for current distribution of all of the income to noncharitable beneficiaries every year, not merely in the year in question. *Id.* However, the regulations take the opposite position. Treas. Reg. §§ 1.651(a)-1, -2(c).

557. Treas. Reg. § 1.651(a)-4(a) provides that a trust is simple for any year in which it does not make a payment to charity which results in an income tax deduction to the trust under I.R.C. § 642(c), even if authorized to do so.

558. I.R.C. §§ 651, 652.

559. I.R.C. § 661(a). In Tech. Adv. Mem. 8446007, the Internal Revenue Service appears to have attempted to apply to a simple trust a section (or the “purpose” of a section) that by its title and terms apparently could apply only to a complex trust. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

560. I.R.C. § 643(i)(2)(D).

561. Treas. Reg. § 1.651(a)-1.

Commissioner,⁵⁶² a simple trust became a complex trust when a local court ordered the trustee to retain all income. Thus, the trustee was neither required nor permitted to distribute income to the beneficiary. A simple trust will be a complex trust in the trust's last year as the final distribution of all trust assets will be a distribution in excess of trust accounting income (because principal is being distributed).⁵⁶³

Trusts with charitable beneficiaries in a given year are not considered simple trusts and the sections 651–52 rules are not applicable.⁵⁶⁴ Moreover, if an individual beneficiary of a simple trust assigns an income interest in a simple trust to a charity, after the assignment the trust will be allowed neither a distribution deduction nor a charitable deduction.⁵⁶⁵ The trust's continuing status as a simple trust is not clear.

Once a trust is classified as either simple or complex, separate Code sections determine the amount of any distribution deduction allowed the entity and the amount of income the beneficiary or beneficiaries must report in income.

§ 3:5 Deductions for Distributions; Inclusions by Beneficiaries

§ 3:5.1 Amounts That Are Treated As Distributed

A simple trust is allowed an income tax deduction by section 651 for amounts of trust-accounting income "required to be distributed currently" to the beneficiaries in the current year.⁵⁶⁶ The concept of trust-accounting income is controlled by rules of state law (and, to some extent, the terms of the governing instrument), subject to the limitations imposed by the regulations.⁵⁶⁷ Section 652 requires that "the amount of income for the taxable year required to be distributed currently by a trust described in section 651 [a simple trust] shall be included in the gross income of the beneficiaries to whom the income is required to be distributed."⁵⁶⁸

562. Steingold v. Comm'r, T.C. Memo. 2000-225.

563. Treas. Reg. § 1.651(a)-3(a).

564. I.R.C. § 651(a)(2).

565. National Office Tech. Adv. Mem. 8446007. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

566. I.R.C. § 651(a).

567. Treas. Reg. § 1.643(b)-1. See section 3:3.1 for a discussion of the meaning of "income" in a trust accounting sense.

568. I.R.C. § 652(a).

A complex trust, including an estate, is allowed a deduction (a) for amounts of trust-accounting income “required to be distributed currently” to the beneficiaries in the current year, whether distributed or not (including that part of an annuity, or a like distribution, that is actually paid out of trust-accounting income),⁵⁶⁹ and (b) for all other amounts “properly paid, credited or required to be distributed” to the beneficiaries.⁵⁷⁰ The beneficiaries of a complex trust or estate report as income “[t]he amount of income for the taxable year required to be distributed currently. . . [and a]ll other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.”⁵⁷¹ For beneficiaries of both simple trusts and complex trusts, it does not matter whether the beneficiaries are on a cash or an accrual basis.⁵⁷² In Chief Counsel Advice 201016073, the Service concluded that the beneficiary of a complex trust must report in income the amount provided in section 662 even if the trust forgoes the corresponding deduction under section 661. It appears that the trustee proposed to shift the income tax liability from the beneficiary to the trust by not claiming the section 661 deduction, but this outcome was rejected.

For both types of trusts, the amount of the income tax deduction is limited by distributable net income computed without including tax-exempt income.⁵⁷³ Similarly, the income reportable by the beneficiaries is limited by the taxable portion of DNI.⁵⁷⁴

569. I.R.C. § 661(a)(1).

570. I.R.C. § 661(a)(2).

571. I.R.C. § 662(a).

572. *But cf.* Rev. Rul. 59-346, 1959-2 C.B. 165 (in case of death, accrual-basis beneficiary of income “required to be distributed currently” includes in his final return such income to date of death); *Alfred I. Du Pont Testamentary Trust v. Comm’r*, 574 F.2d 1332 (5th Cir. 1978), *aff’g* 66 T.C. 761 (1976), *on remand from* 514 F.2d 917 (5th Cir. 1975) (no distribution treatment for expenses on property leased to beneficiary because paid on account of lease and not for beneficiary *per se*); *Plant v. Comm’r*, 30 B.T.A. 133, *aff’d*, 76 F.2d 8 (2d Cir. 1935), *acq.* 1976-1 C.B. 1 (similar).

573. I.R.C. §§ 651(b), 661(a), (c). See section 3:3.2 for a detailed discussion of DNI and its potential tax-exempt element.

574. I.R.C. §§ 652(a)–(b), 662(a)–(b). See section 3:3.2 for a detailed discussion of DNI and its potential tax-exempt element. *See* *Geftman v. Comm’r*, 154 F.3d 61 (3d Cir. 1998) (distribution to the beneficiary from a testamentary trust not includible in beneficiary’s gross income where court found trust had no income on account of distributions from the estate based upon the court’s finding that there was no loan outstanding between the trust and the estate and interest on mortgages belonged to corporations and not the trust).

The terms “beneficiary” and “beneficiaries” include heirs, legatees, and devisees.⁵⁷⁵ The regulations expand the meaning.⁵⁷⁶ A person whose legal obligation is discharged with trust income is a beneficiary;⁵⁷⁷ the grantor of a trust is a beneficiary if a section 677(b) support payment is made;⁵⁷⁸ and the trustee or co-trustees of a trust is a beneficiary if a section 678 support payment is made to a dependent of the trustee or co-trustee.⁵⁷⁹ The term can include also a purchaser of an interest in a trust.⁵⁸⁰ Nevertheless, for purposes of the distribution deduction, a charity is not treated as such a beneficiary.⁵⁸¹ Animals cannot be beneficiaries, either.⁵⁸²

Amounts of income required to be distributed to beneficiaries are frequently called first-tier distributions. Other amounts that are distributed are termed second-tier distributions and are taxable only to the extent that any distributable net income remains after determining the amount of DNI allocated to the first-tier distributions (that is, trust-accounting income for the taxable year “required to be distributed currently”).

When a beneficiary of a trust is also a debtor of the same trust, a question may arise whether the trust has income if the beneficiary fails to make payments. In Revenue Ruling 75-68,⁵⁸³ the trust beneficiary of a simple trust, by agreement with the trust, did not make interest

575. I.R.C. § 643(c).

576. Treas. Reg. § 1.643(c)-1. *See* *Hopkins v. Comm’r*, 13 T.C. 952 (1949); *Trust Estate of Thomas Lonergan v. Comm’r*, 6 T.C. 715 (1946). A testamentary trust can be deemed to be a beneficiary. Treas. Reg. § 1.643(c)-1; Rev. Rul. 57-214, 1957-1 C.B. 203; Gen. Couns. Mem. 24,702, 1945 C.B. 241; *Comm’r v. Crawford’s Estate*, 139 F.2d 616 (3d Cir. 1943); *Estate of Harwood v. Comm’r*, 3 T.C. 1104 (1944); *Estate of White v. Comm’r*, 41 B.T.A. 525 (1940).

577. Treas. Reg. § 1.643(c)-1(a).

578. Treas. Reg. § 1.643(c)-1(b). I.R.C. § 677(b) support payments are more fully explained at section 5:4.4.

579. Treas. Reg. § 1.643(c)-1(c). I.R.C. § 678 support payments are more fully explained at section 5:5.5.

580. *See* Priv. Ltr. Rul. 8143071 (purchaser of interest in estate of trust becomes beneficiary for subchapter J purposes). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

581. I.R.C. § 663(a)(2); *see also* section 3:2.1[J].

582. Rev. Rul. 76-486, 1976-2 C.B. 192. Section 408 of The Uniform Trust Code provides for “Trusts for the Care of Animals.” A “pet trust” is likely taxed as a grantor trust during the settlor’s lifetime because of the statutory reversionary interest (UTC § 408(c)). After the settlor’s death, the taxation of a pet trust is less certain, although traditional rules should apply.

583. Rev. Rul. 75-68, 1975-1 C.B. 184.

payment on mortgages held by the trust. The Service ruled that the trust had income that was deemed distributed to the beneficiary and he was taxable on that income even though he did not make payments to trust.⁵⁸⁴

Sometimes, it is necessary to determine why a distribution is made. Only distributions to beneficiaries are permitted to be deducted under section 651 or 661.⁵⁸⁵ For example, in Revenue Ruling 87-97,⁵⁸⁶ the Service ruled that distributions of funds by perpetual care trust to a cemetery corporation for care/maintenance of gravesites not deductible under section 651 or 661 because the distributions were not made to corporation as beneficiary but as compensation for services.

[A] Meaning of “Required to Be Distributed Currently”

The regulations state:

[t]he determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. . . . The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust’s taxable year.⁵⁸⁷

When the income is subsequently distributed in a later year, the actual distribution is to be ignored.⁵⁸⁸ For example, a trust that is required to distribute all of its accounting income may make a final distribution of income until the month following the close of the year.⁵⁸⁹ A section 2056(b)(7) QTIP marital deduction trust is a classic example of a trust that is required to distribute all of its accounting income annually.⁵⁹⁰

584. See also *Geftman v. Comm’r*, 154 F.3d 61 (3d Cir. 1998) (distribution to the beneficiary from a testamentary trust not includible in beneficiary’s gross income where court found trust had no income on account of distributions from the estate based upon the court’s finding that there was no loan outstanding between the trust and the estate and interest on mortgages belonged to corporations and not the trust).

585. I.R.C. § 643(c).

586. Rev. Rul. 87-97, 1987-2 C.B. 155.

587. Treas. Reg. § 1.651(a)-2(a); see also H.R. REP. NO. 83-1337, at A196 (1954), S. REP. NO. 83-1622, at 345 (1954).

588. I.R.C. § 663(a)(3).

589. I.R.C. § 663(b).

590. I.R.C. § 2056(b)(7)(B)(ii)(I).

The regulations permit a trustee to retain income for a depreciation reserve out of income and other “due allowance” to keep the trust corpus intact without negating simple trust status.⁵⁹¹ Moreover, a trustee may allocate, in good faith, extraordinary dividends to principal and still maintain simple trust status.⁵⁹²

A trust’s governing document “that departs fundamentally from traditional principles of income and principal” will result in a trust not being a simple trust.⁵⁹³ For example, the regulations provide that if a trust instrument defines ordinary dividends and interest as principal, it will not be treated as a trust that is required to distribute its income currently under section 651.⁵⁹⁴

A trust that requires the distribution of all income, but grants the trustee the power to “sprinkle” the income among several beneficiaries, is still a simple trust.⁵⁹⁵ More problematic situations for simple trusts may occur. For example, the trustee may not be able to locate the beneficiary. In Private Letter Ruling 9138034, a trust was allowed a distribution deduction for amounts it was required to distribute currently and it paid into a bank account for a beneficiary whose whereabouts were unknown.⁵⁹⁶

Gross income that is attributed to an estate or trust but that is not received in a distributable form, such as gross income from a partnership or an S corporation that is not accompanied by a cash or other distribution⁵⁹⁷ or zero coupon bond income, should not be deemed income required to be distributed to a beneficiary because under fiduciary accounting rules, trust accounting is determined on a cash basis.⁵⁹⁸ Such income will be part of DNI, however, and may be deemed distributed to a second-tier beneficiary.⁵⁹⁹

The distribution of property in kind (that is, a non-cash distribution) in satisfaction of a beneficiary’s right to the income of a simple

591. Treas. Reg. § 1.651(a)-2(a).

592. I.R.C. § 643(a)(4).

593. Treas. Reg. § 1.643(b)-1.

594. *Id.* See section 3:3.1 for a more thorough discussion of “income.”

595. Treas. Reg. § 1.651(a)-2(b).

596. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

597. For a discussion of the taxation of trusts as S corporations shareholders, see chapter 8.

598. UNIFORM PRINCIPAL AND INCOME ACT (UPIA) § 102 defines income as “money or property that a fiduciary receives.”

599. The separate share regulations (Treas. Reg. § 1.663(c)-2(b)(4)) discussed at section 3:5.3 provide that gross income not attributable to cash is part of DNI, however.

trust will be deemed a sale of the asset.⁶⁰⁰ Nevertheless, the trust may still qualify as a simple trust.⁶⁰¹

It is probable that “required to be distributed currently” has the same meaning as “is to be distributed currently,” which was used in the 1939 Code.⁶⁰² The test there was whether the beneficiaries had “a legal right to receive accrued trust income at the end of each year,” *not* whether there was an actual or constructive receipt of that income.⁶⁰³

The tax consequences of the amount required to be distributed sometimes must be made for a year during which there was a dispute as to the right, such as the current allocation between income and principal, and where there may be litigation in the state courts as to who is entitled to the income. It appears that the correct tax treatment may be determined long after the close of the year when the outcome of the state law dispute is resolved, but it is then given a retroactive effect for the trust and its beneficiaries.⁶⁰⁴ It has been said that the test of a fiduciary’s duty is what instruction a court of equity, if appealed to, would direct.⁶⁰⁵ On the other hand, it is still probable

600. Treas. Reg. § 1.651(a)-2(d). If the asset is appreciated or depreciated, gain or loss will be realized but, in the case of a loss, section 267(a)(1) and (b)(6) will likely disallow a loss deduction. See section 3:5.6 for a discussion of gain resulting from a distribution.

601. *Id.*

602. 1939 I.R.C. § 162(b). See 2 A.L.I. FED. INCOME TAX STAT. 437 cmt. 3 (Draft Feb. 1954) [hereinafter A.L.I., Feb. 1954].

603. Marx v. Comm’r, 39 B.T.A. 537, 547 (1939) (amounts that are improperly distributed were not covered by 1939 Code § 162(b)). Freuler v. Helvering, 291 U.S. 35 (1934); Carpenter v. United States, 57-2 U.S.T.C. (CCH) ¶ 9,755, 52 A.F.T.R. (P-H) 1284 (D. Del. 1957); Hewlett v. United States, 52-1 U.S.T.C. (CCH) ¶ 9158, 44 A.F.T.R. (P-H) 1117 (D. Wyo. 1951); Moseley v. Comm’r, 8 T.C.M. (CCH) 166 (1949). In Tech. Adv. Mem. 8306003, the Internal Revenue Service held that income of an estate was not currently distributable to the income beneficiary of the testamentary residuary trust, which was required to distribute its income currently, where the trust beneficiary was the executor. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

604. Estate of Bruchmann v. Comm’r, 53 T.C. 403 (1969); Rev. Rul. 62-147, 1962-2 C.B. 151. See Michaelson, *Tax Effects of Estate Contests*, 16 INST. ON FED. TAX’N 1021 (1958); Moore & Sorlien, *Homeless Income*, 8 TAX L. REV. 425, 438 *et seq.*, 449-50 (1953). Cf. Treas. Reg. § 1.1312-5(b), (c) (assumes income distributable because of subsequent state court decision that accumulation was invalid).

605. United States v. Higginson, 238 F.2d 439, 445 (1st Cir. 1956); Polt v. Comm’r, 233 F.2d 893, 896 (2d Cir. 1956) (“even though [the trustee] may be guided by an honest, if doubtful, interpretation of the state law”).

that there must be something approaching a “recognized present right,”⁶⁰⁶ or at least a right not dependent upon discretion.⁶⁰⁷

In any event, the amount deemed distributed is the amount of trust-accounting income, whether more or less income in the income tax sense.⁶⁰⁸

606. Estate of Zellerbach v. Comm’r, 9 T.C. 89 (1947), *aff’d*, 169 F.2d 275 (9th Cir. 1948), *cert. denied*, 335 U.S. 903 (1949); Estate of Cohen v. Comm’r, 8 T.C. 784 (1947); *cf.* 1939 Treas. Reg. 118, § 39.162-2(b)(3). *See* Mannheimer & Friedman, *Income Tax Aspects of Various Will and Trust Arrangements*, 10 INST. ON FED. TAX’N 909, 933–36 (1952); Mueller v. Comm’r, 236 F.2d 537, 541 (5th Cir. 1956) (“present right”); Bryant v. Comm’r, 185 F.2d 517, 519 (4th Cir. 1950) (the income “belonged to and was currently payable to the taxpayer”); Broussard v. United States, 59-2 U.S.T.C. (CCH) ¶ 9665 (E.D. Tex. 1959). Income paid for the benefit of the distributee, or satisfying any legal obligation, including the obligation to support, can be treated as paid to him. Treas. Reg. §§ 1.662(a)-4, 1.643(c)-1(a), 1.661(a)-2(d), 1.662(a)-2(d), 1.671-1(c); Edwards v. Comm’r, 37 T.C. 1107 (1962). *See also* chapter 5, note 623. *But cf.* Rev. Rul. 55-286, 1955-1 C.B. 75, recognizing gifts to the grantor’s employees. *See* I.R.C. § 102(c).

Income in undistributable form, such as partnership income, can be deemed to be distributed to a beneficiary. *Brown v. United States*, 21 F. Supp. 214 (D. Mo. 1937), *aff’d*, 106 F.2d 993 (8th Cir. 1939); *cf.* *Caldwell v. United States*, 102 F.2d 607 (7th Cir. 1939) (same conclusion under 1939 I.R.C. § 162(c)); *Fickert v. Comm’r*, 15 T.C. 344 (1950), *nonacq.* 1951-1 C.B. 4. There is considerable litigation on whether valid partnerships exist in particular instances where trusts are members. Another example of undistributable amounts deemed distributed is United States savings bond increment. I.T. 3575, 1943-2 C.B. 113. An estate’s election to report increment annually on series E bonds does not bind a successor trust since it and the successor trust are separate entities. Rev. Rul. 58-435, 1958-2 C.B. 370. *See* Weiss & Blumenfrucht, *Variations in Reporting Beneficiary’s Simple Trust Income Has Planning Potential*, 44 J. TAX’N 226 (1976). *See also* Baumann & McBryde, *Ownership of a Partnership Interest by an Estate or Trust: Tax and Other Considerations*, 38 TAX LAW. 33, 60 (1984) (“the fiduciary . . . should not treat a distributive share of partnership income as ‘income’ . . . under section 643(b)”).

607. *Hill v. Comm’r*, 24 T.C. 1133, 1138 (1955) (“The mere right to apply to a court of competent jurisdiction to compel distribution, where it is possible, but not clear, that such application would be granted, is not equivalent to a present enforceable right.”). *See* L. KENNEDY, *FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES* § 2.05G (1948); *Harrison v. Comm’r*, 7 T.C. 1 (1946); *cf.* *Doty v. Comm’r*, 148 F.2d 503 (1st Cir. 1945).

608. Thus, the amount received by a trust, constituting taxable income from an estate, was held not taxable to the trust’s beneficiaries because the trust was not required to distribute. *United States v. Bank of Am. Nat’l Trust & Sav. Ass’n*, 326 F.2d 51, 53–55 (9th Cir. 1963).

Example: A simple trust with a \$100,000 corpus receives \$4,000 of dividend income. The trust pays a \$1,000 trustee fee that is charged one-half to income and one-half to principal. The fiduciary accounting income is \$3,500 although the taxable income is \$3,000. In the example, the beneficiary will receive \$3,500 of cash, although only \$3,000 of it will be included in the beneficiary's gross income.⁶⁰⁹ Alternatively, if the \$4,000 is all tax-exempt income, the accounting income will still be \$3,500 and taxable income would be zero.

In determining whether particular items are required to be distributed, the terms of the will or trust instrument and the applicable state law are controlling.⁶¹⁰ If the trust instrument clearly requires distribution, an uncontested state court order preventing distribution will be ineffective, at least on income earned before the order.⁶¹¹

An issue arises if the governing instrument provides that the net income is to be paid at reasonable intervals to the income beneficiary. Within this category have been cases in which the direction was to pay income to the beneficiary "periodically," and one in which it was "at least quarterly."⁶¹² A testator's direction to create certain trusts, the income of which was to be applied to the use of the beneficiaries, was held to be a direction to distribute currently; the fact that the trustees made no segregation was immaterial.⁶¹³ In any such case, an agreement by the beneficiaries that the fiduciary may accumulate the

609. See section 3:2.1 for a discussion of how taxable income is calculated.

610. *E.g.*, *Smith's Estate v. Comm'r*, 168 F.2d 431, 435 (6th Cir. 1948) ("it being immaterial whether the decision was before or after the taxable year involved"); *Foerderer v. Comm'r*, 16 T.C. 956 (1951). See Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 TAX L. REV. 213 (1957); *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967); *cf.* Rev. Rul. 73-142, 1973-1 C.B. 405; *Brown v. United States*, 890 F.2d 1329 (5th Cir. 1989) (Service not foreclosed from contending administration of estate unduly prolonged for income tax purposes despite state court order authorizing executor to continue administration).

611. *Saulsbury v. United States*, 101 F. Supp. 280 (S.D. Fla. 1951), *aff'd*, 199 F.2d 578 (5th Cir.), *cert. denied*, 345 U.S. 906 (1952). See *Doll v. Comm'r*, 2 T.C. 276, 284 (1943), *aff'd*, 149 F.2d 239 (8th Cir. 1945); *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967). *Cf.* Rev. Rul. 73-142, 1973-1 C.B. 405.

612. *Kent v. Comm'r*, 26 B.T.A. 482, 486 (1932); *Barrett v. Comm'r*, B.T.A.M. (P-H) ¶ 91,223 (1939). *Cf.* *Estate of Petschek v. Comm'r*, 738 F.2d 67 (2d Cir. 1984) (holding, in effect, that income earned in a simple trust (one governed by subpart B of part 1 of subchapter J) through the date of loss of status as an American taxpayer is attributed to the taxpayer).

613. *Marx v. Comm'r*, 39 B.T.A. 537 (1939).

income may not prevent taxing the beneficiaries on the income otherwise distributable.⁶¹⁴

Income may be required to be distributed currently also if a personal representative unnecessarily delays completing the administration of an estate by failing, in the capacity as personal representative, to transfer the assets to the trustee on behalf of residuary legatees. If the residuary trust's income is to be currently distributable, the income may be taxable to the trust's beneficiaries even if the estate, while it validly continued, did not have to make current distributions.⁶¹⁵

An estate with simple trusts as its devisees sometimes makes distributions directly to the trust beneficiaries. The Service has ruled that distributions of accounting income by an estate to beneficiaries of a testamentary trust of decedent are treated as having been made by the trust. The Service found, "[d]irect distributions by the . . . estate to the beneficiaries of a testamentary trust before the trust has been established are proper under New York law [applicable local law]."⁶¹⁶

Moreover, the income of a simple trust may still be "required to be distributed currently" during the period between the event that causes the trust to terminate and the time when the trust is considered to be fully terminated.⁶¹⁷ For example, trusts are deemed to continue in existence, despite the death of the measuring life or the occurrence of another measuring event, during a reasonable period for winding up and for distribution of the corpus.⁶¹⁸ "[T]he determination of whether a trust has terminated depends upon whether the property held in trust has been distributed . . . rather than upon the technicality of

614. *Id.* at 547; *see also* Warburton v. Comm'r, 193 F.2d 1008 (3d Cir. 1952); Rev. Rul. 75-68, 1975-1 C.B. 184 (beneficiary taxable although by agreement he did not, as mortgagor, pay to trust what would be the trust's income). *But compare* Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955) (consent-type state court decision binding because conclusive of parties' property rights), *with* Comm'r v. Estate of Bosch, 387 U.S. 456 (1967).

615. Stewart v. Comm'r, 196 F.2d 397 (5th Cir. 1952), *aff'g* 9 T.C. 195 (1947); Chick v. Comm'r, 7 T.C. 1414 (1946), *aff'd*, 166 F.2d 337 (1st Cir.), *cert. denied*, 334 U.S. 845 (1948); Friedman & Schacht, *How to Plan for the Income of an Estate*, in ESTATE TAX TECHNIQUES 1540.25, 1578.10-13 (J. Lasser ed., 1968). *See* Treas. Reg. § 1.641(b)-3(a). Conversely, some cases indicate that the transfer of the assets from the estate to the trust may not be done with undue haste. Smith's Estate v. Comm'r, 168 F.2d 431 (6th Cir. 1948); United States v. Britten, 161 F.2d 921 (3d Cir. 1947); *see also* Estate of Bruner v. Comm'r, 3 T.C. 1051 (1944).

616. Tech. Adv. Mem. 8506005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

617. Treas. Reg. § 1.641(b)-3(c).

618. Treas. Reg. § 1.641(b)-3(b).

whether or not the trustee has rendered his final accounting.”⁶¹⁹ During this period, the trustee must continue to file returns.⁶²⁰

A trust that is required to distribute all of its accounting income is permitted a \$300 personal exemption whether it is a simple trust or a complex trust.⁶²¹

[B] Meaning of “Other Amounts Properly Paid, Credited, or Required to Be Distributed”

If distributable net income for a particular tax year exceeds the amount required to be distributed, a complex trust or an estate is permitted a tax deduction not only for income required to be distributed currently but also on other amounts “properly paid, credited or required to be distributed.”⁶²² Likewise, the beneficiaries must report as income the other amounts “properly paid, credited, or required to be distributed.” This may occur if the trustee has discretion either to accumulate income or to pay it out, or if the trustee makes distributions of fiduciary accounting principal.

Because the fiduciary of an estate rarely is required to make annual or more frequent distributions, most distributions from estates will fall under this latter rule.⁶²³ In all events, estate distributions are not covered by sections 651 and 652, which provide simplified rules for trusts (but not estates) that are required to distribute only fiduciary accounting income, make no other distributions, and do not provide for distributions to charity.⁶²⁴ However, if current income distributions are required by an estate, like a complex trust, the estate will be deemed to have made first-tier distributions under the above rules even if no actual distributions have been made.⁶²⁵ The regulations recognize

619. *Id.*; H.R. REP. NO. 83-1337, at A191–92 (1954); S. REP. NO. 83-1622, at 340 (1954).

620. Rev. Rul. 55-287, 1955-1 C.B. 130.

621. I.R.C. § 642(b)(2)(B). A trust that is required to distribute its income currently may be a complex trust if the trust distributes more than accounting income or has a charitable beneficiary.

622. I.R.C. § 661(a)(2).

623. *See, e.g.*, *Bowen v. Comm’r*, 295 F.2d 816 (2d Cir. 1961), *aff’g* 34 T.C. 222 (1960); *First Nat’l Bank of Memphis, Tenn. v. Comm’r*, 7 T.C. 1428 (1946), *aff’d sub nom. Smith Estate v. Comm’r*, 168 F.2d 431 (6th Cir. 1948); *Estate of Igoe v. Comm’r*, 6 T.C. 639 (1946) [New York: amounts were credited]; *Estate of Bruner v. Comm’r*, 3 T.C. 1051 (1944). *See generally* S. Brown, *The Overall Tax Impact of Accumulating vs. Distributing Trust Income*, 28 EST. PLAN. 83 (2001).

624. I.R.C. §§ 651 and 652 are applicable only to trusts. I.R.C. §§ 661 and 662 are applicable to estates and trusts that are either accumulating income or distributing corpus.

625. *Brown v. United States*, 21 F. Supp. 214 (D. Mo. 1937); *Bullard v. Comm’r*, 5 T.C. 1346 (1945); *cf. Caldwell v. United States*, 102 F.2d 607 (7th Cir.

the possibility of such a requirement's existing for an estate.⁶²⁶ The regulations presume that a widow's or family allowance required to be paid out of either income or corpus is payable out of income to the extent available, subject to the separate share rules discussed in section 3:5.3.⁶²⁷ Additional factors such as the fiduciary's power under state law to withhold specifically bequeathed property and its income during a creditors' period may be considered when determining whether income is required to be distributed. Whether a spouse's elective share rights are distributions of accounting income are discussed below.⁶²⁸

If the distribution of income is discretionary with the fiduciary, the income is not treated as distributed to beneficiaries unless actually "paid or credited" to them.⁶²⁹ Under the similar requirements of prior law it has been held that before income not actually paid to a beneficiary can be considered as "credited" to him it has to be set aside for him or allocated to him.⁶³⁰ Thus, an estate, rather than the beneficiary, has been held taxable on the income of the estate already credited to the beneficiary on the personal representative's books, when the personal representative actually used the income to pay an inheritance tax.⁶³¹ On the other hand, an estate was not taxable on the income actually distributed to a testamentary trust for the benefit of a widow, even though she subsequently elected to take her statutory

1939) (same facts, decided under then section 162(c)); *see* Estate of Tait v. Comm'r, 11 T.C. 731, 739 (1948), *modified*, 9 T.C.M. (CCH) 122 (1949); Hibernia Nat'l Bank v. Donnelly, 121 F. Supp. 179, 188 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954).

626. Treas. Reg. § 1.661(a)-2(b).

627. Treas. Reg. § 1.662(a)-2(c).

628. *See* section 3:5.3.

629. Comm'r v. First Trust & Deposit Co., 118 F.2d 449 (2d Cir. 1941) (finding no duty under New York law on part of trustee to make periodical distributions of current income to remainder beneficiaries after termination and before accounting); Orthwein v. Comm'r, 45 B.T.A. 184 (1941); Guitar Trust Estate v. Comm'r, 34 B.T.A. 857 (1936). *Cf.* Bryant v. Comm'r, 185 F.2d 517 (4th Cir. 1950) (income during wind-up period of trust must be distributed currently); Trust Estate of Thomas Lonergan v. Comm'r, 6 T.C. 715 (1946) (paid to individual in capacity as beneficiary as opposed to creditor); Zaharoolis v. Comm'r, T.C. Memo. 1976-76.

630. Cecelia K. Frank Trust of 1931 v. Comm'r, 8 T.C. 368 (1947), *aff'd*, 165 F.2d 992 (3d Cir. 1948); Comm'r v. Stearns, 65 F.2d 371 (2d Cir.), *cert. denied*, 290 U.S. 670 (1933); Weed's Estate v. United States, 110 F. Supp. 149 (E.D. Tex. 1952); Igoe v. Comm'r, 19 T.C. 913 (1953); Estate of Cohen v. Comm'r, 8 T.C. 784 (1947); Estate of Bruner v. Comm'r, 3 T.C. 1051 (1944); Estate of Johnson v. Comm'r, 88 T.C. 225, *aff'd*, 838 F.2d 1202 (2d Cir. 1987) (funds credited on accountants' workpapers were not allocated beyond fiduciary's recall and, therefore, not credited so as to allow fiduciary deduction under I.R.C. § 661(a)(2)).

631. Estate of Hubbard v. Comm'r, 41 B.T.A. 628 (1941); *cf.* Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied*, 414 U.S. 820 (1973)

share of the estate in lieu of the testamentary provisions.⁶³² For income that is actually paid, it is necessary that the payment qualify as “proper” under the applicable law for the amounts to be treated as distributions. Under this rule, taxing a partial distribution from an estate might be defeated where state law makes the distribution subject to recall until the final decree.⁶³³

The rules as to what constitutes payments to beneficiaries apply both to discretionary distributions of current income and required or discretionary distributions of accumulated past income, and also to required or discretionary distributions of corpus, except in the few specified situations where corpus distributions are exempt.⁶³⁴ Examples of payments to which the above rules apply appear in the regulations.⁶³⁵ The value of a non-exempt distribution in kind is limited by section 643(e) to the basis of the property in the hands of the distributing fiduciary.⁶³⁶ This section also permits the fiduciary to elect to recognize gain or loss upon distributions of other than cash and as a result to increase the amount of DNI deemed distributed to fair market value.⁶³⁷

Any amount paid to a U.S. person that is derived directly or indirectly from a foreign trust of which the payor is not the grantor

632. (estate taxes charged against residuary were not beneficiary-trusts’ “legal obligation”). *But cf.* Warburton v. Comm’r, 193 F.2d 1008 (3d Cir. 1952) (under 1939 I.R.C. § 162(b), beneficiaries taxable where tax was their obligation). On payment of obligations generally, see Treas. Reg. § 1.662(a)-4. Bohan v. United States, 326 F. Supp. 1356 (W.D. Mo. 1971), *aff’d*, 456 F.2d 851 (8th Cir. 1972) (residuary legatee not taxable because partial distribution held not unconditional); Murphy v. United States, 1991-1 U.S. Tax Cas. (CCH) ¶ 50,167 (W.D. Okla. 1991) (income taxed to estate rather than beneficiaries to whom distributions were made as they violated state law when made without obtaining prior court order for same), *rev’d*, 984 F.2d 379 (10th Cir. 1993); *see* Proctor v. White, 28 F. Supp. 161 (D. Mass. 1939); Dole, *A Technique for Making Distributions from Principal and Income to Residuary Beneficiaries during Administration of Estates: With Application to Trusts*, 79 HARV. L. REV. 765 (1966); Gorenberg, *How to Avoid Unforeseen Income Tax Consequences in Estate Distributions*, 40 J. TAX’N 194 (1974). *But cf.* Rev. Rul. 72-396, 1972-2 C.B. 312 (Commissioner will not follow *Bohan*). *See also* Cohan & Frimmer, *Trapping Distributions: The Trap That Pays*, 112 TR. & EST. 766 (1973).

633. *Id.*

634. These exempt situations are discussed section 3:5.4.

635. Treas. Reg. § 1.662(a)-3(b).

636. I.R.C. § 643(e). *See* section 3:5.6.

637. I.R.C. § 643(e)(3). *But see* Edward D. Rollert Residuary Trust v. Comm’r, 80 T.C. 619 (1983), *aff’d*, 752 F.2d 1128 (6th Cir. 1985) (holding that the distribution of the right to receive income in respect of a decedent is not a distribution for purposes of I.R.C. §§ 661, 662). Note, also, that the election granted to the fiduciary by I.R.C. § 643(e) does not change the prior law that distributions (other than of cash) in satisfaction of pecuniary legacies automatically result in recognition. *See* STAFF OF JOINT COMM. ON TAXATION,

is deemed paid by the foreign trust.⁶³⁸ Moreover, except as may be provided in regulations, a loan of cash or marketable securities directly or indirectly from a foreign trust to a beneficiary who is a U.S. person (other than an entity exempt from income tax) is treated as a distribution.⁶³⁹ A loan to a U.S. person related to the beneficiary or grantor is treated as though it was made to the beneficiary or grantor if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under sections 267⁶⁴⁰ or 707(b) and, for purposes of this rule, includes loans to spouses of members of the family of such related parties.⁶⁴¹ For purposes of this rule, cash includes foreign currencies and cash equivalents.⁶⁴² When such a loan is treated as such a distribution, any subsequent transaction (for example, repayment of loan) is disregarded for income tax purposes.⁶⁴³ A trust that makes a loan described in section 643(i) cannot be treated as a simple trust under section 651(a).⁶⁴⁴

[C] Indirect Payments

The seminal decision *Old Colony Trust Co. v. Commissioner*⁶⁴⁵ establishes that a third-party payment of someone's legal obligation, such as an employer paying an employee's income tax liability, has an income tax consequence. The regulations under subchapter J adopt this rule by providing that a trust's payment of a beneficiary's legal

98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 (H.R. 4170, 98th Cong., Pub. L. No. 98-369) 253-54 (Comm. Print 1984). Note that I.R.C. § 267(a)(1) may deny a loss deduction to a trust (but not an estate) in some cases.

638. I.R.C. § 643(h). This rule is to ignore the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. It applies whether or not the trust was created by a U.S. person. It does not apply, as the language of this section suggests, to a withdrawal from a foreign trust by a U.S. grantor and the subsequent payment to a U.S. person. H.R. REP. NO. 104-542, pt. 2, at 28 (1996).
639. I.R.C. § 643(i). This deemed distribution by loan rule applies to loans made after September 19, 1995, and also applies to loans to a grantor of the trust who is a U.S. taxpayer.
640. *Joseph E. Widener Trust No. 5 v. Comm'r*, 80 T.C. 304 (1983) (sale of property from one trust to another not subject to I.R.C. § 267 where trusts had different grantors but same beneficiaries); *Hanna's Estate v. Comm'r*, 320 F.2d 54 (6th Cir. 1963) (transaction, prior to enactment of I.R.C. § 267(b)(13), between an estate and an estate beneficiary not subject to I.R.C. § 267); Rev. Rul. 77-439, 1977-2 C.B. 85 (same); Rev. Rul. 71-50, 1971-1 C.B. 106 (transaction between stepchild and stepmother not subject to I.R.C. § 267).
641. I.R.C. § 643(i)(2)(B). Regulations to be promulgated are to determine the appropriate allocation if such a relationship is applicable to more than one person (*e.g.*, the loan is made to a person who is both the spouse of the grantor and the parent of the beneficiary).
642. I.R.C. § 643(i)(2)(A).
643. I.R.C. § 643(i)(3).
644. I.R.C. § 643(i)(2)(D).
645. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929).

obligation is deemed a distribution to the beneficiary.⁶⁴⁶ This might happen if a trust pays something that a parent who is the beneficiary is obligated to provide a child. In that circumstance, the payment is deemed a distribution to the parent and is taxable to the parent to the extent any distribution from the trust to a beneficiary would be.

The issue gets more problematic when the payments benefit the trust and also may indirectly benefit a trust's beneficiary. For example, a trust might provide that the trust is to provide the rent-free use of a residence to a beneficiary. Because the residence is a trust asset, the trustee has a fiduciary obligation to maintain the residence; yet, the beneficiary receives the benefit of the rent-free use of the property. Courts have held in this situation that the beneficiary is not treated as receiving a distribution from the trust for income tax purposes. For example, in *Commissioner v. Plant*,⁶⁴⁷ a testamentary trust directed that the trustee maintain the decedent's home for as long as the decedent's son wanted to use it as a permanent residence or a summer home. Judge Augustus Hand, for the Second Circuit, concluded that the beneficiary did not receive taxable income by the trust's maintenance or the beneficiary's use of the house.⁶⁴⁸ The Service has favorably applied this interpretation in a Technical Advice Memorandum.⁶⁴⁹ In a different context, a U.S. district court ruled that the income from a non-grantor portion of a trust was taxable to the beneficiary when the trust paid expenses related to a property owned by the trust but was considered owned by a grantor trust portion of the same trust.⁶⁵⁰ The court reasoned that the payments by the non-grantor trust portion of the trust were not deductible personal expenses of the grantor-beneficiary and were distributions of trust income to the beneficiary.⁶⁵¹

A related question concerns a trust's deduction for the expenses paid.⁶⁵² In *Commissioner v. Plant*,⁶⁵³ discussed above, the trustee

646. Treas. Reg. § 1.662(a)-4.

647. *Comm'r v. Plant*, 76 F.2d 8 (2d Cir. 1935).

648. *See also* *Carson v. United States*, 317 F.2d 370 (Ct. Cl. 1963) (holding that the government did not carry its burden of proof regarding a counter-claim involving this issue).

649. Tech. Adv. Mem. 8341005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

650. *Moreell v. United States*, 221 F. Supp. 864 (W.D. Pa. 1963).

651. The *Moreell* court found also:

If the expenditures made by the trust for the maintenance of the property are not includable in the gross income of [the grantor-beneficiary], then the fair market rental value of the property is income to her.

Id. at 874.

652. For a more thorough discussion, see Leonard Goodman et al., *Income Tax Implications of Putting Title to a Personal Residence into a Trust*, 108 J. TAX'N 10 (2008).

653. *See* note 647, *supra*, and accompanying text.

did not deduct the expenses of maintaining the home owned by the trust and it paid income taxes on that portion of retained income. In the Technical Advice Memorandum discussed in the immediately preceding paragraph, the trust did not deduct caretaker expenses paid out of trust income but did deduct real property taxes. Of course, a deduction of property taxes is permitted by section 164. Whether interest on a mortgage loan would be deductible likely would depend on whether the trust could satisfy the provisions of section 163.⁶⁵⁴ In *A.I. DuPont Testamentary Trust v. Commissioner*,⁶⁵⁵ the Fifth Circuit denied a section 212 deduction for the expenses of maintaining a “mansion” occupied by a trust beneficiary. The court held that the residence was not income-producing property.⁶⁵⁶

Conversely, when a trust beneficiary pays an expense that would normally be deductible by the trust, the question is whether the trust or the beneficiary deducts the expense. In *Horsford v. Commissioner*,^{656.1} the Tax Court ruled that the beneficiary of a trust could deduct a real property tax paid by the beneficiary. The trust did not have liquid assets to pay the tax and the court concluded that the beneficiary was paying the tax to protect the beneficiary’s property right in the house owned by the trust that the beneficiary was permitted to live in pursuant to the terms of the trust. Somewhat similarly, a trust required a beneficiary to pay property taxes on property the trust owned as a condition to living in the house. The Tax Court, citing *Horsford*, ruled that the beneficiary was entitled to the property tax deduction.^{656.2}

Legislation adopted in 2010 provides that the uncompensated use of any trust property held in a foreign trust, including below-market loans by a U.S. person, is treated as a distribution.⁶⁵⁷ This rule does not apply if the trust is paid fair market value for the use of trust property.⁶⁵⁸

654. See notes 27–34, *supra*, and accompanying text.

655. *Alfred I. DuPont Testamentary Trust v. Comm’r*, 514 F.2d 917 (5th Cir. 1975).

656. Under I.R.C. § 212, a deduction is allowed for the management, conservation, or maintenance of property held for the production of income.

656.1. *Horsford v. Comm’r*, 2 T.C. 826 (1943).

656.2. *Cummings v. Comm’r*, T.C. Memo. 1949-1666. *Horsford* was favorably cited by the Tax Court in *Trans v. Comm’r*, T.C. Memo. 1999-233, a case not involving a trust but involving equitable owners. See also *Estate of Movius v. Comm’r*, 22 T.C. 391.

657. I.R.C. § 643(i), Pub. L. No. 111-147, § 533; I.R.C. § 679(c)(6), Pub. L. No. 111-147, § 533(c).

658. I.R.C. § 643(i), Pub. L. No. 111-147, § 533; I.R.C. § 679(c)(6), Pub. L. No. 111-147, § 533(c).

§ 3:5.2 Tier System

From the beneficiaries' perspective, all amounts treated as distributed or distributable will fall into one of two categories: (1) the amount of income, for trust-accounting purposes, required to be distributed currently, including the amount of an annuity (or other item payable out of income or corpus) that is actually paid out of such income for the year, or (2) all other amounts of income or corpus either required to be distributed or properly paid or credited.⁶⁵⁹ This division into two categories provides what can be described as a two-tier system of taxation. The total amount taxable to the beneficiaries is limited to distributable net income, however, and then only to the taxable portion of DNI.⁶⁶⁰

Amounts in the first category, or first tier, are taxed in full, to the extent distributable net income is not exceeded, before amounts in the second tier are taxed at all. If the first-tier amounts exceed distributable net income, each recipient of first-tier distributions includes in income a proportionate part of the distributable net income.⁶⁶¹

If first-tier distributions alone do not exceed distributable net income, the second-tier distributions are taxable to the recipient-beneficiaries. When the total of first-tier and second-tier distributions exceed DNI, each recipient of second-tier distributions includes in income a proportionate part of the amount that remains after distributable net income is reduced by the first-tier distributions.⁶⁶²

In all instances, beneficiaries are taxable only on the portion of DNI that is taxable income⁶⁶³ and the trust's distribution deduction is limited to the taxable income element of DNI.⁶⁶⁴

For purposes of the DNI limit on taxing first-tier distributions, the trust's income tax charitable deduction is not allowed when computing distributable net income.⁶⁶⁵ This is the case even when deductible charitable distributions are out of trust-accounting income; thus, trust-accounting income (required to be distributed currently) may exceed distributable net income. In effect, charitable distributions of income are in a middle category: available income is first treated as going to first-tier beneficiaries; then, to the extent that income is distributed to charity, there is a charitable deduction. As a result, only

659. I.R.C. § 662(a).

660. Distributable net income is described in detail in section 3:3.2. However, in the very limited circumstances when the "throwback rules" apply, distributions of accumulated (prior years') income may also become taxable to the beneficiary.

661. An exception exists if certain classes of income are distributable to only certain beneficiaries. Treas. Reg. § 1.662(b)-1.

662. I.R.C. § 662(a)(2).

663. I.R.C. §§ 652(a)-(b), 662(a)-(b). See section 3:3.2 for a detailed discussion of DNI and its potential tax-exempt element.

664. I.R.C. §§ 651(b), 661(a), (c). See section 3:3.2 for a detailed discussion of DNI and its potential tax-exempt element.

665. I.R.C. § 662(a)(1).

the residue of income is taxed to the second-tier beneficiaries. As to the determination of the specific items of income and deduction, a portion of each class is deemed to go to the charity.⁶⁶⁶

Example: A complex trust has \$65,000 of taxable dividend income. Annually, the Trust is required to distribute the first \$10,000 of income to a qualified charity, *C*, and the balance of its accounting income to an individual, *A*. In addition, the Trustee is authorized to invade principal for the benefit of a second individual, *B*, and distributes \$10,000 to *B*. The trust pays \$10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is \$60,000 (\$65,000 less \$5,000 (one-half of the trustee's fee)). Thus, the amount distributable to *A* is \$50,000 (\$60,000 less \$10,000 due the charity).

The trust's taxable income is \$45,000 (\$65,000 less \$10,000 trustee fee and less \$10,000 charitable deduction). The DNI for the trust is \$45,000. Because distributions to *A* and *B* exceed DNI, the trust's distribution deduction is limited to \$45,000.

When the amount of income *A* must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is \$55,000 for this purpose and *A* has \$50,000 of taxable income under section 662. Note that the amount of income *A* must report is less than the recomputed DNI by \$5,000.

Nevertheless, *B* has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original \$45,000 and that amount is not in excess of the tier 1 distribution to *A*.

Many annuities may also, in effect, be in a middle category. For example, if \$40,000 is to be paid annually, payable out of income to the extent that income is available, with the balance payable out of principal, the annuity payment is in the second tier in years when all of the income is distributed to other beneficiaries, but in years when all accounting income is not distributed to first-tier beneficiaries, the annuity payment is entirely or partly in the first tier (and thus taxed ahead of ordinary corpus distributions) because it is paid entirely or partly out of income.⁶⁶⁷

666. See Treas. Reg. §§ 1.642(c)-2, 1.662(b)-2.

667. See Treas. Reg. § 1.662(a)-2(c), which may imply that every type of annuity is deemed paid out of income to the extent that income is available. See generally Del Cotto & Joyce, *Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code*, 23 TAX L. REV. 257 (1968).

Three examples in Table 3-1 below illustrate. First-tier distributions total \$36,000 and second-tier distributions total \$12,000. The only variant is the amount of distributable net income.

Table 3-1
Examples of the Tier System

	Example 1 Distributable net income: \$48,000 or more (in thousands)	Example 2 Distributable net income: \$42,000 (in thousands)	Example 3 Distributable net income: \$30,000 (in thousands)
Amount of trust-accounting income required to be distributed currently to <i>A</i> (first tier)	\$12	\$12	\$12
Amount taxed to <i>A</i>	\$12	\$12	\$10
Amount of trust-accounting income required to be distributed currently to <i>B</i> (first tier)	\$24	\$24	\$24
Amount taxed to <i>B</i>	\$24	\$24	\$20
Amount of either discretionary current income, past income, or nonexcepted corpus distributions to <i>C</i> (second tier)	\$8	\$8	\$8
Amount taxed to <i>C</i>	\$8	\$4	\$0
Amount of either discretionary current income, past income, or nonexcepted corpus distributions to <i>D</i> (second tier)	\$4	\$4	\$4
Amount taxed to <i>D</i>	\$4	\$2	\$0
	\$48	\$42	\$30

Thus, when the two-tier system applies, substantial tax differences may depend upon whether a distribution is in the first or second tier.⁶⁶⁸

The 1954 Code changed the 1939 Code to shift discretionary income distributions to the second tier; it brings into the first tier the amount of an annuity that is actually paid out of income for the year. The throwback rules, when applicable, tax distributions of income accumulated in earlier years as if they had been made in the years of accumulation. This effectively created a third tier. Changes in the throwback rules made in 1986 all but eliminate a third tier.⁶⁶⁹

The rationale of the tier system is that first-tier distributions are more realistically distributions of income than are other distributions by the trust, and as a result should be taxed first as income and thus absorbing distributable net income.⁶⁷⁰

Example: Assume that the income of a trust for trust-accounting purposes is \$50,000, and that the distributable net income and the taxable income are each \$40,000 (being less than the trust-accounting income because of a deductible expense chargeable to corpus). Assume that the trustee is required to distribute the income currently, one-half to *A* and one-half to *B* (\$25,000 to each), and in addition makes a \$50,000 corpus distribution to *B*. *A* and *B* will both pay tax on one-half of the distributable net income (that is, on \$20,000 each). Except for the tier system, *B* would have to pay tax on 75,000/100,000ths of the distributable net income (that is, on \$30,000), while *A* would have to pay tax on only 25,000/100,000ths of the distributable net income (that is, on \$10,000).

The tier rule is potentially more complex if a beneficiary of a trust dies mid-year and a successor beneficiary becomes entitled to income. The general rule provides that the deceased beneficiary's final return includes only income actually distributed, limited by DNI.⁶⁷¹ For a

668. Other examples appear in Treas. Reg. §§ 1.662(a)-2(e), -3(d), and 1.662(c)-4.

669. For a discussion of the throwback rules, see section 3:6.

670. See A.L.I., Feb. 1954, *supra* note 670, at 435-36 cmt. 2. Under the Tax Reform Act of 1969, distributions of capital gains accumulated in earlier years were taxed as if they had been made in the years of accumulation; this might be viewed as creating a fourth tier, but the capital gains rule created by the Tax Reform Act of 1969 was repealed by the Tax Reform Act of 1976.

671. *Alfred I. DuPont Testamentary Trust v. Comm'r*, 514 F.2d 917 (5th Cir. 1975); Treas. Reg. §§ 1.652(c)-2, 1.662(c)-2.

simple trust, application of the rule is likely to be straightforward. However, for a complex trust that distributes more than fiduciary accounting in a tax year in which an income beneficiary dies, the application of the tier rule is less certain. It is possible that the DNI limitation on the amount of income to be included on the decedent's final return is computed based on the amount of tier-one income distributed to the deceased beneficiary before death, plus some share of DNI attributable to tier-two distributions made to the beneficiary before death. In effect, DNI is first apportioned between the amount of tier-one income distributed to the beneficiary's estate, if any, and the amount of tier-one distributions distributed to the successor beneficiary, if any. If these distributions are insufficient to carry out all of the estate's or trust's DNI for the year, the balance of the DNI may be divided among the tier-two recipients based on the relative proportions of the tier-two distributions. The regulations provided that a temporal division of the DNI under the separate share rules, discussed below,⁶⁷² is not permitted for a tax year ending after December 31, 1978.⁶⁷³

§ 3:5.3 Separate Shares

In the above example, if *A*'s share of trust income (\$25,000) was accumulated rather than being required to be distributed, the tier system would not prevent taxing *B* on the full \$40,000 of distributable net income because he is the only recipient of distributions during the year. This result may in some instances be unfair and the 1954 Code added an adjunct to the tier system which in some instances recognizes that some income of a trust is being accumulated although corpus is simultaneously being distributed to another beneficiary. Section 663(c), which applies to trusts and to estates,⁶⁷⁴ provides that for the sole purpose of determining the distributable net income for application of the tier system, "substantially separate and independent shares of different beneficiaries of the trust shall be treated as separate trusts,"⁶⁷⁵ pursuant to the regulations. Thus, in the preceding example, *B*'s share of the trust will have only \$20,000 of distributable net income. Accordingly, *B* will be taxable on only \$20,000 and will receive \$5,000 of trust-accounting income plus the \$50,000 of corpus

672. See section 3:5.3, *infra*.

673. Treas. Reg. § 1.663(c)-3(e).

674. For estates of decedents dying after August 5, 1997. Final regulations have been promulgated on the separate share rules that apply to estates of decedents generally effective for decedents dying after December 28, 1999. T.D. 8849. (Rev. Rul. 64-101, 1964-1 C.B. 77, and Rev. Rul. 71-167, 1971-1 C.B. 163, are now obsolete.)

675. I.R.C. § 663(c).

tax-free. The trust will be taxable on *A*'s share of distributable net income, which is accumulated.

The regulations set forth a general rule that separate-share treatment "will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created."⁶⁷⁶ As a result, a separate share may exist even if, upon the termination of the beneficiary's interest in the share, the principal and accumulated income will go to other beneficiaries, rather than to the beneficiary's estate or appointees.

A share may be considered as separate from other shares even though more than one beneficiary has indeterminate interests in it; also, the same person may be a beneficiary of more than one separate share.⁶⁷⁷ A share may be separate even if there is a remote possibility that it can be invaded for another, but not if there is a strong possibility of an invasion that would change the beneficiaries' proportionate shares.⁶⁷⁸

Example: A decedent's will devises a decedent's residuary estate to a trust and directs a trustee to divide the testamentary trust into separate shares (not constituting separate trusts, and not necessarily having separate and independent accounts) for each of the testator's children. The trustee is given discretion, with respect to each share, to distribute or to accumulate the income. In addition, the will provides that when each child reaches age thirty-five his or her share is to be distributed outright to the child. The shares are separate even if the interest of a beneficiary dying without issue before age thirty-five is to be equally divided among the other beneficiaries. The shares created will be separate. This is the case even if the trustee has discretion to invade the corpus of a child's share for the benefit of the child, but not any other child.⁶⁷⁹

The regulations provide that separate-share treatment is mandatory when applicable and is not elective. Separate-share treatment does not apply for purposes other than determining the entity's distribution

676. Treas. Reg. § 1.663(c)-3(a).

677. Treas. Reg. § 1.663(c)-3(c) for trusts; Treas. Reg. § 1.663(c)-4(c) for estates and trusts making the I.R.C. § 645 election to be treated as a part of an estate.

678. Treas. Reg. § 1.663(c)-3(b), (d).

679. This example combines Treas. Reg. §§ 1.663(c)-1(c), -3(a), -4.

deduction and the amount of income a beneficiary must report.⁶⁸⁰ Separate-share treatment in determining distributable net income can enable earmarking of different kinds of items of trust income to different beneficiaries.⁶⁸¹ A separate share doesn't mean separate tax ID numbers, separate tax returns, separate tax payments (including separate estimated payments), or multiple personal exemptions.⁶⁸²

The separate-share rule was extended to estates in 1997.⁶⁸³ Because dispositions of and entitlements to a probate estate are often different than those of a trust, the regulations provide special rules and examples for estates and qualified revocable trusts described in section 645(b).⁶⁸⁴ The applicability of the separate-share rule of section 663(c) to trusts other than qualified revocable trusts described in section 645(b) generally depends upon whether distributions are to be made in substantially separate and independent shares.⁶⁸⁵ The applicability of the rule to estates and qualified revocable trusts generally depends upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries.⁶⁸⁶

Ordinarily, a separate share for an estate will exist if the economic interests of the beneficiary or class neither affect nor are affected by the economic interests accruing to another beneficiary or class.⁶⁸⁷

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680. Treas. Reg. § 1.663(c)-1. Separate-share treatment is applicable in the determinations under the throwback provisions of I.R.C. §§ 665-67, except insofar as the separate share rule applies (basically, pre-1979 years) to successive interests in points of time. Treas. Reg. § 1.665(b)-1(c); Rev. Rul. 74-299, 1974-1 C.B. 154 (separate-share rule applied to nonexempt employees' trust).
681. *Van Buren v. Comm'r*, 89 T.C. No. 76 (1987) (neither trust nor local (New York) law requires allocation of different classes of trust income, based on income imputed to trust on distributions from estate and income actually earned by trust, to income beneficiary of trust).
682. Treas. Reg. § 1.663(c)-1(b).
683. Pub. L. No. 105-34, § 307.
684. The special rules for estates are not expressly made applicable to former revocable trusts other than qualified revocable trusts. Revocable trusts are often used as will substitutes. *See* chapter 8. However, as noted, the regulations deal expressly with qualified revocable trusts that elect under I.R.C. § 645 to be treated for certain purposes and for a limited time as part of the decedent's probate estate. *See, e.g.*, Treas. Reg. §§ 1.663(c)-3, -4. *See* C. Newlin, *Coping with the Complexity of Separate Shares Under the Final Regs.*, 27 EST. PLAN. 243 (2000).
685. Treas. Reg. § 1.663(c)-3(a).
686. Treas. Reg. § 1.663(c)-4(a).
687. Priv. Ltr. Rul. 200210002 (IRA proceeds collected by estate "enter into the computation of DNI as defined in § 643(a) with respect to the taxable year of Estate in which IRA proceeds are received" and, because decedent died prior to the effective date of the final regulations promulgated under I.R.C. § 663(c), as to its separate share rule application to decedents' estates, the

A trust's DNI is divided among the separate shares under rules in the regulations.⁶⁸⁸ First DNI for each share is computed as if each share is a separate trust.⁶⁸⁹ This special DNI is "based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses."⁶⁹⁰ Note that this computation appears to exclude tax-exempt income that is included in DNI when computed in accordance with section 643(a). In addition, to the extent that items of income in respect of a decedent (IRD) are not included in fiduciary accounting income, the computation of DNI for section 663(c) purposes does not include IRD. Again, this is different than the computation of DNI under section 643(a). The result of the special computation of DNI for each share may be quite different than the regular computation of DNI and has the potential to skew the allocation of the overall DNI as required by section 663(c).⁶⁹¹

Second, any deduction or loss that is applicable solely to one separate share is not available to any other share.⁶⁹² Notwithstanding this rule, when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

Example: A trust with two shares has DNI of \$10,000 before the application of the separate-share rules. However, one share has a net loss of \$5,000 for the tax year and thus no DNI if computed separately, and the second share would have DNI of \$15,000 if computed separately. In this example, the allocation of the trust's DNI between the shares can not create DNI and, thus, the second share will be allocated all \$10,000 of the trust's DNI, but no more.

distributions to fund some bequests respected as carrying out such DNI). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

688. Treas. Reg. § 1.663(c)-2.

689. Treas. Reg. § 1.663(c)-2(b).

690. *Id.*

691. For a discussion of issues raised by ignoring tax-exempt income and IRD items not included in fiduciary accounting income, see M. Yu, *A Proposed Allocation of Distribution of Net Income to the Separate Shares of a Trust or Estate*, 3 PITT. TAX REV. 121 (Spring 2006).

692. Treas. Reg. § 1.663(c)-2(b)(5).

The separate-share rule only applies to allocate the DNI of the trust among the shares, not to create DNI.⁶⁹³ Moreover, there is no concept of negative DNI so that in the example the net loss of the first share does not mean that it has negative DNI that is added to the potential DNI of the second share to give the trust total DNI of \$10,000.⁶⁹⁴

A separate share of an estate or qualified revocable trust includes income on bequeathed property if the recipient of the specific bequest is entitled to that income.⁶⁹⁵ "Income" apparently means income under section 643(b)—that is, fiduciary accounting income.⁶⁹⁶ Thus, an interest in the accounting income of an estate or trust may be a separate share even if the underlying interest is not. For example, if accounting income is allocable under the governing instrument to a devise of a specific sum described in section 663(a)(1), the DNI attributable to that accounting income may be attributed, in part, under the separate-share rule of section 663(c) to the bequest's share of accounting income, even though no DNI may be attributed, by reason of section 663(a)(1), to the bequest itself.⁶⁹⁷ This means, for example, a specific devise of corporate stock is not a separate share and no DNI will be attributable to it, but the dividend income paid to an estate on the stock is a separate share.

Under a special rule, a pecuniary (fixed sum) formula bequest that is not entitled to income or to share in appreciation (or depreciation) is a separate share.⁶⁹⁸ The use of the word "formula" suggests that this rule is limited to a pecuniary bequest that is not determinable as of death and, therefore, is the type of funding which can be deemed to consist of DNI under section 663(a)(1).⁶⁹⁹

A surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation is a separate share,⁷⁰⁰ as well

693. Treas. Reg. § 1.663(c)-1 provides that separate "shares are treated as separate trusts (or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662."

694. For a discussion of the problem of allocating DNI among shares when one share has a net loss, see Michael T. Yu, *Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate*, 5 *PITT. TAX REV.* 123 (Spring 2008).

695. Treas. Reg. § 1.663(c)-4(a).

696. See Treas. Reg. § 1.663(c)-5, ex. 8.

697. See Treas. Reg. § 1.663(c)-2(b)(2); Treas. Reg. § 1.663(c)-4(a) (last sentence). In essence, this seems to require two different calculations of DNI: one for the DNI attributable to accounting income and one for the DNI attributable to corpus.

698. Treas. Reg. § 1.663(c)-4(b).

699. Cf. Treas. Reg. § 1.663(c)-5, ex. 4. Treas. Reg. § 1.663(c)-4(a) (last sentence) expressly states that "a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share."

700. Treas. Reg. § 1.663(c)-4(a).

as an elective share that is determined as of death but is not entitled to income or appreciation or depreciation.⁷⁰¹ The regulations provide that if a spouse's elective share is not entitled to estate income under local law, none of the estate's DNI is allocated to the spouse's separate share.⁷⁰² Instead, the example provides that any interest paid on the amount due, as required under local law of some states,⁷⁰³ to the spouse on the spouse's elective share is includible in the spouse's gross income as interest under section 61 and not under section 662.⁷⁰⁴ And, although the regulation forecloses any distributions deduction under section 661(a) and any interest deduction under section 163, it may be possible to argue that the interest on the legacy is an estate (or trust) administration expense under section 212.⁷⁰⁵

Prior case law on the elective share issue was conflicting. In *Deutsch v. Commissioner*,⁷⁰⁶ distributions in satisfaction of a surviving spouse's elective share under Florida law were not includible in spouse's income because the Tax Court ruled that sections 661(a) and 662(a) did not apply. However, in *Brigham v. United States*,⁷⁰⁷ a district court ruled that distributions in satisfaction of surviving spouse's elective share under New Hampshire law may be

701. Treas. Reg. § 1.663(c)-4(b).

702. Treas. Reg. § 1.663(c)-5, ex. 7.

703. See UNIFORM PROBATE CODE § 3-904.

704. See J. Blattmachr, *A Potential New Problem in Estate and Trust Administration*, 15 PROB. PRAC. REP., May 2003, at 1 (explaining how Treas. Reg. § 1.663(c)-5, Example 7, may result in double taxation of interest paid on legacies and other interests and denial of deduction under I.R.C. § 642(c)). But see *Schwan v. United States*, 264 F. Supp. 2d 887 (D.C.S.D. 2003) (no deduction permitted under I.R.C. § 212 for interest paid on pecuniary legacies because estate of decedent who died in 1993 need not have incurred the interest expense by paying the legacies "on time" and, under the facts, the interest was not incurred to benefit the estate but rather the charitable residuary legatee; no deduction permitted under I.R.C. § 163 because interest constituted non-deductible personal interest); Priv. Ltr. Rul. 9604002 (interest paid pursuant to state law (Pennsylvania) on pecuniary bequest in revocable trust is not deductible under I.R.C. § 2053 because state law construed as provision for interest was "merely a mechanism to allocate estate income" among beneficiaries, including those entitled to pecuniary legacies, and rejecting application of Rev. Rul. 73-322, 1973-2 C.B. 44 because "income tax and estate tax are not in pari material"). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

705. Cf. *Turner v. United States*, 306 F. Supp. 2d 668 (N.D. Tex. 2004) (allowing an estate tax deduction under I.R.C. § 2053 for interest due and paid under state law where administration of estate prevented earlier payment of legacy).

706. *Deutsch v. Comm'r*, T.C. Memo. 1997-470.

707. *Brigham v. United States*, 983 F. Supp. 46 (D. Mass. 1997).

includible in spouse's income because the distributions were subject to sections 661(a) and 662(a).

A qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares.⁷⁰⁸

Income in respect of a decedent within the meaning of section 691(a) that is not accounting income is allocated among the separate shares that could be potentially funded with IRD based upon the relative value (using a reasonable and equitable method) of each share to the extent each could be funded with IRD.⁷⁰⁹

Distributable net income that is not attributable to cash (for example, original issue discount, a distributable share of partnership tax items, and a pro rata share of an S corporation's tax items) is allocated among the separate shares of the estate or trust in the same proportion as accounting income from the same source (for example, cash dividend from the S corporation) would be allocated under the governing instrument or applicable local law.⁷¹⁰

For purposes of calculating DNI for each share, the personal representative or trustee must use a reasonable and equitable method to make the allocations, calculations, and valuations needed to effect the separate share rule.⁷¹¹ For example, if the fiduciary makes a distribution early in the year, it may not be proper under the regulations to allocate DNI for the entire year based upon relative values of the shares at the beginning of the year.⁷¹²

The regulations provide a series of examples to provide guidance on how the separate-share rules apply in specific factual situations.⁷¹³

In Example 1, a single trust is created for three minors. Each child's share is a separate share because the shares are economically independent of each other. The example illustrates how distributions from one share do not carry out DNI attributable to another share.

In Example 2, the Testator is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the personal representative makes a partial proportionate distribution to the surviving spouse and

708. Treas. Reg. § 1.663(c)-4(a).

709. Treas. Reg. §§ 1.663(c)-2(b)(3), -5, exs. 9 & 10.

710. Treas. Reg. §§ 1.663(c)-2(b)(4), -5, ex. 5.

711. Treas. Reg. § 1.663(c)-2(c).

712. See Treas. Reg. § 1.663(c)-5, ex. 3.

713. Treas. Reg. § 1.663(c)-5. Some of the rules illustrated by the examples are discussed above.

to the children's trust and makes no other distributions. The fractional formula bequests to the surviving spouse and to the children's trust are separate shares.

In the facts of the example, having separate shares makes no difference because the distributions are proportionate. Under section 662, the spouse and the children's trust will divide the DNI (that is, report income) in the same proportions as the distribution was made without the application of section 663.

In Example 3, the facts are the same as in Example 2, except that the personal representative makes a distribution to partially fund the children's trust but makes no distribution to the surviving spouse. Under the regulations, the fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's shares. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution, the relative size of the trust's separate shares are reduced and the relative size of the spouse's separate share is increased. Before the separate share rule applied to estates, the distribution to the children's trust would have carried out income to the trust to the full extent of the DNI.

The regulation example is not mandating an automatic allocation of 40% of the DNI to the children's trust. Rather, it is requiring the fiduciary to determine what is a fair allocation. For example, if the distribution to the trust is made on the first day of the tax year for the full amount due the children's trust, that is, before the estate has earned any income, and is for the full amount due the children's trust, fairness might dictate that no DNI be attributed to the children's trust (separate share). Alternatively, if the distribution to the children's trust is made on the last day of the year, a fair allocation might be 40%.

In Example 4, the testator's will provides for a pecuniary formula bequest of the maximum amount that may pass free of federal estate taxes, to be paid in not more than three installments, to a trust for the benefit of his child and a bequest of the residuary estate to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. The example states that the estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that share is zero.

If the facts of the example are changed so that the child's trust is entitled to a share of estate income, it would be entitled to an allocation of its share of DNI as illustrated in Example 2.

In Example 5, the facts are the same as in Example 4, except that the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share.

If the facts of Example 5 are changed to require the pecuniary devise to receive a share of estate income, the tax result to the estate and the children's trust change. The regulations provide a special rule for gross income not attributable to cash:

This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as § 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.⁷¹⁴

In Example 6, the facts are the same as in Example 4, except that the estate receives a distribution of \$900,000 from the decedent's IRA that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire \$900,000 is allocated to corpus under applicable local law. Both the child's trust and the residuary (spouse's share) may be funded with the IRA proceeds (although the child's trust is not entitled to a share of fiduciary accounting income). Therefore, a portion of the \$900,000 gross income must be allocated to each of the separate shares. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a section 661 distribution deduction for the portion of the IRA properly allocated to the trust's separate share, if distributions are made, and the trust must include this amount in income under section 662.

The regulations provide a special rule for gross income attributable to an IRA, and presumably other qualified retirement benefits that are fiduciary accounting principal and section 691 IRD:

714. Treas. Reg. § 1.663(c)-2(b)(4).

Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.⁷¹⁵

The different results in Examples 5 and 6 occur because in Example 5, the income, if cash had been received, would be fiduciary accounting income and the child's trust is not entitled to any. In Example 6, the cash is fiduciary accounting principal although taxable income because it is an item of IRD.

When an estate is the beneficiary of a large IRA, consideration should be given to directing an allocation of the IRA away from any GST exempt transfers (such as a long-term trust for descendants). This will maximize the GST.

In Example 7, the testator is survived by a spouse and three adult children. The testator's will divides the residue of the estate equally among the three children. The surviving spouse files an elective share claim. Under state law, a surviving spouse is entitled to one third of the decedent's estate after the payment of debts and expenses. The surviving spouse is not entitled to any estate income and does not participate in appreciation or depreciation of the estate's assets. However, under the elective share statute, the surviving spouse is entitled to interest on the elective share. During the taxable year, the estate makes a distribution in partial satisfaction of the elective share and pays \$200,000 of interest on the delayed payment of the elective share. The estate has four separate shares—the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state law, none of the estate's DNI is allocated to the spouse's separate share. The \$200,000 of interest paid to the spouse must be included in the spouse's gross income under section 61. The estate's \$200,000 interest payment is a nondeductible personal interest expense described in section 163(h).

The regulation Example 7 states that a surviving spouse's statutory elective share is a separate share of the estate for purposes of determining DNI, whether or not state law allows the surviving spouse to share in estate income or in appreciation and depreciation in estate assets. When the elective share is entitled to a share of estate income, a distribution of a surviving spouse's elective share will carry out only a proportionate share of the estate's DNI.

715. Treas. Reg. § 1.663(c)-2(b)(3).

In Example 8, the testator's will devises *X* stock and all dividends therefrom to *A* and the residue of the estate to *B*. The estate has two separate shares consisting of the income on the *X* stock bequeathed to *A* and the residue of the estate bequeathed to *B*. The bequest of the *X* stock meets the definition of section 663(a)(1) and therefore is not a separate share.

Distribution of the *X* stock to *A* will not give rise to a distribution deduction or cause *A* to receive taxable income. When the dividends on the *X* stock received by the estate and distributable to *A* are distributed, that distribution will carry out DNI.

In Example 9, the testator's will divides the residuary estate equally between *A* and *B*. The will directs the personal representative to fund *A*'s share first with the proceeds of testator's IRA. The date-of-death value of *A*'s share exceeds the date-of-death value of the IRA. The entire value of the IRA is allocated to corpus under local law and is section 691(a) income in respect of a decedent. The estate has two separate shares, one for *A* and one for *B*. If any distributions are made to either *A* or *B* during the year, the entire amount of the IRA is section 691(a) income in respect of a decedent and must be allocated to *A*'s share.

In Example 10, the facts are the same as in Example 9, except that the will directs the personal representative to fund *A*'s share first with *X* stock rather than with the IRA proceeds. The estate has two separate shares, one for *A* and one for *B*. If any distributions are made to either *A* or *B* during the year, then, for purposes of determining the distributable net income for each separate share, the proceeds from the IRA must be allocated between the two shares to the extent that they could potentially be funded with the IRA proceeds, after taking into account that *A*'s share of the estate must include the *X* stock. Thus, the IRA is deemed divided proportionally between the value of *A*'s share (reduced by the value of the *X* stock) and the value of *B*'s share, that is, more of the IRA is deemed to be apportioned to *B* than to *A*.

In Example 11, the decedent's will devises the residue of the estate to his three children. During the estate administration, one-half of the estate income is distributable to a qualified charity. The Example provides that the estate is three shares with each child and the charity being the beneficiaries of each share. Moreover, distributions to the charity are deductible under section 642(c) but not as distributions under section 661.⁷¹⁶

716. See section 3:2.1[J] for a discussion of the charitable deduction.

§ 3:5.4 Nontaxable Corpus Distributions

The basic premise of the provisions of subchapter J is all distributions by a trust are out of income to the extent of the taxable portion of distributable net income and thus are deductible by the trust and income to the recipient. The tier system and separate-share treatment only tweak the basic rule.⁷¹⁷ Similarly, with estates, distributions during the administration will be taxable to the extent of DNI. Nevertheless, certain distributions are so clearly considered distributions of corpus that they are exempt from tax and are not subject even to the tier system, regardless of the amount of distributable net income. Thus, several exceptions exist.

First, an exception exists when any interest in real estate owned by a decedent passes directly to decedent's heirs or devisees under local law. The value of the property is not included as an amount paid, credited, or required to be distributed.⁷¹⁸ But see Revenue Ruling 75-61,⁷¹⁹ discussed in section 3:7.1 discussing when real estate income is taxable to an estate.

A second exception provides that the distribution of the right to receive income in respect of a decedent is not considered an amount paid, credited, or required to be distributed, that is, it is not treated as consisting of DNI of the estate or trust.⁷²⁰ This rule is confirmed by section 643(e), discussed below.⁷²¹

A third exception is found in section 663. It excepts amounts not payable solely from income "which, under the terms of the governing instrument, [are] properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which [are] paid or credited all at once or in not more than three installments."⁷²² The exclusion applies not only to such amounts as are "paid or credited," but to cash gifts and gifts of property even if the gifts are subject to a contingency such as attaining a specific age.⁷²³ If the number of installments exceeds three, however, none of the installment payments is within the exception.⁷²⁴ The exception is applied on a

717. See sections 3:5.2–3.

718. Treas. Reg. § 1.661(a)-2(e). Under I.R.C. § 643(e), the maximum amount of DNI the distribution could carry out is limited to the property's adjusted basis. But, of course, under Treas. Reg. § 1.661(a)-2(e), no DNI is carried out regardless of the adjusted basis or fair market balance.

719. Rev. Rul. 75-61, 1975-1 C.B. 180.

720. *Edward D. Rollert Residuary Trust v. Comm'r*, 80 T.C. 619 (1983), *aff'd*, 752 F.2d 1128 (6th Cir. 1985); *Estate of Dean v. Comm'r*, T.C. Memo. 1983-276. *Cf.* Rev. Rul. 68-195, 1968-1 C.B. 305.

721. See section 3:5.6.

722. I.R.C. § 663(a)(1); Treas. Reg. § 1.663(a)-1(a).

723. Treas. Reg. § 1.663(a)-1(c)(2), ex. 1(iii).

724. Treas. Reg. § 1.663(a)-1(c)(2), ex. 2.

“per beneficiary” basis so that three installment payments to several beneficiaries still qualify.⁷²⁵

Under the regulations, the gift is or is not specific depending, in general, on whether the amount of money or the identity of the property is or is not ascertainable under the terms of the will as of the date of decedent’s death, or under the terms of an *inter vivos* trust as of its inception.⁷²⁶ Accordingly, a single, lump-sum payment of an amount other than income, such as “\$10,000” or a distribution of “Blackacre” is exempted. However, a final or other distribution of corpus to a residuary legatee (whether an individual or trust) will not qualify for the exclusion.⁷²⁷

The exclusion can apply to the special sum payable in three installments even if the recipient is to be a beneficiary of taxable distributions, and perhaps even if the beneficiary is a recipient of annual payments.⁷²⁸ It would appear that the total number of installments required under the terms of the governing instrument will control the excludability of each installment, at least if the actual number of payments does not exceed three.⁷²⁹

The regulations contain tests as to the manner in which the bequest is “to be paid or credited,” and also indicating that in the absence of specification all bequests are payable “in a single installment.”⁷³⁰ They also indicate that payment of a sum can be sufficiently specific even if the payment of an installment is subject to a condition.⁷³¹ In counting installments, a decedent’s estate and his testamentary trust are treated separately.⁷³²

Further, a general legacy, such as a proportionate part of the “adjusted gross estate” or similar tax-driven concepts (such as the minimum amount necessary to reduce the federal estate tax to zero) which is used to define an outright distribution of the maximum or minimum marital deduction or to set up a marital deduction trust, will not qualify for the exclusion.⁷³³ The income taxation of the distribution of the widow’s marital deduction share seems to apply whether a fractional or a pecuniary formula is used. Among other reasons for this result given by the regulation when a pecuniary

725. Treas. Reg. § 1.663(a)-1(c)(2), ex. 3.

726. Treas. Reg. § 1.663(a)-1(b)(1).

727. Treas. Reg. § 1.663(a)-1(b)(2)(iii).

728. See Treas. Reg. §§ 1.663(a)-1(b)(3), ex. 1, -1(c); A.L.I., Feb. 1954, *supra* note 670, § X837(c)(2) & cmt. *cf.* Treas. Reg. § 1.665(b)-2(b)(3).

729. Treas. Reg. §§ 1.663(a)-1(a), 1.663(a)-1(c)(2), ex. (3).

730. Treas. Reg. §§ 1.663(a)-1(c)(1), 1.663(a)-1(a), 1.663(a)-1(b)(2)(iv).

731. Treas. Reg. § 1.663(a)-1(b)(4).

732. Treas. Reg. § 1.663(a)-1(c). See *Mahler v. Comm’r*, T.C. Memo. 1987-64 (no exclusion under I.R.C. § 663(a) for “fixed” monthly distributions from trust income of testamentary trust).

733. Treas. Reg. § 1.663(a)-1(b)(1).

formula is used is that the marital deduction amount is dependent upon administration costs, the exact amount of which are not known on the date of decedent's death.⁷³⁴ The regulation contains fairly concrete rules concerning various types of distributions. Pre-residuary marital formula, sometimes called minimum marital deduction, exemption-equivalent, or credit-shelter share formulas (a common planning and drafting scheme after 1981), usually will be nonspecific as of the decedent's death and therefore nonspecific for purposes of section 663(a)(1).⁷³⁵ Even though a pecuniary marital formula amount is not a "specific sum of money or of specific property" for purposes of section 663, it is nonetheless treated as a specific dollar amount under the section 661 regulations so that the distribution of property in kind in satisfaction of the pecuniary marital formula causes gain or loss to be realized.⁷³⁶

Under the regulations, annuity payments are not exempted from the general rule and neither are periodic distributions of property that have the effect of being an annuity.⁷³⁷ In addition, the Service has ruled that a nonrefundable annuity policy distributed and voluntarily accepted in lieu of a monthly payment for life is nonspecific as of the date of decedent's death.⁷³⁸

Under the tests for what is exempt from the general rule that distributions are taxable to the extent of DNI, it is possible that any "interest" paid on devises under state law would be taxable, at least to the extent of distributable net income.⁷³⁹ Nevertheless, the separate share regulations take the position that the interest paid on

734. For a criticism, see Trautman, *The Income Taxation of Estate Distributions: A Need for Reform*, 44 IND. L.J. 397, 410-13 (1969).

735. See generally Blattmachr & Lustgarten, *The New Estate Tax Marital Deduction: Many Questions and Some Answers*, 121 TR. & EST., Jan. 1982, at 18; Blattmachr & Lustgarten, *Selected Considerations in Structuring Wills (or Will Substitutes)*, 121 TR. & EST., May 1982, at 37. Priv. Ltr. Rul. 200210002 (size of bequest consisting of "largest amount . . . which can pass free of federal estate tax under Will by reason of the . . . 'unified credit' described in § 2010 of the Code" held not ascertainable as of date of death and, therefore, its funding is deemed to consist of estate's distributable net income under I.R.C. § 662). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

736. Treas. Reg. § 1.661(a)-2(f). See H.R. REP. NO. 94-1380, at 44-45 (1976).

737. Treas. Reg. § 1.663(a)-1(b)(2)(ii).

738. Rev. Rul. 69-432, 1969-2 C.B. 144.

739. See *United States v. Folckemer*, 307 F.2d 171 (5th Cir. 1962) (indicates that it is taxed strictly as interest; presumably distributable net income limit would not apply); see also Rev. Rul. 73-322, 1973-2 C.B. 44. *But cf.* *Davidson v. United States*, 149 F. Supp. 208 (Ct. Cl. 1957) (under 1939 Code); Freeland & Stephens, *Legatees: Taxable Income and Deductions Arising out of Their Peripheral Rights*, 19 FLA. L. REV. 591 (1967).

a pecuniary devise is personal interest and not deductible under section 163(h).⁷⁴⁰

A distribution of accumulated income (as distinguished from a corpus distribution) to a beneficiary may be exempt from the exception, that is, a distribution of accumulated income can carry out DNI.⁷⁴¹ For example, if a trustee is granted authority to accumulate income until a beneficiary reaches a specific age, the distribution of the accumulated income may carry out DNI to the extent it exists.⁷⁴²

§ 3:5.5 **Sixty-Five-Day Rule and Delayed Income Distributions**

Apart from the foregoing exceptions, all distributions are treated as distributions of current income to the extent that the trust or estate has distributable net income. In 1969, a broad sixty-five-day rule was enacted for trusts by amendments to section 663(b)⁷⁴³ and a 1997 amendment included estates under the sixty-five-day rule. Under the rule, any amount or all trust or estate distributions properly paid or credited within the first sixty-five days of a taxable year may now be considered paid or credited on the last day of the preceding taxable year, provided the fiduciary makes an election, pursuant to regulations. The purpose of the sixty-five-day rule is to give the fiduciary time to determine the amount of the income for the year and an opportunity to distribute it. Presumably, the throwback rules to the limited extent they continue to apply will cut down the taxpayer's potential advantages of shifting taxes during the sixty-five days, and conversely will lead to more complications if the trustee does not fully

740. Treas. Reg. § 1.663(c)-5, ex. 7.

741. See Treas. Reg. § 1.663(a)-1(b)(2)(i). S. REP. NO. 83-1622, at 354 (1954).

742. Query whether the current year's portion of such a required distribution would be a first-tier distribution. Cf. *Carlisle v. Comm'r*, 165 F.2d 645 (6th Cir. 1948) (dealing with 1942 amendment to 1939 I.R.C. § 162(b)); *Spreckels v. Comm'r*, 101 F.2d 721 (9th Cir. 1939) (prior to 1942 amendment, not treating such amount as currently distributable income); *Roebing v. Comm'r*, 78 F.2d 444 (3d Cir. 1935) (same); A.L.I., Feb. 1954, *supra* note 670, at 440 (assuming first-tier coverage). In applying these tests, amounts received in settlement of a will contest would be treated as if acquired by the inheritance itself. *Lyeth v. Hoey*, 305 U.S. 188 (1938); *Harte v. United States*, 252 F.2d 259 (2d Cir. 1958); *Williams v. Comm'r*, 36 T.C. 195 (1961); see *Bath v. United States*, 480 F.2d 289 (5th Cir. 1973) (tax-free bequest versus compensation for services); Rev. Rul. 87-97, 1987-2 C.B. 155 (distribution to cemetery corporation not made to it as beneficiary but as compensation); see also *Getty v. Comm'r*, 913 F.2d 1486 (9th Cir. 1990) (although amount paid in settlement was measured by income, it did not constitute DNI).

743. Pub. L. No. 91-172, 83 Stat. 487.

distribute the income once determined.⁷⁴⁴ The amount to which the election applies cannot exceed the trust accounting income for the year or distributable net income, if greater, reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year as a result of the sixty-five-day rule.⁷⁴⁵

The regulations provide that if a return is required to be filed, the election is made “in the appropriate place on such return.”⁷⁴⁶ The election must be made not later than the due date for filing the return (including extensions). The election, once made, is irrevocable after the last day for making it.⁷⁴⁷ If no return is required to be filed, the election is made in a statement filed with the Service office where a return would be filed, if required.⁷⁴⁸ An election when no return is due is made not later than the time for filing the income tax return if one were required. This election is irrevocable after the last day for making it.⁷⁴⁹ In Private Letter Ruling 8908005 the Service granted relief under Treasury Regulations section 1.9100-1(a) to make late election of the sixty-five-day rule for distributions made within the first sixty-five days.⁷⁵⁰ The trust’s accountant made a valuation mistake and, therefore, did not realize election would have been favorable.

§ 3:5.6 Taxable Corpus Distributions and the Section 643(e) Election

In some situations it is possible that a distribution in kind can itself give rise to capital gain or ordinary income.⁷⁵¹ For example, the distribution of an appreciated asset made in satisfaction of a right to receive a specific dollar amount will result in the recognition of income.⁷⁵² In addition, a “simple” trust is treated as having sold the property (with realization of gain or loss) for its fair market value on the date the trust distributes property in kind as part of its requirement

744. See I.R.C. §§ 665–68.
 745. Treas. Reg. § 1.663(b)-1(a)(2).
 746. Treas. Reg. § 1.663(b)-2(a)(1).
 747. *Id.*
 748. Treas. Reg. § 1.663(b)-2(a)(2).
 749. *Id.*
 750. Priv. Ltr. Rul. 8908005. See also Priv. Ltr. Ruls. 201245008, 201115004, 200904020, 200834006. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 751. In some situations, I.R.C. § 1239 will cause realized capital gains to be recognized as ordinary income.
 752. *Kenan v. Comm’r*, 114 F.2d 217 (2d Cir. 1940); Rev. Rul. 66-207, 1966-2 C.B. 243 (even though value is insufficient to satisfy the pecuniary legacy);

to distribute all income.⁷⁵³ Gain or loss is realized by a “complex” trust or estate (or the other beneficiaries) by reason of a distribution of non-cash assets in satisfaction of a right to receive a specific dollar amount, or property other than that distributed, or income if income is required to be distributed currently.⁷⁵⁴ Similarly, if an appreciated asset is distributed to a creditor in satisfaction of the debt gain is realized.⁷⁵⁵

In Revenue Ruling 69-486⁷⁵⁶ a taxable exchange occurred when remainder beneficiaries agreed to non-pro rata distribution, but no authority in the trust instrument or local law allowed the trustee to make distributions other than pro rata. Several Private Letter Rulings have distinguished this revenue ruling when state law is different.⁷⁵⁷

In Revenue Ruling 72-295,⁷⁵⁸ the Service ruled that a devise in kind of a specified value of certain stock owned by decedent using the date of distribution value is not in satisfaction of a right to receive a distribution in a specific dollar amount. Thus, the estate does not realize gain or loss on the distribution of the shares of stock. Nevertheless, the stock distribution will result in the receipt of DNI by the beneficiary under the rules otherwise applicable to distributions of property discussed below.

Revenue Ruling 60-87,⁷⁵⁹ addressed the complex problem of determining if a formula devise such as a marital deduction or by-pass formula is pecuniary or fractional. Some such formulas use language that might be interpreted as either type. The difference is important as

Rev. Rul. 82-4, 1982-1 C.B. 99 (similar); Rev. Rul. 67-74, 1967-1 C.B. 194. *See also* Priv. Ltr. Rul. 200920031. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

753. Treas. Reg. § 1.651(a)-2(d).

754. Treas. Reg. § 1.661(a)-2(f).

755. Rev. Rul. 74-178, 1974-1 C.B. 196.

756. Rev. Rul. 69-486, 1969-2 C.B. 159.

757. Priv. Ltr. Rul. 94-10-030 (non-pro rata but fairly valued division of trust does not result in gain recognition); Priv. Ltr. Rul. 9324015 (similar); Priv. Ltr. Rul. 9830017 (“[P]resent case is distinguishable from Rev. Rul. 69-486 because the proposed addition will be mostly pro rata and because the trustee is authorized under the trust documents to make non-pro rata distributions based upon fair market values.”); Priv. Ltr. Rul. 200452004 (non-pro rata distribution to charity, as a residuary beneficiary, of individual retirement accounts and deferred annuity contracts does not cause estate to recognize income where will, as interpreted by local court, allowed non-pro rata distributions). *See also* Priv. Ltr. Ruls. 201516008, 201516020. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

758. Rev. Rul. 72-295, 1972-1 C.B. 197.

759. Rev. Rul. 60-87, 1960-1 C.B. 286.

funding a pecuniary formula may cause the recognition of income, but funding a fractional formula will not. In the ruling, the Service distinguished the two types on the basis that:

[A] marital deduction trust of the pecuniary formula type provides for a trust fund in a fixed and definite amount, once the value of the adjusted gross estate is finally determined. The amount is unaffected by any appreciation or depreciation in value of the assets comprising the estate.⁷⁶⁰

. . . [W]hereas under the residuary formula clause the percentage or fraction will be applied for the purpose of making distribution of the residuary estate as constituted at the time of distribution. Therefore, under a residuary formula clause, the trust will share in appreciation and depreciation of the value of the estate, which is not the cause under a pecuniary formula clause.⁷⁶¹

In several Private Letter Rulings, the Service ruled that when assets of a trust are transferred to new trusts as a result of “decanting” under state law, there is no recognition of gain by the transferor trust and the transferee trust or trusts will have the same basis and holding periods in the transferred assets.⁷⁶² The rulings discuss the non-application of *Cottage Savings* in this situation.⁷⁶³

Under section 643(e), distributions other than in cash are treated as consisting of distributable net income only to the extent of the fiduciary’s basis (or fair market value, if lower) plus the amount of gain recognized by the fiduciary on the distribution.⁷⁶⁴ The fiduciary may elect to realize gains and losses on distributions in kind, if realization does not otherwise occur.⁷⁶⁵ The election for any year applies to all assets distributed that year by the fiduciary,⁷⁶⁶ and once made the election is irrevocable.⁷⁶⁷ However, the election is

760. *Id.*

761. *Id.*

762. Priv. Ltr. Ruls. 200804015, 200607015. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

763. *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991).

764. I.R.C. § 643(e)(1).

765. I.R.C. § 643(e)(3).

766. I.R.C. § 643(e)(3)(B).

767. I.R.C. § 643(e)(3); Treas. Reg. § 301.9100-6T(g); *see* Priv. Ltr. Rul. 9641018 (estate, which relied upon its accountant’s incorrect advice to make the I.R.C. § 643(e)(3) election to recognize gain on the distribution of appreciated property, granted permission from the Service under Treas. Reg. § 301.91003T(a) to revoke the election). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

made on a year-by-year basis so that an election in one year does not apply to the next. The election does not apply to distributions of specific assets that satisfy the “no DNI distributed” rule of section 663.⁷⁶⁸ No regulations have been promulgated for section 643(e).

Section 643(e)(3)(A)(ii) provides that losses as well as gains are recognized as if the property were sold to the distributee. Nevertheless, it seems uncertain whether section 643(e) will override section 267 to permit the election to cause a loss to be recognized on the distribution because the distributee will be a related party within the meaning of section 267(b)(6) and (13). Until guidance is provided, a safer course of action for the fiduciary with loss assets is to sell the loss assets to an unrelated party to make sure the loss is recognized where recognition is appropriate.

The distributee of property distributed in kind (a non-cash asset) takes the estate’s or trust’s adjusted basis unless the section 643(e) election is made.⁷⁶⁹ If the election is made, the distributee is allowed to increase the basis of the property by the amount of the gain recognized.⁷⁷⁰ If a loss is recognized, the same rule will decrease the basis by the amount of the loss.⁷⁷¹

Notwithstanding the section 643(e) rule that distributions in kind carry out DNI to the extent of basis, *Edward D. Rollert Residuary Trust v. Commissioner*⁷⁷² and *Estate of Dean v. Commissioner*⁷⁷³ both hold that the distribution of an IRD item does not carry out any DNI to the recipient. This appears to be the case even if the IRD item has some basis as the case may be when the IRD item is an installment sale note in which the decedent had basis.

The Heroes Earnings Assistance and Relief Tax Act of 2008⁷⁷⁴ provides that if appreciated property is distributed by a non-grantor trustee to a “covered expatriate” gain is recognized by the trust as though the property were sold to the expatriate.⁷⁷⁵

768. I.R.C. § 643(e)(4).

769. I.R.C. § 643(e)(1)(A).

770. I.R.C. § 643(e)(1)(B).

771. *Id.*

772. *Edward D. Rollert Residuary Trust v. Comm’r*, 80 T.C. 619 (1983), *aff’d*, 752 F.2d 1128 (6th Cir. 1985).

773. *Estate of Dean v. Comm’r*, T.C. Memo. 1983-276.

774. Pub. L. No. 110-245, 122 Stat. 1624 (codified as amended in scattered sections of 26 U.S.C.).

775. I.R.C. § 877A(f)(1)(B). “Covered expatriate” is defined in § 877A(g)(1).

§ 3:6 Throwback Rule

§ 3:6.1 Purpose and Operation of the Rule

The Code's basic scheme of taxing most trust⁷⁷⁶ distributions to the extent of the trust's distributable net income for the year is designed to prevent undue use of a trust as a separate taxpaying entity when distributions are being made.⁷⁷⁷ However, a trust whose distributions were discretionary and irregular could be used to shield beneficiaries from part of the income tax, even if all of the income were distributed more or less frequently. Because taxation of the beneficiaries is limited generally to the amount of the trust's DNI for the year, the tax savings could be achieved by lumping all of the distributions into a few years. For example, if distribution of fiduciary income for one year were postponed until the next year, the trust's DNI in first year would have no effect on the amount taxable to the beneficiary in second. Then, if the trustee distributed the fiduciary income for the second year at the end of the second year, the trust's DNI for the second year would become the limit on the taxation of the distributions of fiduciary income for both years. Thus, a trustee with discretion could pay out fiduciary income in even-numbered years on the following January 5, while fiduciary income in odd-numbered years might be paid on or before December 31 of the same year. With this scheme, only one half of these approximately annual distributions would be taxable to the beneficiaries as nothing would be distributed and taxable to them in even-numbered years. The trust would pay the tax for those years. The taxation of the two distributions made in an odd-numbered year would be limited to the DNI of that particular year.⁷⁷⁸

For many years, the Code attempted to prevent this type of device and also to prevent less extreme cases of tax savings resulting from temporary accumulation of income. Distributions of accumulated income by trusts, but not by estates, were taxable to the beneficiary even if the distributions exceeded the distributable net income for the year under the throwback rules.⁷⁷⁹ However, the throwback rules were

776. Estates are not usually considered as income tax deferral schemes and as a result, the throwback rules discussed in this section are not applicable to estates. Treas. Reg. § 1.665(a)-0A(d).

777. Under the rate structure introduced by the Tax Reform Act of 1986, for years after 1987, the capacity to reduce income tax by use of a trust as a separate taxpaying entity was severely curtailed.

778. In the case of trusts electing to have the sixty-five-day rule apply, the same device could be employed by using, as the alternative distribution dates, March 3 and March 8.

779. See I.R.C. §§ 665–67.

repealed by the Taxpayer Relief Act of 1997 with respect to distributions made in taxable years of trusts other than (1) foreign trusts, (2) domestic trusts which at any time were foreign trusts (except as provided in the regulations),⁷⁸⁰ and (3) domestic trusts which were created before March 1, 1984, and, but for the “grandfathering” exception provided by section 643(f), would be subject to the multiple-trust rule under that section beginning after August 5, 1997.⁷⁸¹

For a foreign trust created by a U.S. person as defined in the Code,⁷⁸² the tax avoidance possibilities of foreign income accumulation were regarded as so great that foreign trusts are subject to throwback provisions that are generally more severe and costly than those that apply to domestic trusts.⁷⁸³ The Small Business Job Protection Act, enacted in 1996, made the rules applicable to foreign trusts even more severe.⁷⁸⁴

§ 3:6.2 Distributions Exempted from the Operation of the Rule

The throwback rules are found in subpart D of subchapter J.⁷⁸⁵ When applicable, they apply only to trusts, not to estates.⁷⁸⁶ The subpart is also inapplicable to “simple trusts,” which always distribute only their current income, even though variations of trust-accounting “income” under state law from tax law income could cause a simple trust to distribute less than its distributable net income in one year and more than its distributable net income in the following year.⁷⁸⁷ Nevertheless, an accumulation by a simple trust in one year of a taxable item allocable to corpus can be a source of tax if the trust distributes corpus in a subsequent year.⁷⁸⁸ Moreover, some trust

780. I.R.C. § 665(c)(2)(A). The Taxpayer Relief Act of 1997 does not specify whether the determination of whether a trust was at any time foreign will be made under the current definition of foreign trust contained in I.R.C. § 7701(a)(31) or under the definition in effect for each prior year of the trust. *Cf.* Rev. Rul. 91-6, 1991-1 C.B. 89.

781. *See* section 3:7.4.

782. I.R.C. § 7701(a)(30), (31).

783. Rev. Rul. 91-6, 1991-1 C.B. 89 (distribution to beneficiary while trust is domestic (U.S.) of income accumulated while trust was foreign is treated as accumulation distribution from foreign trust).

784. Foreign trusts are discussed in greater detail in chapter 6.

785. I.R.C. §§ 665–68.

786. I.R.C. § 666(a); Treas. Reg. § 1.665(a)-0A(d).

787. I.R.C. § 666 states that it applies only to trusts “subject to subpart C,” that is, complex trusts. *See* section 3:4 for a discussion of simple and complex trusts.

788. I.R.C. § 665(e); Treas. Reg. § 1.665(e)-1A(b). *See* Cohan & Frimmer, *Trapping Distributions: The Trap That Pays*, 112 TR. & EST. 766 (1973).

distributions are excepted from the definition of “accumulation distribution” and thus from the operation of the throwback rule:

- (1) Amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of the beneficiary or before the beneficiary attains the age of twenty-one, except if the beneficiary has received accumulation distributions from two or more⁷⁸⁹ other trusts that were deemed distributed in any of the prior taxable years to which the current distribution applies. This exception applies only to domestic trusts.⁷⁹⁰
- (2) Amounts properly paid, credited, or required to be distributed by a trust for a tax year to a beneficiary that do not exceed the income of the trust for the year.⁷⁹¹

Cf. I.R.C. § 665(b), last sentence, which provides that if the amounts properly paid, credited, or required to be distributed by a trust for a taxable year do not exceed the income of the trust for that year, there shall be no accumulation distribution for the year.

789. I.R.C. § 665(b) (next-to-last sentence). *See* S. REP. NO. 94-938, pt. 1, at 172 (1976). This, in effect, excepts from the throwback rules only the distributions of income accumulated during minority from two trusts. If distributions are from a third or any additional trusts, the minority exception is not applicable. If the beneficiary dies before reaching twenty-one, distribution of the accumulated income to his estate would not seem to come within the exception. If in such a case the distribution is to another person, the test is: what is the other person's age at the time of the accumulations? If a distribution is made to another trust that is less than twenty-one years old, the exception does not apply. Treas. Reg. § 1.665(b)-1A(b)(1). The exception will not apply if the distribution satisfies someone else's support obligation as that person is deemed the beneficiary. Treas. Reg. § 1.665(b)-1A(b)(3). Although not certain, it seems as though distributions falling under this “minority” exception if made to a person under the age of eighteen (and in some cases age twenty-three) are not subject to the so-called kiddie tax of I.R.C. § 1(g). *See generally* J. Blattmachr, *Child's Income May Be Taxed at Parent's Rate*, 66 J. TAX'N 48 (Jan. 1987). Under I.R.C. § 643(f), for tax years beginning after March 1, 1984, with respect to contributions to the trust after March 1, 1984, two or more trusts are treated as one if they have substantially the same grantor or grantors and beneficiary or beneficiaries, and a principal purpose of the trust is the avoidance of federal income tax. Husband and wife are treated as one person for purposes of this rule.

790. *Id.*

791. I.R.C. § 665(b) (last sentence). *See* Tax Reform Act of 1976, §§ 701(b), 701(c). As explained in S. REP. NO. 94-938, at 172, this is to cover a situation where if a trust has certain corpus deductions taken into account in determining distributable net income, accounting income may exceed distributable net income so that the distribution in that year of the trust's income would otherwise cause an accumulation distribution.

§ 3:6.3 “Accumulation Distribution” and “Undistributed Net Income”

Subject to the foregoing exceptions, an “accumulation distribution” for any year is the amount by which second-tier distributions⁷⁹² exceed the amount of distributable net income remaining after reduction for first-tier distributions.⁷⁹³ In other words, “accumulation distributions” are generally the excess of all nonexcepted distributions over distributable net income. “Undistributed net income” is the amount by which distributable net income for a given year exceeds the sum of (a) the distributions for that year, plus (b) the amount of federal income taxes that are imposed on the trust attributable to such distributable net income.⁷⁹⁴

If a trust makes an “accumulation distribution,” then under section 666, the distribution is deemed a second-tier distribution made on the last day of the earliest preceding taxable year in which there was “undistributed net income,” up to the amount of the “undistributed net income” for that year. If the accumulation distribution exceeds the undistributed net income for that year, the excess is carried forward to the next year. Any remaining excess of accumulation distribution over the undistributed net income of these two years is similarly carried forward in turn to each of the following years up to the year of actual

792. That is, amounts required to be distributed or properly paid, credited, or distributed other than amounts of accounting income required to be distributed currently. I.R.C. § 665(b).

793. However, because the definition in I.R.C. § 665(b) is in terms of second-tier distributions, it follows that no accumulation distribution arises out of first-tier income required to be distributed currently even if this first-tier income exceeds distributable net income. Treas. Reg. § 1.665(b)-1A(c)(3). A termination distribution of a trust that is otherwise a simple trust may be excepted from the throwback rule, except for defined “outside income.” Treas. Reg. § 1.665(e)-1A(b). Outside income is any amount included in distributable net income of the trust that is not accounting income, other than certain distributions from estates. Moreover, I.R.C. § 665(b) excludes from the meaning of accumulation distribution any distribution made or required to be made by a trust to a beneficiary in a year in which the distribution does not exceed the accounting income of the trust for that year. Cf. Priv. Ltr. Rul. 9314031 (distribution made to U.S. income taxpayer of income earned in grantor trust under I.R.C. §§ 671–79 in prior years while a non-resident alien of the United States is not an “accumulation distribution”). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

794. I.R.C. § 665(a). In regard to distributions for the given year, the permissible sixty-five-day delay should be taken into account if I.R.C. § 663(b) applies. Under the regulations, taxes are federal income taxes, but not minimum taxes except for minimum taxes on capital gains. Treas. Reg. § 1.665(d)-1.

distribution. In no event will it be carried back to a year prior to effectiveness of the rules, imposed by the 1969 amendments.⁷⁹⁵ In effect a "first-in, first-out" type of rule applies.⁷⁹⁶

Because distributions of corpus can cause a beneficiary to report taxable income based upon accumulated income, it can be important if the separate share rule is applicable, even for throwback purposes, to certain common types of trust.⁷⁹⁷ Consider an accumulation trust for two children, with one-half of the corpus and accumulated income distributable to the first child as he or she reaches a specified age, and the balance distributable to the second child when he or she later reaches the same age. The separate-share rule would apply so as to prevent the substantive distortion of having the older child bear the tax on years of income accumulated for both, and the younger child shortly thereafter being left with little past tax to pay. However, as the trust provisions are varied (for example to give discretion on apportioning or distributing income or corpus, or perhaps even if only to provide for participation of subsequent children), the separate-share regulations do not provide assurance that the distortion will be avoided.⁷⁹⁸

§ 3:6.4 **Beneficiaries' Taxes**

When an accumulation distribution is carried back and treated as made in a preceding year, a further adjustment is made in an attempt to produce the same result as if the distribution actually had been made in the preceding year(s).⁷⁹⁹ Under these conditions, the trust would have accumulated less income and thus would have paid less income tax. The tax thus saved would have been available to increase the taxable distributions. For this reason, an additional distribution is deemed to have been made in the year to which the accumulation distribution is carried back.⁸⁰⁰ This additional distribution is the same proportion of the federal income tax imposed on the trust for the earlier year as the accumulation distribution carried back to that year bears to the otherwise undistributed net income of the trust for that year.⁸⁰¹ Thus, if the accumulation distribution equals or exceeds the

795. Pub. L. No. 91-172, 83 Stat. 487.

796. I.R.C. § 666(a).

797. Treas. Reg. § 1.665(g)-2A.

798. See sections 3:6.2 and 3:6.3 for a discussion of the throwback rules.

799. However, these rules are equally applicable even if different persons would have been the beneficiaries had distributions been made in the preceding year. See I.R.C. § 665(b); Treas. Reg. § 1.668(a)-2A.

800. I.R.C. § 666(b).

801. I.R.C. § 666(c).

year's undistributed net income, all of the applicable federal income tax for that year is deemed to have been distributed.⁸⁰²

The foregoing rules result in accumulation distributions being treated as made in earlier years when there was undistributed net income. However, the rules do not lead to reopening of the tax returns of the earlier years. The throwback device is used in part to determine what the taxes would have been in the earlier years. Actual taxation of the beneficiaries takes place in the year of the accumulation distributions (that is, the year in which the beneficiary actually receives the accumulation distribution).

The amounts treated as distributed in prior years are included in a beneficiary's income in the year actually paid, credited, or required to be distributed, to the extent that the total would have been included if paid in the prior years.⁸⁰³ This limitation is not necessary to prevent the beneficiaries from being taxed on more than the distributable net income for the prior year; the amount of the carryback, even including taxes deemed distributed, is automatically limited to prevent this result.⁸⁰⁴ Rather, the function of this limitation is, in general, to have the nature of the earlier year's distributable net income determine the portion, if any, of the accumulation distribution that is made up of tax-exempt items.⁸⁰⁵ The accumulation distribution is treated as though received by the beneficiaries in proportion to amounts actually received. Presumably, the regulations, if ever adopted, will require adjustments on account of distributed amounts that are excepted from treatment as accumulation distributions (that is, certain distributions of income accumulated before birth or before a beneficiary reaches twenty-one).⁸⁰⁶

The accumulation distributions must be reported by the beneficiaries in the year of actual distribution, and are taxed to them in that year. However, the distributions are treated in somewhat the same manner as they would have been had they been made in the prior years when income was accumulated.

A "short-cut" method is used for computing a beneficiary's taxes on accumulation distributions.⁸⁰⁷ Under this short-cut method, the

802. I.R.C. § 666(b), (c). The minimum tax under I.R.C. § 55 is not included. Where only part of the taxes are deemed distributed, the rules set forth in the text in effect use the trust's average tax rate in computing the amount of tax distributed to the beneficiaries.

803. I.R.C. § 667(a); *see* Treas. Reg. §§ 1.668(a)-1A, -2A.

804. Thus the throwback will not require recomputation of portions of distributable net income received by other beneficiaries.

805. *See* Treas. Reg. § 1.668(a)-1A(a).

806. *See* I.R.C. § 665(b).

807. I.R.C. § 667(b); Tax Reform Act of 1976, § 701(h), (a)(3), (a)(1). *See* Neumark, *How to Plan Trust Distributions in Light of the Elimination of the Exact Method*, 48 J. TAX'N 94 (1978).

beneficiary's five taxable years immediately preceding the year of the accumulation distribution are used, but the years with the highest and lowest taxable income of the beneficiary are disregarded.⁸⁰⁸ An amount equal to the total accumulation distribution, divided by the number of years for which undistributed net income is deemed to be distributed under section 666(a), is added to the beneficiary's taxable income for each of the three tax years that are not disregarded. The additional tax owed by the beneficiary on the accumulation distribution is equal to the excess, if any, of the product of the average increase in tax for the three tax years multiplied by the number of years in which accumulated income is deemed distributed, over the taxes deemed distributed under sections 666(b) and 666(c) in preceding tax years. Because the tax is "an excess," there is no refund or credit to the beneficiary if the taxes paid by the trust exceed the beneficiary's liability. In computing⁸⁰⁹ the tax under the short-cut method, taxable income for any of the three years used cannot be treated as less than zero and no preceding tax year may be taken into account if the amount of undistributed net income deemed distributed in any preceding tax year is less than 25% of the amount of the accumulation distribution divided by the number of preceding tax years to which the accumulation distribution is allocated.⁸¹⁰

808. I.R.C. § 667(b)(1)(B).

809. However, the Revenue Act of 1978 modified these rules (primarily for foreign trusts). Rather than using the net federal income taxes paid by the trust attributable to the accumulation distribution as an offset against the tax computed upon the beneficiary on the accumulation distribution, the federal income taxes paid by the trust include the foreign tax credit, investment credit, or any other credit allowed under I.R.C. §§ 21–26; the credits do not come through to the beneficiary of a domestic trust as identifiable credits, but are simply used as offsets in computing the beneficiary's tax on the accumulation distribution. In computing the beneficiary's tax on the accumulation distribution in case of a foreign trust, the deemed distribution of foreign income taxes is allowed, subject to the foreign tax credit limitations, as a credit against the increase in tax for the computational year: they may not be carried over or back to the other two computational years except to the extent they are used as offsets against the beneficiary's tax on the accumulation distribution. The limitations on the foreign tax as a credit, using the foreign tax as a credit or a deduction, in certain cases, and other rules in cases of foreign trusts are set forth in the Code and are explained in the Committee Reports. *See* I.R.C. §§ 665(d), 667(d); H.R. REP. NO. 95-700, at 29–31 (1977).

810. Under I.R.C. § 904(f)(4), a special rule is provided for the application of the foreign loss recapture rules to accumulation distributions from foreign trusts. If the beneficiary sustained an overall foreign loss (or foreign oil-related loss) in a taxable year prior to the distribution year, the portion of the accumulation distribution that is out of foreign source income (or foreign oil-related income) of the trust is "recaptured" to the extent set

Except for tax-exempt income, amounts deemed distributed as accumulation distributions lose their tax income character.⁸¹¹

The tax computed on the accumulation distribution is reduced by the federal estate tax or federal generation-skipping transfer tax attributable to the accumulated income. The reduction is equal to an amount equal to the pre-death portion of the tax multiplied by a fraction whose numerator is the estate or generation-skipping transfer tax that is attributable (on a proportionate basis) to amounts included in the accumulation distribution and whose denominator is the amount of the accumulation distribution that is subject to estate or generation-skipping transfer taxation.⁸¹² The pre-death portion is an amount that bears the same ratio to the tax on the accumulation (determined without regard to this reduction) as the accumulation distribution that is attributable to the period before the date of death of the decedent or the date of the generation-skipping transfer bears to the total accumulation distributions.⁸¹³

For beneficiaries of trusts that may be subject to the throwback rules, it is advisable to retain all tax returns and, if none were filed, income information. There may be some disabilities where records are not kept.⁸¹⁴ However, on account of the required short-cut method, usually beneficiaries need tax returns (or tax information) only for the five years immediately preceding the years of distribution.

forth in I.R.C. § 904(f)(4). The taxable income of the beneficiary for any year is deemed not to be less than the zero bracket amount for an individual or zero for a corporation. If accumulation distributions from different trusts are made to the beneficiary in the same year, the distributions are treated as consecutively made in the order the beneficiary selects. The tax computed under section 667(b)(1) is reduced on account of estate or generation-skipping transfer tax deemed imposed upon the distribution in certain cases. I.R.C. § 667(b).

811. I.R.C. § 667(a). Character is retained for purposes of the inclusion in gross income of beneficiaries of distributable net income (*i.e.*, distributions of current rather than past income). Also, in order to apply U.S. withholding of tax on distributions to nonresident aliens and foreign corporations, the character of income is retained under I.R.C. § 667(e) for accumulation distributions to them. Also, for purposes of limitations on foreign tax as a credit under I.R.C. § 667(d), items of income, deduction, and credit retain character and source.
812. I.R.C. § 667(b)(6)(A).
813. I.R.C. § 667(b)(6)(B), (C).
814. I.R.C. §§ 666(d), 668(b)(5)(A) (prior to the 1976 Code amendments). *See* Treas. Reg. §§ 1.666(d)-1A, 1.668(b)-4A.

§ 3:7 Returns and Other Filing Requirements

§ 3:7.1 Filing Requirements

Trusts and estates file income tax returns and determine taxes on an annual basis.⁸¹⁵ A trust must file a return if it has any net taxable income, or if its gross income is \$600 or over, and an estate must file if its gross income is at least \$600.⁸¹⁶ An estate or trust that is required to file a return is required also to provide beneficiaries who receive distributions or an “item with respect to such taxable year is allocated” certain “information . . . as the Secretary may prescribe.”⁸¹⁷ Usually, this is done on IRS Form 1041 K-1.⁸¹⁸ The beneficiary is required to report the item as consistent with the estate’s or trust’s return or to notify the Service of the inconsistency.⁸¹⁹

A trust that claims a charitable deduction under section 642(c) may be required to file additional information.⁸²⁰ Every estate or trust with a nonresident alien beneficiary must file a return, except a trust exempt from taxes under section 501(a).⁸²¹

If an estate is under administration in more than one state, that is, an estate with domiciliary and ancillary administrators, separate income tax returns must be filed by each fiduciary.⁸²² The domiciliary administrator reports all income of the estate; the ancillary administrator must file a return:

with the district director for his internal revenue district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary.⁸²³

815. In Publication 1437 (Rev. Dec. 2013), the Service detailed its e-file program for income tax returns for estates and trusts.

816. I.R.C. § 6012(a)(3), (4); Treas. Reg. § 1.6012-3(a)(1)(i)–(ii).

817. I.R.C. § 6034A(a)(2).

818. Treas. Reg. §§ 1.6041-1(a)(2), 1.6042-1(a)(1)(ii)(A).

819. I.R.C. § 6034A(c).

820. I.R.C. § 6034, as amended by § 1201(b)(1) of the Pension Protection Act of 2006, Pub. L. No. 109-280; Treas. Reg. §§ 1.642(c)-4, 1.6034-1. Upon request by the Service, the fiduciary must furnish a copy of the will or trust and a descriptive statement concerning the taxation of the estate or trust and its beneficiaries. Treas. Reg. § 1.6012-3(a)(2). *See* instructions to Form 1041.

821. I.R.C. § 6012(a)(5); Treas. Reg. § 1.6012-3(a)(1)(iii). *See* instructions to Form 1041. Under I.R.C. § 6048, information returns are required upon transfers to foreign trusts.

822. Treas. Reg. § 1.6012-3(a)(3).

823. *Id.*

If the ancillary administration is for the estate of a nonresident alien, the ancillary administrator must file the return required of the domiciliary administrator.⁸²⁴ If there is more than one ancillary administrator of a nonresident alien's estate, the regulations do not provide which one must act as the domiciliary administrator or if all must.

A fiduciary who serves as trustee of more than one trust must file a separate return for each trust.⁸²⁵

In situations where there is more than one fiduciary of an estate or trust, only one of the fiduciaries must file an income tax return.⁸²⁶ The return prepared by one of the fiduciaries should contain "a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct."⁸²⁷

Under the regulations, no return or tax identification number need be obtained for certain grantor trusts.⁸²⁸ This special rule applies if the grantor is a trustee and section 676 applies. Moreover, under the regulations, the trustees of certain grantor trusts may use, in lieu of filing a Form 1041, optional reporting methods.⁸²⁹

Returns for estates and trusts are required to be filed by the fiduciary within three and one-half months after the close of the taxable year.⁸³⁰ Thus, for example, the return filing due date for almost any noncharitable trust⁸³¹ and for a calendar-year estate is April 15 of the following year, as in the case of returns of calendar-year individuals.

Beginning with returns due in 2009, an estate or a trust may receive a *five-month* automatic extension of time to file its income tax return by timely filing the appropriate form (IRS Form 7004).⁸³² Note that the extension is for five months and not six as is available to individual

824. *Id.*

825. Treas. Reg. § 1.6012-3(a)(4).

826. Treas. Reg. § 1.6012-3(d).

827. *Id.*

828. Treas. Reg. §§ 1.671-4, 301.6109-1.

829. Treas. Reg. § 1.671-4. See section 3:5.5 for a complete discussion of the filing options. See also Waxenberg & Leibowitz, *New Grantor Trust Reporting Regs. Offer Greater Flexibility*, 23 EST. PLAN. 291 (1996).

830. I.R.C. § 6072(a); Treas. Reg. § 1.6072-1(a). The fiduciary return is Form 1041.

831. In Rev. Rul. 90-55, 1990-2 C.B. 161, the Service ruled that a grantor trust created by a corporation could use a tax year other than a calendar year.

832. I.R.C. § 6081, Treas. Reg. § 1.6081-6T(a)-(b). Electing Alaska Native Trusts and Qualified Funeral Trusts are permitted an automatic six-month extension. A transitional rule permits a six-month extension for trusts and estates with a return due date between July 1, 2008, and December 31, 2008. Treas. Reg. § 1.6081-6T(g).

taxpayers. Such an extension does not extend the time for payment of any taxes due by the estate or trust⁸³³ and does not extend the time by which a beneficiary must file a return and pay taxes.⁸³⁴

Any unpaid tax liability shown on a trust's return must be paid in full on or before the due date of the return.⁸³⁵ The estate's personal representative may be personally liable for the unpaid tax, up to an amount equal to the value of property distributed by the estate, "if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed."⁸³⁶

Filing requirement issues arise if someone holds assets belonging to another. For example, in Revenue Ruling 82-177,⁸³⁷ a bank simply held and paid interest on funds of an estate involved in a will contest where no administrator was appointed. The ruling held that the bank was not a fiduciary of an estate required to file returns.⁸³⁸

Revenue Ruling 75-61⁸³⁹ dealt with three additional situations involving fiduciary income tax filing requirements. In the ruling, the decedent's estate apparently consisted entirely of real estate. One-third of the estate passed to the decedent's spouse in satisfaction of dower rights.⁸⁴⁰ A second one-third of the estate passed to the decedent's son for life and then to the son's child, subject to a power held in trust.⁸⁴¹

833. Treas. Reg. § 1.6081-6T(c).

834. Treas. Reg. § 1.6081-6T(d).

835. For years before 1987, the tax liability shown on an estate's return could be paid in quarterly installments following the year for which the income tax liability was due. I.R.C. § 6152(a)(2), before amendment by the Tax Reform Act of 1986. For years after 1986, trusts and estates, in some cases, must make estimated quarterly tax payments.

836. Treas. Reg. § 1.641(b)-2(a); Rev. Stat. § 3467, 31 U.S.C. § 192 (1982). See generally Alexander, *Personal Liability of Executors and Trustees for Federal Income, Estate, and Gift Taxes*, 9 TAX L. REV. 1 (1953); Ferguson, *The Fiduciary's Personal Liability for Federal Taxes of the Decedent and His Estate: The Problems of Distribution and Partial Distribution*, 25 INST. ON FED. TAX'N 1185 (1967). The distributees also may be liable. Miller, *Tax Problems in Administration of Estates*, 14 INST. ON FED. TAX'N 331, 345 (1956).

837. Rev. Rul. 82-177, 1982-2 C.B. 365.

838. *But cf.* Rev. Rul. 69-300, 1969-1 C.B. 167 (where bank is granted certain discretionary powers of administration and management).

839. Rev. Rul. 75-61, 1975-1 C.B. 180.

840. One-third of the decedent's estate was "allotted and assigned" to the decedent's spouse in satisfaction of dower rights under provision in the will. "Under local law, real property and income therefrom is subject to [estate] administration." *Id.*

841. The will provided that the income from the second one-third of the estate was to be paid to the decedent's son for life and, at his death, the property

The final one-third of the estate was devised to the decedent's daughter, but was subject to a trustee's control for a period of time.⁸⁴²

The ruling addressed the issues of (1) whether the income generated by the property held by the estate, but eventually distributed to the spouse, is income of the surviving spouse or income of the estate before distribution; (2) whether the income generated by the property owned by the son's child,⁸⁴³ but held subject to the power in trust,⁸⁴⁴ is income of the beneficial owner or is income of a trust; and (3) whether income generated by property conveyed to an individual, but subject to a trustee's control, is the individual's income or income of a trust. The ruling assumed that legal title passed under state law to the beneficial owners—the decedent's surviving spouse, the child of the decedent's son, after the son's death, and the decedent's daughter.

The Service ruled that income from the property eventually transferred by the estate to satisfy the spouse's dower rights was reportable by the estate until the property was transferred. The Service reached this conclusion because "under local law the property and income therefrom was subject to administration during that period," and cited Revenue Ruling 57-133.⁸⁴⁵

For the second and third portions, the Service concluded that the property was subject to the control of a trustee and the trustee was "vested with the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of the

was to be distributed to son's living children. The child died survived by a minor child. The will vested the minor child in the property, but directed that the property "would be retained by a trustee under a power in trust to invest and reinvest the principal, to collect the income and apply the net income, or as much thereof as the trustee should in his sole discretion determine, to the support and maintenance of" the minor. Under state law "legal title to property held under a power in trust is in the beneficiaries." *Id.*

842. The remaining one-third of the estate was devised to the decedent's daughter in fee simple, but she could not "sell, convey, mortgage, encumber or dispose of" the property for eight years after the decedent died. In addition, she could not "control, receive, or collect income" from the property for four years after the decedent's death, unless the trustee gave her that right. *Id.*

843. In the facts of the ruling, the decedent died, and his only child was entitled to the property, subject to the control restriction.

844. "A 'power in trust' involves a form of express fiduciary obligation similar to that of an express trust, and it therein differs from a mere agency, revocable at pleasure, which imposes no duty, but merely grants authority to act. A power in trust places on the grantee a duty to execute a trust in favor of a person or persons other than himself and involves the idea of a trust as much as does a trust estate. See *Brooklyn Trust Company*, 295 N.Y.S. 1007." *Id.*

845. Rev. Rul. 57-133, 1957-1 C.B. 200.

responsibility.” Thus, the ruling held that the trustees of the second and third portions of the decedent’s estate must file fiduciary income tax returns. The trusts must report the income from the property held under the power in trust and must report income from the real estate of the final portion as long as it receives the income for that portion of the property.

The state law aspects of Revenue Ruling 75-61 for the spouse’s interest in the decedent’s estate are consistent with the Uniform Probate Code (UPC). Under UPC section 3-101, title to a decedent’s real estate passes at the moment of death to the beneficiaries of the estate. Nevertheless, under section 3-101, the passing-of-title-at-death rule is “subject to homestead allowance, exempt property and family allowance, to rights of creditors, elective share of the surviving spouse, and to administration.”⁸⁴⁶

Moreover, section 3-711 of the Uniform Probate Code grants a decedent’s “personal representative . . . the same power over the title to property of the estate that an absolute owner would have, in trust however, for the benefit of the creditors and others interested in the estate.” A third Uniform Probate rule that relates to title to property is section 3-907. It provides that a personal representative must execute a deed or other document “assigning, transferring or releasing the assets to the distributee as evidence of the distributee’s title to the property.”

The effect of these Uniform Probate Code sections is to vest title in the beneficiaries of the estate at the time of the decedent’s death, but the property remains subject to control of the personal representative and is subject to the estate administration process. When a personal representative concludes that property is no longer necessary for the administration of an estate, a deed of distribution evidences that the property has been released from the administration process by the personal representative.

Collectively, the three Uniform Probate Code sections should result in tax reporting for the estate outlined in Revenue Ruling 75-61. The income of a decedent’s estate, including real property income, is reportable by estate until a deed of distribution is signed by the personal representative and delivered to the devisee.

In non-UPC states that do not provide estate administration rules similar to the UPC, the treatment of income generated by real estate passing from a decedent to an heir or devisee may be different. Gain or loss on the sale of real property passing from a decedent directly to devisees may be reportable by the devisees rather than by the estate if the property passes free of any powers of the personal representative

846. UNIF. PROB. CODE § 3-101.

under state law.⁸⁴⁷ For example, in Revenue Ruling 75-339,⁸⁴⁸ the Service ruled that although a will contest was pending, if the local court did not impose restrictions on the transfer of income from devised real property, the income was taxable to the named devisee. The Service cited the claim-of-right doctrine established in the Supreme Court's ruling in *North American Oil Consolidated v. Burnet*.⁸⁴⁹ However, if the decedent's will directs that property be sold and the proceeds transferred to the devisees so that the interests of the devisees are only in the proceeds, the gain or loss is reportable by the estate.⁸⁵⁰

In the 1950s, the Service ruled that income earned by a custodian of a Uniform Gift to Minors Act account is taxable to the minor.⁸⁵¹ Similar arrangements are similarly taxable to the minor.⁸⁵² However, when the income of the account is used to discharge another's obligation to support the minor, the income is taxed to the other person.⁸⁵³ In *Anastasio v. Commissioner*,⁸⁵⁴ the Tax Court held that winnings of a minor in a lottery, which under state law became payable to his parents as custodians under the Uniform Gifts to Minors Act, were taxable to the minor in the year the prize was won and not taxed

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847. Radin v. Comm'r, 33 F.2d 39 (3d Cir. 1929); Harman v. Comm'r, 4 T.C. 335 (1944); see Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 C.B. 304 (in such case, relinquishment of possession by executor is not a taxable distribution); Rev. Rul. 59-375, 1959-2 C.B. 161 (same proportion of gain taxed to an insolvent estate as the proportion of sale proceeds that became payable to estate to discharge debts).
848. Rev. Rul. 75-339, 1975-2 C.B. 244.
849. 286 U.S. 417 (1932).
850. Anderson v. Wilson, 289 U.S. 20 (1933); Gen. Couns. Mem. 12,771, 1934-1 C.B. 148 (1934); see Rev. Rul. 57-133, 1957-1 C.B. 200. However, some cases suggest that the gain and loss may be taxable exclusively to the estate regardless of the distinctions. Jones v. Whittington, 194 F.2d 812 (10th Cir. 1952) (under local law personal property is subject to same rule as realty; title passes to devisees); Wooley v. Malley, 30 F.2d 73 (1st Cir.), cert. denied, 279 U.S. 860 (1929). Other authority leans toward taxability of the devisees rather than the estate despite possible powers of management. Arrott v. Comm'r, 23 B.T.A. 478 (1931); see also Hibernia Nat'l Bank v. Donnelly, 121 F. Supp. 179 (E.D. La.), aff'd, 214 F.2d 487 (5th Cir. 1954) (stock); Weber v. Comm'r, 111 F.2d 766 (2d Cir. 1940) (land). But cf. Estate of Cohen v. Comm'r, 8 T.C. 784 (1947) (income and expense of realty were not needed to pay debts of the estate).
851. Rev. Rul. 56-484, 1956-2 C.B. 23. For a discussion of UTMA's, see Stephanie E. Heilborn & Jonathan G. Blattmachr, *UTMA Accounts, Planning Options for UTMA Accounts & Other Transfers to Minors*, Part 1, 35 EST. PLAN. 3 (Dec. 2007), Part 2, 35 EST. PLAN. 11 (Jan. 2008).
852. Rev. Rul. 55-469, 1955-2 C.B. 519; Rev. Rul. 58-65, 1958-1 C.B. 13; Rev. Rul. 59-357, 1959-2 C.B. 212.
853. Rev. Rul. 56-484, 1956-2 C.B. 23; Rev. Rul. 59-357, 1959-2 C.B. 212.
854. *Anastasio v. Comm'r*, 67 T.C. 814 (1977), aff'd, 573 F.2d 1287 (2d Cir. 1977).

to the custodian as a separate taxpayer (as a separate trust). Moreover, interest earned on the prize money was taxable to the minor in the year earned and not in the year in which it was turned over to him by his parents as custodians.

As to whether a trust is to be considered valid for tax purposes or instead is to be treated as a corporation, see section 7:3.

§ 3:7.2 Statute of Limitations

Section 6501 provides for a three-year general statute of limitations on the assessment of income taxes. This section is applicable to trusts and estates as it is to individuals and other taxpayers. When there is a substantial omission of income on a return, the time for assessing taxes is six years. For beneficiaries of trusts and estates, the question arises of when the statute of limitations expires for income and an income tax liability passing out from an estate or trust. The Eighth Circuit in *Fendell v. Commissioner*,⁸⁵⁵ ruled that the running of statute of limitations for assessment of the trust's income tax return prevented assessment with respect to returns of beneficiaries for the trust income distributed to them. According to the court, the adjustment of the liability must be made at the source, which was the trust.

The Eighth Circuit distinguished *Fendell* in *Paulson v. Commissioner*,⁸⁵⁶ in which the court determined that the trusts involved were "sham entities lacking economic substance"⁸⁵⁷ and were ignored for tax purposes. The Tax Court distinguished *Fendell* in *Lardas v. Commissioner*,⁸⁵⁸ when the trusts involved were grantor trusts, and ruled that the statute of limitations was measured by the beneficiary's individual return filing.

The holding in *Fendell* should be evaluated in light of the Supreme Court's decision in *Bufferd v. Commissioner*,⁸⁵⁹ which held that the statute of limitations for shareholders of S corporations begins to run with the filing of the shareholder's return and not the filing of the corporate return. The Court noted, however, that the particular issue involved would not affect corporate income—only the income of the shareholder. This distinction may make a difference when the trust is a regular trust that may pay taxes as was involved in *Fendell* compared with a grantor trust that does not pay taxes as was involved in *Lardas*.

855. *Fendell v. Comm'r*, 906 F.2d 362 (8th Cir. 1990), *rev'g* 92 T.C. 708 (1989), *nonacq. recommended* by AOD 1991-01, 1991 WL 495573 (IRS AOD Feb. 11, 1991).

856. *Paulson v. Comm'r*, 992 F.2d 789 (8th Cir. 1993).

857. *Id.*

858. *Lardas v. Comm'r*, 99 T.C. 490 (1992).

859. *Bufferd v. Comm'r*, 506 U.S. 523 (1993).

§ 3:7.3 Tax Years for Noncharitable Trusts and Estates

As discussed below, most trusts must file returns on a calendar-year basis, but this rule does not apply to estates.⁸⁶⁰ An estate's first taxable year need not end on December 31, on the first anniversary of the decedent's death, or on the date the decedent's taxable year would have ended had the decedent survived. Rather, the estate's personal representative may elect to end the first taxable year of the estate on the last day of any month that falls within one year of the decedent's death.⁸⁶¹ Thus, if a decedent died on May 13, 2007, the estate's first taxable year could end on May 31, 2007, on April 30, 2008, or the last day of any month between May 31, 2007, and April 30, 2008.

A decedent's date of death seems to be based on the calendar date at the decedent's domicile at the time of death rather than the calendar date where the decedent actually died. In two Revenue Rulings, the Service held that a decedent's date of death for estate tax purposes is not controlled by the calendar date where the decedent died, but rather the calendar date at decedent's domicile.⁸⁶² For example, if a New York domiciled decedent dies shortly after midnight on July 1 while on a European vacation, the date of death is June 30 if it is still June 30 in New York when the decedent died. Similarly, if a New York resident dies on June 30 shortly before midnight while on vacation in Hawaii, the date of death is July 1 because it is already July 1 in New York when the decedent died.

If the first year does not end exactly one year after the decedent dies, a short-period return is filed.⁸⁶³ Moreover, the decedent's last taxable year will be a short period unless the decedent died on the last day of his or her reporting period—typically December 31. Using a short period for its first return allows an estate to spread income over more tax years. The fact that the first year is short does not require adjustments to deductions and exemptions, however.⁸⁶⁴

The date of the decedent's death is the first day of the estate's first tax year.⁸⁶⁵ What income is reported on the estate's first return is less certain. Also, what income is to be reported on the decedent's final return is not clear. The regulations suggest that the final return includes

860. I.R.C. § 644 is applicable to trusts but not estates. I.R.C. § 441 permits taxpayers who do not have a "required taxable year" to elect any tax year with its first return. *See* Treas. Reg. § 1.441-1(c).

861. I.R.C. § 441.

862. Rev. Rul. 66-85, 1966-1 C.B. 213, *modified by* 74-424, 1974-2 C.B. 294. The Service does not have a similar published ruling for income tax purposes, however.

863. I.R.C. § 443.

864. I.R.C. § 443(a)(2), (c).

865. Rev. Rul. 69-563, 1969-2 C.B. 104. This ruling was declared obsolete by T.D. 8996, but for the proposition cited, T.D. 8996 is not on point. *See also* Gen. Couns. Mem. 38,960 ("[t]he moment of death determines the end of

all the reportable income for the entire day the decedent dies.^{865.1} Nevertheless, General Counsel Memorandum 38,960 quotes the 1982 instructions for IRS Form 1041 which states: “[t]he moment of death determines the end of the decedent’s tax year and the beginning of the estate’s tax year.”^{865.2} This instruction is found in more recent instructions for IRS Form 1041 including the 2013 instructions. The rule that the date of a decedent’s death is the first day of the estate’s tax year may be a trap for a personal representative of an estate if the decedent dies the last day of a month. The first tax year begins on the last day of that month and the longest tax year that may be elected ends on the last day of the eleventh month following the decedent’s death. For example, if a decedent dies on April 30, the estate may elect any tax reporting year so long as that year ends no later than March 31 of the year after the decedent’s death.

Under the regulations, the tax reporting year for an estate is elected on the first return the estate files.⁸⁶⁶ Neither an application for automatic extension of time to file a return, an application for an employer identification number, nor the payment of estimated taxes for a particular taxable year, are considered an election for a particular tax year.⁸⁶⁷ The regulations do not prohibit making a fiscal election on a late filed return. In deciding to make a tax year election on a late filed return, a personal representative must consider, however, the potential tax penalties for a late filed return and the consequences of a breach of fiduciary duties arising out of the late filing.⁸⁶⁸

As in the case of individuals, estates and trusts must have an accounting method.⁸⁶⁹ The method may include the cash receipts and disbursement method, the accrual method, or some other allowable method.⁸⁷⁰

the decedent’s tax year and the beginning of the estate’s tax year”). Moreover, the General Counsel Memorandum provides an example of a decedent who dies on February 1 and it summarily concludes that estate’s tax year begins on February 1.

865.1. Treas. Reg. § 1.451-1(b).

865.2. Gen. Couns. Mem. 38,960.

866. Treas. Reg. § 1.441(c)-1 provides: “A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year.”

867. Treas. Reg. § 1.441(c)-1 provides:

The filing of an application for automatic extension of time to file a Federal income tax return . . . , the filing of an application for an employer identification number (i.e., Form SS-4, “Application for Employer Identification Number”), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

868. *See, e.g.*, I.R.C. § 6651, among others.

869. I.R.C. § 446.

870. I.R.C. § 446(c). This section does not provide any special rules for estates or trusts. Rather, general method of accounting rules applicable to all taxpayers apply to estates and trusts.

With the exception of certain tax-exempt and wholly charitable trusts,⁸⁷¹ all trusts are required to use calendar tax years.⁸⁷² A charitable remainder trust is normally income-tax-exempt,⁸⁷³ but charitable remainder trusts are required to use calendar tax years.⁸⁷⁴ In Revenue Ruling 90-55,⁸⁷⁵ the calendar-year requirement for trusts was not applicable to grantor trust where a corporation was the grantor.

If a trust instrument provides that the trust terminates upon the happening of an event such as a beneficiary reaching a certain age or the income beneficiary dying, the trust's tax year does not end on the day the event occurs. Rather, the regulations provide for a reasonable period of time after the terminating event to complete the trust's administration.⁸⁷⁶ Once all assets have been distributed, other than a reserve to pay contingent liabilities or unascertained expenses, the trust terminates for tax purposes. However, the winding down of the trust or estate cannot be unduly prolonged or the trust or estate is deemed terminated under the regulations.⁸⁷⁷

For trusts that are treated as owned by a decedent under section 676 by reason of a power held by the decedent to revoke, the trustee and personal representative (if any) of the decedent's estate may elect for the trust to be treated and taxed as part of the estate.⁸⁷⁸ The election, once made, is irrevocable and applies for all taxable years of the estate after the decedent's death and before the date which is either two years after decedent's death if no U.S. estate tax return is required to be filed, or six months after the date of final determination of estate tax if an estate tax return is required.⁸⁷⁹ During the time that the trust is treated as part of the estate, the trust will use the estate's tax year.

A beneficiary may have a different taxable year from the trust or estate.⁸⁸⁰ The amount of income the beneficiary reports is based on the distributable net income and the distributions of the trust or estate for its taxable year that ends within the beneficiary's taxable year.⁸⁸¹ For example, if an estate reports income on a January 31 year-end and the beneficiary is reporting income on a calendar-year basis, any

871. See I.R.C. § 644(b).

872. I.R.C. § 644(a).

873. I.R.C. § 664(c).

874. I.R.C. § 644(b).

875. Rev. Rul. 90-55, 1990-2 C.B. 161.

876. Treas. Reg. § 1.641(b)-3(b).

877. See section 3:9 for further discussion.

878. I.R.C. § 645; see also section 3:9 for a more detailed discussion of the section 645 election.

879. See section 3:8.

880. Trusts must use a calendar year; however, the trust's beneficiary might not use one. Thus, it is possible for the trust and its beneficiary to have different years.

881. I.R.C. §§ 652(c), 662(c).

income of the estate earned between February 1 and December 31 and distributed to the beneficiary will not be reported by the beneficiary until the beneficiary's next tax year as the estate's year does not close until January 31. Of course, in the second year, the beneficiary must report income distributed during the prior year, to the extent of DNI. The rule thus may provide a short postponement of tax.⁸⁸² Moreover, if the estate files a short year return, it is possible for the beneficiary to be required to include two years of distribution on one return.⁸⁸³ For example, if an estate with a January 31 year-end closes out on December 31, any income distributed by the estate for both of its years will be reportable on a single return of a calendar year beneficiary.

If the beneficiary dies during the tax year, the beneficiary's tax year ends.⁸⁸⁴ This also may result in a bunching of income. For example, if an estate is filing returns on a June 30 year-end, and the beneficiary dies on November 30, the beneficiary must report income distributed in the year ending on June 30 and must report income actually distributed from July 1 until the date of death.⁸⁸⁵ The validity of the regulations supporting this rule was upheld in *Schimberg v. United States*.⁸⁸⁶ The amount that must be reported on the final return of a deceased beneficiary is limited by DNI.⁸⁸⁷

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882. One district court has further indicated that the statutory language permitting a trust to deduct discretionary distributions "for" a particular year may enable a deduction prior to the beneficiary's inclusion under the "during" language of I.R.C. § 662(c), regardless of the regulations. *Hay v. United States*, 263 F. Supp. 813 (N.D. Tex. 1967). See Trautman, *The Income Taxation of Estate Distributions—A Need for Reform*, 44 IND. L.J. 397, 413–15 (1969).
883. Rev. Rul. 71-180, 1971-1 C.B. 204 (beneficiary must include income from estate's normal fiscal year and final short taxable year, both ending within his year).
884. A "taxpayer's taxable year ends on the date of his death." Treas. Reg. § 1.451-1(b)(1); see Treas. Reg. § 1.443-1(a)(2) (similar). See also Instructions, Form 1041 (U.S. Fiduciary Income Tax Return) (rev'd, Feb. 28, 1990), p.2 ("for an estate, the moment of death determines the end of the decedent's tax year and the beginning of the estate's tax year"). Cf. Rev. Rul. 75-267, 1975-2 C.B. 254.
885. See Treas. Reg. §§ 1.652(c)-2, and 1.652(c)-3, 1.662(c)-2, and 1.662(c)-3 for the applicability of this rule when an individual beneficiary dies or any other beneficiary terminates before the end of the taxable year. See also Rev. Rul. 59-346, 1959-2 C.B. 165 (in case of death, accrual-basis beneficiary of income "required to be distributed currently" includes in his final return such income to date of death); *Estate of Petschek v. Comm'r*, 738 F.2d 67 (2d Cir. 1984) (regardless of when trust's tax year ends, beneficiary of simple trust must include all distributable net income through date beneficiary became nonresident alien).
886. *Schimberg v. United States*, 365 F.2d 70 (7th Cir. 1966).
887. For a discussion of how to allocate DNI to the decedent, see the discussion of the tier rule at section 3:5.2, *supra*.

§ 3:7.4 Multiple Trusts

The use of multiple trusts has been a means to reduce the tax rates on accumulated trust income. The distinction between treatment as a single trust or as separate trusts is a classic issue. This remained true even though the 1969 Code amendments to the throwback rules limited the eventual savings: in the long term, all of the accumulated income was expected to end up attributed to the beneficiaries who eventually receive that income.⁸⁸⁸ However, the Treasury adopted regulations that made clear its view that the throwback rules were not a complete solution.⁸⁸⁹ The regulations would consolidate and treat as one trust multiple trusts having “no substantially independent purposes (such as independent dispositive purposes)” and having substantially the same beneficiary and the same grantor with a tax-avoidance purpose.⁸⁹⁰ Court decisions did not support this sweeping regulatory attack.⁸⁹¹ In response to an adverse court ruling,⁸⁹² Congress enacted section 643(f) as a part of the Tax Reform Act of 1984.⁸⁹³ This section provides that, under regulations to be prescribed by the Treasury Department, more than one trust is treated as a single trust if the trusts have substantially the same grantor(s) and primary beneficiary(ies) and a principal purpose of the trusts is to avoid income tax.⁸⁹⁴

The usefulness of multiple trusts was all but eliminated in 1986 with the adoption of almost flat (or compressed) tax rates applicable to estates and trusts.⁸⁹⁵ In 2014, an estate or trust reaches the maximum

888. See section 3:6.4.

889. Treas. Reg. § 1.641(a)-0(c). The regulation was originally proposed as part of the throwback regulations themselves, and in stricter form in that one or the other of the listed factors would have caused single-trust treatment. Prop. Treas. Reg. § 1.665(a)-0A(e). See Cornfeld & Huffaker, *Accumulation Trusts Are Treated More Reasonably by Final Regulations*, 37 J. TAX’N 266, 268 (1972); Newman & Kalter, *Consolidation of Multiple Trusts*, 27 TAX L. REV. 561 (1972). See also *Judy Trust for David Quinn v. United States*, 87-2 U.S. Tax Cas. (CCH) ¶ 9650 (5th Cir. 1987) (one trust could not be treated as more where under state law there could only be one when there was only one current beneficiary living).

890. *Id.*

891. See *Edward L. Stephenson Trust v. Comm’r*, 81 T.C. 283 (1984), holding regulation invalid. Note that under I.R.C. § 683, transfers to a trust that acts as an exchange fund may result in gain recognition. Note also that the throwback rules of I.R.C. §§ 665–67 continue to apply to trusts created before March 1, 1984, which would be subject to the multiple-trust rule of I.R.C. § 643(f) but for the grandfathering granted to such trusts.

892. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF REVENUE PROVISIONS OF DEFICIT REDUCTION ACT OF 1984, 98TH CONG., 2D SESS. 255–57 (Comm. Print 1985).

893. Deficit Reduction Act of 1984, Pub. L. No. 98-369.

894. For this purpose, a husband and wife are considered one taxpayer. I.R.C. § 643(f) (last sentence).

895. I.R.C. § 1(e).

tax bracket of 39.6% on all income in excess of \$12,150.⁸⁹⁶ Thus in 2012, the maximum savings that can be achieved by accumulating income to be taxed at a trust's lower brackets is less than \$1,100.

In addition, the Health Care and Education Reconciliation Act of 2010⁸⁹⁷ added section 1411 that provides for a 3.8% "medicare contribution tax" starting in 2013 for estates and trusts. This extra tax is on the lesser of net investment income or modified adjusted gross income in excess of the threshold for the maximum income tax rate.⁸⁹⁸ For 2012, the threshold for the maximum income tax rate is \$11,650. Net investment income is defined as "gross income from interest, dividends, annuities, royalties, and rents," unless attributed to an active trade or business, passive trade or business income and gains from the sale or disposition of property, less related expenses.⁸⁹⁹

If a will or trust instrument provides for separate trusts, a separate return should be filed for each trust;⁹⁰⁰ this is true even if the grantor and trustee are the same in each trust unless the multiple trust under section 643(f) applies.⁹⁰¹ Taxation as separate trusts, even upon accumulated income, may be achieved although:

- (a) the grantors and fiduciaries are the same,
- (b) the trusts are created by the same instrument, and
- (c) the trust corpora are held *in solido*.⁹⁰²

Whether a will or trust instrument creates a single trust or separate trusts depends upon the construction placed upon the trust instrument, interpreted in the light of the applicable state law.⁹⁰³ The courts have remained liberal in finding the existence of separate trusts,

896. Rev. Proc. 2011-52, 2011-45 I.R.B. 701.

897. Pub. L. No. 111-152, § 1411(a), 124 Stat. 1029.

898. I.R.C. § 1411(a)(2).

899. I.R.C. § 1411(c).

900. *United States Trust Co. v. Comm'r*, 296 U.S. 481 (1936); *Helvering v. McIlvaine*, 296 U.S. 488 (1936). *See generally* Ervin, *Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402 (1956); Rothenberg, *Numerical Limitations on Multiple Trusts*, 48 TAXES 169 (1970).

901. *Treas. Reg. § 1.6012-3(a)(4)*; *cf. Smith v. Comm'r*, 25 T.C. 143 (1955) (unsuccessful attempt to file single return under former regulations so as to offset income of one with loss of other).

902. *U.S. Trust Co. v. Comm'r*, 296 U.S. 481 (1936); *Moody Trust v. Comm'r*, 65 T.C. 932 (1976). *But see* I.R.C. § 643(e).

903. *Id. See also Kelly's Trust v. Comm'r*, 168 F.2d 198 (2d Cir. 1948); *Fiduciary Trust Co. v. United States*, 36 F. Supp. 653 (S.D.N.Y. 1940); *Trust of Grace v. Comm'r*, 13 T.C. 632 (1949); *John Shertzer Trust v. Comm'r*, 10 T.C. 1126 (1948); *Helms Bakeries v. Comm'r*, 46 B.T.A. 308 (1942); *Marx v.*

at least where the trusts have been maintained separately.⁹⁰⁴ A state court decree in an adversary proceeding as to the number of trusts may prove controlling.⁹⁰⁵

If, however, a will or trust instrument creates separate trusts, a separate return should be filed for each trust unless section 643(f) applies;⁹⁰⁶ this is true even if the grantor and trustee are the same for each trust.⁹⁰⁷

Section 643(f) applies for tax years beginning after March 1, 1984,⁹⁰⁸ but only to new trusts and to the extent corpus is added to existing trusts after March 1, 1984.⁹⁰⁹ Hence, the multiple-trust rule does not apply to contributions made to irrevocable trusts before March 2, 1984. A husband and wife are treated as one person (apparently, either as grantor or as beneficiary) for purposes of this rule.⁹¹⁰

- Comm'r, 39 B.T.A. 537 (1939); *St. Louis Union Trust Co. v. Comm'r*, 40 B.T.A. 165 (1939); *Davis v. Comm'r*, 37 B.T.A. 587 (1938); *Tiernan v. Comm'r*, 37 B.T.A. 1048 (1938); *cf. Hale v. Dominion Nat'l Bank*, 186 F.2d 374 (6th Cir.), *cert. denied*, 342 U.S. 821 (1951).
904. *E.g., Commercial Bank v. United States*, 450 F.2d 330 (5th Cir. 1971); *Estelle Morris Trusts v. Comm'r*, 51 T.C. 20 (1968), *aff'd*, 427 F.2d 1361 (9th Cir. 1970) (apparently even though created with tax avoidance purpose); *McHarg v. Fitzpatrick*, 210 F.2d 792 (2d Cir. 1954) (belief or desire of settlor not among indicia); *Estate of Holdeen v. Comm'r*, 34 T.C.M. (CCH) 129 (1975); *Moody Trust v. Comm'r*, 65 T.C. 932 (1976); *Mary E. Fennerty Trust v. Comm'r*, 13 T.C.M. (CCH) 831 (1954). *But cf. Sence v. United States*, 394 F.2d 842, 851 (Ct. Cl. 1968) (taxpayer "did not adequately maintain the trusts as separate"); *Boyce v. United States*, 190 F. Supp. 950 (W.D. La.), *aff'd*, 296 F.2d 731 (5th Cir. 1961). I.R.C. § 663(c), which treats separate shares as separate trusts in determining the availability of distributable net income, does not apply for the purpose of taxing accumulated income in separate shares. S. REP. NO. 83-1622, at 355-56 (1954); *Treas. Reg. § 1.663(c)-1(b)(1)*. *See also* I.R.C. §§ 665(b), 667(c), and 668(b)(2)(B), (b)(4) (before the Tax Reform Act of 1976), as to multiple trusts under the throwback rule.
905. *Kelly's Trust v. Comm'r*, 168 F.2d 198 (2d Cir. 1948); *Louise Savage Knapp Trust A v. Comm'r*, 46 B.T.A. 846 (1942); *cf. M.T. Straight's Trust v. Comm'r*, 245 F.2d 327 (8th Cir. 1957) (denying retroactive effect to uncontested nunc pro tunc reformation); *James S. Reid Trust v. Comm'r*, 6 T.C. 438 (1946). *Compare* *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967), *with* *Rev. Rul. 73-142*, 1973-1 C.B. 405.
906. *U.S. Trust Co. v. Comm'r*, 296 U.S. 481 (1936); *Helvering v. McIlvaine*, 296 U.S. 488 (1936). *See generally* *Ervin, Multiple Accumulative Trusts and Related Problems Under the Income Tax*, 29 S. CAL. L. REV. 402 (1956); *Rothenberg, Numerical Limitations on Multiple Trusts*, 48 TAXES 169 (1970).
907. *Treas. Reg. § 1.6012-3(a)(4)*; *cf. Smith v. Comm'r*, 25 T.C. 143 (1955) (unsuccessful attempt to file single return under former regulations so as to offset income of one with loss of other).
908. *Deficit Reduction Act of 1984*, Pub.L. No. 98-369, § 82(b).
909. *Pub. L. No. 99-514*, tit. XVII, § 1806(b).
910. I.R.C. § 643(f). *See* *Gerhart, Trust and Estate Income Taxes Changed by Tax Reform Act*, 124 TR. & EST., Feb. 1985, at 16.

The legislative history contains an example of when Congress believes section 643(f) should apply:

A establishes, with the principal purpose of avoidance of Federal income tax, Trust 1 for the benefit of his sister *S1*, his brother *B1*, and his brother *B2*; Trust 2 for the benefit of his sister *S2*, his brother *B1*, and his brother *B2*; Trust 3 for the benefit of his sister *S1*, his sister *S2*, and his brother *B1*; and Trust 4 for the benefit of his sister *S1*, his sister *S2*, and his brother *B2*. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.⁹¹¹

The legislative history provides a second example when Congress believes that section 643(f) should not apply:

X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support, and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.⁹¹²

How effective section 643(f) may be is uncertain, as no regulations have been issued. Without regulations, section 643(f) may have little effect.⁹¹³

The division of an existing trust into two or more new trusts potentially raises the multiple trust issue, as the new trusts will have the same grantor as the original trust. A division of a trust is not uncommon when the trust has generation-skipping provisions. The Service has ruled privately that a trust that was divided pursuant to a court order into five new trusts was not subject to the multiple-trusts rule of section 643(f).⁹¹⁴ The new trusts had

911. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF REVENUE PROVISIONS OF DEFICIT REDUCTION ACT OF 1984, 98TH CONG., 2D SESS. 255–57 (Comm. Print 1985).

912. *Id.*

913. See *Alexander v. Comm'r*, 95 T.C. 467, *Estate of Neumann v. Comm'r*, 106 T.C. 216 (1996), Tech. Adv. Mem. 200447037. See generally Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Regulations*, 56 TAX LAW. 413 (2002–2003); Amandeep S. Grewal, *Substance over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42 (2006).

914. Priv. Ltr. Rul. 200806010. See also Priv. Ltr. Ruls. 201245007, 200832020, 201003015, 201026018, 201133007. Under I.R.C. § 6110(k)(3), neither

different primary beneficiaries and were to be separately managed and administered.

In the limited circumstances in which the throwback rules are still applicable,⁹¹⁵ the 1976 Tax Reform Act added a different rule for multiple trusts under certain circumstances. Under section 667(c) in the case of an accumulation distribution from a third trust (and any additional trusts) deemed to have been made in the same prior taxable year of the beneficiary as the other two (or more) accumulation distributions, then in computing the tax on the accumulation distributions, the beneficiary is denied any “credit” for tax previously paid by the trust with respect to the accumulated income. The special multiple-trust rule does not apply, however, if an accumulation distribution from a trust (including all prior accumulation distributions from the trust to the beneficiary for that same year) is less than \$1,000.⁹¹⁶ On the other hand, the exception from the throwback rules for accumulations occurring before the birth or twenty-first birthday of the beneficiary does not apply to an accumulation distribution from a third trust (and any additional trusts) deemed to have been made in the same prior taxable year of the beneficiary as the other two (or more) accumulation distributions.⁹¹⁷

§ 3:7.5 Estimated Payments of Income Tax

Most trusts and estates are required to make estimated payments of income tax similar to individual taxpayers.⁹¹⁸ Excepted from the estimated tax payment rule for two years following a decedent’s death is a decedent’s estate and a “grantor trust” deemed wholly owned by the decedent under the grantor trust rules,⁹¹⁹ but only if the residue of the decedent’s probate estate passes to the trust.⁹²⁰ Alternatively, if no will is admitted to probate, the grantor trust is exempt from the estimated tax rules if the trust is primarily responsible for a decedent’s taxes, debts, and administration expenses.⁹²¹ The two-year exception ends for tax years beginning more than two years after the decedent

a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

915. See section 3:6 for a discussion of the throwback rules and their continued application.

916. I.R.C. § 667(c)(2). The effect of this particular multiple-trust rule is to convert a credit into a deduction.

917. I.R.C. § 665(b) (second-to-last sentence).

918. I.R.C. § 6654(l). See *Special Estimated Tax Exceptions for Trusts and Beneficiaries*, TAX ADVISER, Sept. 2002, at 565.

919. See I.R.C. §§ 661–78, subch. J, pt. I, subpt. E, discussed in section 5:4.1.

920. I.R.C. § 6654(l)(2)(B)(ii).

921. *Id.*

dies. The failure to make estimated tax payments will result in penalties.⁹²²

A trustee of a trust may elect, subject to certain limits and in certain cases, to treat any portion of an estimated income tax payment made by the trust for the taxable year as a payment made by the beneficiary.⁹²³ Also, a fiduciary of a decedent's estate may make the election, but only for a taxable year reasonably expected to be the last taxable year of the estate. This treatment applies to the extent of the election.⁹²⁴

The estimated tax payment treated as paid by the beneficiary is deemed paid or credited to the beneficiary by the trust or estate as of the last day of the fiduciary's taxable year (so that, apparently, it may be treated as consisting of distributable net income within the meaning of Code section 643(a) or undistributed net income within the meaning of Code section 665(a) if the throwback rules apply). The amount treated as paid to the beneficiary is not considered an estimated payment made by the trust, but rather as an estimated payment made by the beneficiary on January 15 following the taxable year for which the estimated payments of tax were made.⁹²⁵ The election by the fiduciary must be made on or before the sixty-fifth day after the close of the taxable year (and is to be made as specified in regulations).⁹²⁶ In most cases, this will be March 6 (or March 5 if the year following is a leap year) for a calendar-year trust.⁹²⁷ Of course, for a fiscal year estate, the due date of the election will be different.

The effect of the estimated tax election on DNI allocations among several beneficiaries is not certain. For example, nothing prohibits a trustee from assigning disproportionate amounts of the estimated

922. I.R.C. § 6654(a), (d)(1)(C)(iii). The penalty is described as an addition to the tax, but is computed using an interest rate determined under section 6621 for the amount of time the payment is late.

923. I.R.C. § 643(g)(1)(A).

924. I.R.C. § 643(g)(1)(B).

925. I.R.C. § 643(g)(1)(C).

926. I.R.C. § 643(g)(2).

927. Although I.R.C. § 644(a) requires all trusts, other than wholly charitable trusts, to use a calendar year for tax reporting, a trust may have a "short" final year ending other than at the end of a calendar year. If that is the case, it would appear under the requirement that the election be made not later than after the sixty-fifth day after the close of the "short" final taxable year. It is uncertain what the effect would be for the final year when the trustee does not make the election within sixty-five days after the close of the year for the final year of the trust and the trust has over-estimated its tax liability. Presumably, the amount of the excess estimated payment will be treated as an amount distributed to the beneficiary (because a refund of income taxes due the trust would belong to the beneficiary), but the beneficiary will not be treated as having made the estimated payment of tax.

payments to several beneficiaries whose interests are otherwise held in separate shares. Of course, a disproportionate allocation of the estimated tax payment must be reconciled with the fiduciary accounting for the trust and the separate share rules of section 663.

The tax credit under section 31(c) for backup withholding required under section 3406 is allocated between an estate or trust and its beneficiaries based on their interests in the payment subject to withholding.⁹²⁸ The allocation of the credit to the beneficiary is treated as though an amount equal to that credit has been distributed by the estate or trust and may result in a distribution deduction for the estate or trust.⁹²⁹

§ 3:8 Election for a Trust to Be Taxed As Part of an Estate

Certain grantor trusts that were revocable during a decedent's lifetime (called "qualified revocable trusts") may elect to be taxed for income tax purposes as part of the grantor-decedent's estate.⁹³⁰ A "qualified revocable trust" is a trust that was treated under section 676 as owned by the decedent because of a power held by the grantor (determined without applying section 672(e), governing powers held by the grantor's spouse).⁹³¹ In addition, a trust that was treated as owned by the decedent under section 676 because of a power exercisable by the decedent with the consent or approval of a nonadverse party or the approval of the decedent's spouse is a qualified revocable trust. However, a trust in which only the decedent's spouse held the power to revoke is not a qualified revocable trust.⁹³²

It is possible that there may be more than one qualified revocable trust. The section 645 election may be made for one or more of the qualified revocable trusts and it is not necessary that all make the election.⁹³³

928. I.R.C. § 643(d).

929. See I.R.C. §§ 3406(h)(10), 643(d).

930. I.R.C. § 645, enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 102-229, § 1305(a). In 2002, the Internal Revenue Service issued final regulations for section 645. The regulations apply to estates and trusts of decedents dying, or for taxable years ending, after December 24, 2002. For estates and trusts of decedents dying before December 24, 2002, a fiduciary may follow the procedures set forth under either I.R.S. Notice 2001-26, or Rev. Proc. 98-13, 1998-1 C.B. 370. See A. Acker, *Electing to Treat Certain Trusts as Part of Estate*, 2 EST. TAX PLAN. ADVISOR, Mar. 2003, at 1; J. Kasner, *Final 645 Regs.*, LEIMBERG'S EST. PLAN. NEWSL., Jan. 7, 2003. See generally Dennett & Moseley, *Maximizing the Benefits of the Section 645 Election*, 31 EST. PLAN. 546 (Nov. 2004).

931. I.R.C. § 645(b)(1).

932. Treas. Reg. § 1.645-1(b)(1).

933. Treas. Reg. § 1.645-1(c)(3).

The trustee and the executor make the section 645 election by filing IRS Form 8855, “Election to Treat a Qualified Revocable Trust as Part of an Estate.”⁹³⁴ The section 645 election must be made by both the trustee of the qualified revocable trust and the executor⁹³⁵ of the decedent’s estate, if any.⁹³⁶ The regulations confirm that the use of the phrase “if any” means that the trustee may make the election unilaterally if no executor is acting.⁹³⁷ If an executor is appointed after the election is made, that fiduciary must consent to the election within ninety days of appointment by filing a revised form.⁹³⁸ Failing such consent, the election terminates the day before the date of appointment of the executor.⁹³⁹

The 645 election may be made for foreign qualified revocable trusts and estates. However, a foreign qualified revocable trust for which the 645 election is made is treated as an estate only under subtitle A of the Code and not under subtitle F;⁹⁴⁰ therefore, information reporting under section 6048 will continue to apply to a foreign qualified revocable trust.⁹⁴¹

A section 645 election will not affect the qualification of a trust under section 401(a)(9), so long as it is still a trust under state law.⁹⁴²

The election must be made by the time for filing of the first income tax return of the decedent’s estate (determined with regard to any extension)⁹⁴³ and is irrevocable.⁹⁴⁴ If no executor of the decedent’s estate is appointed and the trustee makes the election, it is due when the first return is due (including any extension) after taking into account that the trust is filing as an estate.⁹⁴⁵ This means that the

934. Treas. Reg. § 1.645-1(c)(1)(i); 67 Fed. Reg. 78,371, 2003-1 C.B. 471.

935. Treas. Reg. § 1.645-1(b)(4) defines “executor” to include a personal representative or administrator appointed to administer a decedent’s estate. This definition is similar to the one in I.R.C. § 2203.

936. I.R.C. § 645(a).

937. Treas. Reg. § 1.645-1(c)(1)(i).

938. Treas. Reg. § 1.645-1(g)(1).

939. *Id.*

940. I.R.C. subtitle F covers tax procedure and administration.

941. T.D. 9032 (preamble), 2003-1 C.B. 471.

942. *Id.*; T.D. 8987 2002-1 C.B. 852. Section 401(a)(9) provides minimum distribution rules for qualified plans, IRAs, section 457 plans, and section 403(b) accounts and annuities.

943. Treas. Reg. § 1.645-1(c). An automatic extension for up to six months may be available to make a late election under Treasury Regulation section 301.9100-2(b). This extension is computed from the original due date, excluding extensions. The discretionary relief under Treasury Regulation section 301.9100-3 is not likely available because the time limit for a section 645 election is statutory.

944. I.R.C. § 645(c); Treas. Reg. § 1.645-1(e)(1).

945. Treas. Reg. § 1.645-1(c)(2).

trust may elect a fiscal tax year and the election due date is based on the due date, including any extension, for the fiscal year elected.

During the election period, the executor will file one United States Fiduciary Income Tax Return (Form 1041) for both the estate and the qualified revocable trust(s), under the name and tax identification number of the estate.⁹⁴⁶ Nevertheless, the estate (if any) and each electing trust is treated as a separate taxpayer for all purposes of subtitle F of the Internal Revenue Code.⁹⁴⁷ The estimated tax rules of section 6654 still apply. However, the two-year exception to estimated tax payments for estates authorized in section 6654(l)(2)(A) applies to each electing trust.⁹⁴⁸

If the trustee and the executor make the section 645 election, the qualified revocable trust will be treated and taxed as part of the decedent's estate, and not as a separate trust, for federal income tax purposes for all taxable years of the estate until the "applicable date," which is the later of (i) two years after the date of the decedent's death and (ii) six months after the final determination of estate tax liability.⁹⁴⁹ If the decedent's estate has made a valid section 645 election, the estate will not be treated as terminating before the earlier of (i) the day before the applicable date and (ii) the day on which both the qualified revocable trust and the estate have distributed all of their assets.⁹⁵⁰

The final determination of estate tax liability is the earliest day on which any of the following has occurred: (i) six months after the issuance of an estate tax closing letter, unless a claim for refund for the estate tax is filed within twelve months after the issuance of the letter; (ii) the final disposition of a claim for refund that resolves the liability for the federal estate tax, unless suit for refund of that tax is instituted within six months of the disposition of the claim; (iii) the execution of a settlement agreement that resolves the liability of the federal estate tax; (iv) the issuance of a decision or other court order resolving the liability for estate tax unless a notice of appeal is filed within ninety days after the issuance of the decision; or (v) the expiration of the period of limitations for assessment of federal estate tax under section 6501.⁹⁵¹

For an estate that files an estate tax return but does not file a claim for refund or otherwise contest the estate tax liability after the closing letter is issued, the section 645 election expires one year after the

946. Treas. Reg. § 1.645-1(e)(2)(ii).

947. Treas. Reg. § 1.645-1(e)(4). I.R.C. subtitle F covers tax procedure and administration.

948. *Id.*

949. I.R.C. §§ 645(a), 645(b)(2); Treas. Reg. § 1.645-1(f)(2)(ii).

950. Treas. Reg. § 1.641(b)-3.

951. Treas. Reg. § 1.645-1(f)(2)(ii).

closing letter is issued.⁹⁵² Example 2 of the regulations set out below confirms this result.⁹⁵³ In addition, the regulations provide examples where no estate tax return (Form 706) is filed (Example 1) and where a Tax Court decision resolves the estate tax liability (Example 3):

Example 1: A died on October 20, 2002. The executor of A's estate and the trustee of Trust, an electing trust, made a section 645 election. A Form 706 is not required to be filed as a result of A's death. The applicable date is October 20, 2004, the day that is two years after A's date of death. The last day of the election period is October 19, 2004. Beginning October 20, 2004, Trust will no longer be treated and taxed as part of A's estate.

Example 2: Assume the same facts as Example 1, except that a Form 706 is required to be filed as the result of A's death. The Internal Revenue Service issues an estate tax closing letter accepting the Form 706 as filed on March 15, 2005. The estate does not file a claim for refund by March 15, 2006, the day that is twelve months after the date of issuance of the estate tax closing letter. The date of final determination of liability is September 15, 2005, and the applicable date is March 15, 2006. The last day of the election period is March 14, 2006. Beginning March 15, 2006, Trust will no longer be treated and taxed as part of A's estate.

Example 3: Assume the same facts as Example 1, except that a Form 706 is required to be filed as the result of A's death. The Form 706 is audited, and a notice of deficiency authorized under section 6212 is mailed to the executor of A's estate as a result of the audit. The executor files a petition in Tax Court. The Tax Court issues a decision resolving the liability for estate tax on December 14, 2005, and neither party files an appeal within 90 days after the issuance of the decision. The date of final determination of liability is December 14, 2005. The applicable date is June 14, 2006, the day that is six months after the date of final determination of liability. The last day of the election period is June 13, 2006. Beginning June 14, 2006, Trust will no longer be treated and taxed as part of A's estate.⁹⁵⁴

A section 645 election does not relieve a qualified revocable trust from filing a return for the taxable year that ends with the death of the grantor. The trust will continue to report under the rules of Treasury

952. The election expires six months after the final determination of the estate tax liability and the final determination of the estate tax liability is six months after the closing letter is issued, unless one of the exceptions occurs. *See* § 1.645-1(f)(2)(ii).

953. *Treas. Reg.* § 1.645-1(f)(2).

954. *Id.*

Regulations section 1.671-4. If the section 645 election is made for a qualified revocable trust, the trustee need not file a Form 1041 for the short taxable year of the qualified revocable trust beginning with the decedent's date of death and ending on December 31 of that year.⁹⁵⁵ If the qualified revocable trust was filing a Form 1041 during the decedent's life, the due date for that return will be the date specified under section 6072 as though the decedent had lived throughout the decedent's last taxable year.⁹⁵⁶ If the qualified revocable trust files a return for the balance of the year in which the decedent died and thereafter a section 645 election is made, the trustee of the revocable trust must file an amended return to remove the items of income and deductions that are properly reportable on the estate's income tax return as a result of the election.⁹⁵⁷

Regardless of whether a section 645 election is made for the qualified revocable trust, the trustee must obtain a tax identification number for the qualified revocable trust upon the decedent's death.⁹⁵⁸

On the Form 1041, the items of income, deductions and credits against tax of the estate and qualified revocable trust are combined and only one personal exemption is permitted.⁹⁵⁹ The executor and trustee must apportion the tax liability in a manner that reasonably reflects the tax obligations of each; otherwise, there may be a deemed gift from the beneficiaries of one entity to the beneficiaries of the other.⁹⁶⁰ The trustee and executor are each responsible for ensuring that the qualified revocable trust's and estate's shares, respectively, of the tax obligations of the combined electing trust and estate are timely paid.⁹⁶¹

The qualified revocable trust and estate are treated as separate shares for purposes of computing distributable net income and applying the distribution provisions of sections 661 and 662.⁹⁶² In addition, the estate and the electing trust may each contain more than one separate share.⁹⁶³

The income of the combined entity is computed on a consolidated basis and initially DNI should also be calculated on combined basis, although deductions and losses attributable to one share may not be deducted by another.⁹⁶⁴ Nevertheless, if a net loss in one share results in the DNI of the combined entity being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI

955. Treas. Reg. § 1.645-1(d)(2)(i).
 956. Treas. Reg. § 1.6072-1(a)(2).
 957. Treas. Reg. § 1.645-1(d)(2)(ii)(B).
 958. Treas. Reg. §§ 1.645-1(d)(1), 301.6109-1(a)(3).
 959. Treas. Reg. § 1.645-1(e)(2)(ii).
 960. Treas. Reg. § 1.645-1(c)(1)(ii).
 961. *Id.*
 962. Treas. Reg. §§ 1.645-1(e)(2)(iii)(A), 1.663(c)-4.
 963. *Id.*
 964. Treas. Reg. § 1.663(c)-2(b)(5).

of the share with net income should not exceed the DNI of the combined entity. The effect of limiting the DNI of the profitable share to the DNI of the combined entity effectively gives the share with net income the benefit of the net loss in the other share.

Example: An estate with a valid section 645 election in place has DNI of \$10,000 before the application of the separate-share rules. However, one share has a net loss of \$5,000 for the tax year and thus no DNI when computed separately, and the second share would have DNI of \$15,000 if computed separately. In this example, the allocation of the estate's DNI between the shares can not create DNI and, thus, the second share will be allocated all \$10,000 of DNI, but no more.

The separate-share rule only applies to allocate the DNI of the trust among the shares, not to create DNI.⁹⁶⁵ If this was not the case, an estate filing a combined return with an electing trust that makes no distributions of DNI would have less taxable income than the amount of income reportable by beneficiaries of the separate entities if distributions were made.

If the estate or qualified revocable trust makes a distribution to another share of the combined electing qualified revocable trust and estate, the share making the distribution reduces its distributable net income by the amount of the distribution deduction to which that share would have been entitled (determined without regard to the section 663(c) separate-share rule) if it had made the distribution to a beneficiary and not to another share, and, for the purposes of computing distributable net income, the share receiving the distribution increases its gross income by the same amount.⁹⁶⁶ The regulations provide an example:

- (i) *A's* will provides that, after the payment of debts, expenses, and taxes, the residue of *A's* estate is to be distributed to Trust, an electing trust. The sole beneficiary of Trust is *C*. The estate share has \$15,000 of gross income, \$5,000 of deductions, and \$10,000 of taxable income and DNI for the taxable year based on the assets held in *A's* estate. During

965. Treas. Reg. § 1.663(c)-1 provides that separate "shares are treated as separate trusts (or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662."

966. Treas. Reg. § 1.645-1(e)(2)(iii)(B).

the taxable year, A's estate distributes \$15,000 to Trust. The distribution reduces the DNI of the estate share by \$10,000.

- (ii) For the same taxable year, the trust share has \$25,000 of gross income and \$5,000 of deductions. None of the modifications provided for under section 643(a) apply. In calculating the DNI for the trust share, the gross income of the trust share is increased by \$10,000, the amount of the reduction in the DNI of the estate share as a result of the distribution to Trust. Thus, solely for purposes of calculating DNI, the trust share has gross income of \$35,000, and taxable income of \$30,000. Therefore, the trust share has \$30,000 of DNI for the taxable year.
- (iii) During the same taxable year, Trust distributes \$35,000 to C. The distribution deduction reported on the Form 1041 filed for A's estate and Trust is \$30,000. As a result of the distribution by Trust to C, C must include \$30,000 in gross income for the taxable year. The gross income reported on the Form 1041 filed for A's estate and Trust is \$40,000.⁹⁶⁷

The charitable deduction provided for in section 642(c) is permitted to both the estate and an electing trust.⁹⁶⁸ The amount of the deduction allowed, however, must be gross income of each entity, computed separately, and paid or set aside pursuant to the terms of the will or trust document.⁹⁶⁹ If there is no executor appointed, a section 645 election will qualify the electing trust for a charitable deduction set aside under section 642(c)(2).⁹⁷⁰

The 645 election will cause the trust to be deemed an estate for qualification as a shareholder of an S corporation under section 1361(b)(1).⁹⁷¹ This status ends when the section 645 election expires, apparently even if the payment of taxes is being deferred under section 6166. In Private Letter Ruling 200529006, a trust that owned S corporation stock planned to make a section 645 election and to defer payment of estate taxes under section 6166.⁹⁷² The Service ruled that a section 6166 election had no effect on when the 645 election period terminates. This conclusion should be compared with Revenue Ruling 76-23,⁹⁷³ where the Service ruled that an estate could continue

967. *Id.*

968. Treas. Reg. § 1.645-1(e)(2)(iv).

969. *Id.*

970. *Id.*

971. *See* section 8:4.

972. Priv. Ltr. Rul. 200529006. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

973. Rev. Rul. 76-23, 1976-1 C.B. 264.

to remain open and own S corporation stock during the period it was paying estate taxes under section 6166.

To extend the time a trust is deemed part of an estate for section 645 purposes and thus an eligible S corporation shareholder, the executor might file a protective claim for refund of estate taxes to deduct additional estate administration expenses that are likely to arise after the original estate tax return is filed. So long as the Service leaves the claim for refund open, the “final determination of estate tax liability” has not occurred, and as a result the section 645 election should still be in effect, thereby permitting S status to continue (as the estate is an eligible S shareholder even if the trust would not be).

On the last day of the election period, the combined estate and qualified revocable trust are deemed to distribute all the assets of the electing trust to a new trust in a distribution to which sections 661 and 662 apply.⁹⁷⁴ Therefore, the combined entity is entitled to a distribution deduction under section 661 in the taxable year in which the election period terminates, and the “new” trust must include the deemed distribution in its gross income under section 662. The net capital gains attributable to the qualified revocable trust are includible in the distributable net income of the share comprising the qualified revocable trust for purposes of applying sections 661 and 662 to the deemed distribution to the “new” trust.⁹⁷⁵

The new trust must obtain its own tax identification number, and the estate must continue to use the estate’s tax identification number.⁹⁷⁶ The taxable year of the new trust must be the calendar year, and the estate must continue to use the taxable year chosen by the combined entity during the election period.⁹⁷⁷

For several reasons, it may not be appropriate to make the section 645 election. For example, an opportunity to “split” income with another taxpayer (that is, the formerly revocable trust) may be present if the election is not made. Also, the allocation of depreciation or depletion between the fiduciary and beneficiaries may be preferable for a trust rather than an estate.⁹⁷⁸ On the other hand, reasons to make the election include the ability to use a non-calendar year (if otherwise used by the estate), to deduct certain passive losses under section 469(i),

974. Treas. Reg. § 1.645-1(h)(4).

975. *Id.*

976. See Treas. Reg. § 1.645-1(h)(3). See I.R.S. Notice 2003-33, 2003-1 C.B. 990 (if U.S. Form 1041 has not been filed treating the I.R.C. § 645 election as terminated, trusts and estates of decedents dying before December 24, 2002, may treat the date that the election terminates as twelve months after the date of issuance of the closing letter as provided in Treas. Reg. § 1.645-1(f)(2)(ii), rather than six months after such issuance).

977. See Treas. Reg. § 1.645-1(h)(1).

978. See section 3:2.1[A] for a discussion of the depreciation deduction.

to deduct and amortize certain reforestation expenses under section 194, to receive an income tax deduction under section 642(c) for gross income set aside for charity (even if not paid), and not to have only a limited deduction under section 642(c) for unrelated business income paid to charity by reason of section 681(a).

Consideration should be given to whether the section 645 election will affect state or local taxation of income of the electing trust. In states that use federal adjusted gross income or federal taxable income as a base to compute state income taxes, the section 645 election presents potentially unanswered questions.

Example: An example illustrates the problem: A resident of State 1 created a revocable trust in another jurisdiction (State 2) with a trustee in that state. If, after the decedent's death, all of the trust's beneficiaries are domiciled in State 2, the trust should be subject to state income taxes in State 2, not State 1. However, if the personal representative of the decedent's estate makes a section 645 election, the income of the revocable trust will be included on the State 1 income tax return if State 1 uses federal adjusted gross income or federal taxable income to compute income taxable in State 1. Whether State 1 will permit the estate to reduce its taxable income by the amount of income attributable to the out-of-state trust or whether State 2 will not tax the trust so long as the section 645 election is effective is not certain in most if not all states. This issue may not be limited to states that use federal adjusted gross income or federal taxable income as a base to compute state income taxes, however, and the personal representative of a decedent's estate should evaluate the potential problem when considering a section 645 election.

§ 3:9 Termination of Estates and Trusts

Estates do not ordinarily remain in administration for extended periods. The permissible period of administration is:

the period actually required by the administrator or executor to perform the ordinary duties of administration, . . . whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates.⁹⁷⁹

979. Treas. Reg. § 1.641(b)-3(a); H.R. REP. NO., 83-1337, at A192 (1954), S. REP. NO. 83-1622, at 340 (1954). See *Hedges v. Comm'r*, 18 T.C. 681 (1952),

Not all of the income from a decedent's property is necessarily taxable to the estate. For a discussion of when income is not reportable by a decedent's estate, see section 2:2.

There is much litigation whether the delay in closing an estate has been unreasonable and the period has come to an end. If it has, the legatees may be required to report the income,⁹⁸⁰ or the income may be deemed currently distributable. The Service will not rule in advance whether the period for administration is unduly prolonged.⁹⁸¹

When an estate is paying estate taxes installments as permitted by section 6166, the Service has ruled that an estate may remain open and may own S corporation stock during the section 6166 payout period.⁹⁸²

Trusts are deemed to continue in existence, despite the death of the measuring life, during a reasonable period for winding up and for distribution of the corpus.⁹⁸³

In the year a trust or estate terminates, it is possible that deductible expenses may exceed trust income. Section 642(h) provides that if the deductions for the final taxable year of the estate or trust are in excess of gross income, the excess will, under regulations, be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.⁹⁸⁴ Likewise, the beneficiaries are allowed in the final year any

aff'd, 212 F.2d 593 (9th Cir. 1954); *Carson v. United States*, 317 F.2d 370 (Ct. Cl. 1963); *Brown v. United States*, 890 F.2d 1329 (5th Cir. 1989) (estate administration unduly prolonged for income tax purposes despite probate court order expressly authorizing executor to continue administration). See generally Frieze & Neville, *Estate Can Be Ended by IRS If It Continues Too Long*, 21 TAX'N FOR LAW. 230 (Jan.-Feb. 1993).

980. Treas. Reg. § 1.641(b)-3(d); *Estate of Johnson v. Comm'r*, 88 T.C. 225, *aff'd*, 838 F.2d 1202 (2d Cir. 1987); Rev. Rul. 73-397, 1973-2 C.B. 211; *Miller v. Comm'r*, 333 F.2d 400 (8th Cir. 1964); *Estate of Hargis v. Comm'r*, 19 T.C. 842 (1953); *LeFiell v. Comm'r*, 19 T.C. 1162 (1953). *But cf.* *Brown v. Comm'r*, 215 F.2d 697 (5th Cir. 1954); *Wylie v. United States*, 281 F. Supp. 180 (N.D. Tex. 1968); *McCauley v. United States*, 193 F. Supp. 938 (E.D. Ark. 1961).

981. Rev. Proc. 84-22, 1984-1 C.B. 449.

982. Rev. Rul. 76-23, 1976-1 C.B. 264. For a discussion of I.R.C. § 645 elections and trust ownership of S corporations during an I.R.C. § 6166 payout, see section 8:4.

983. Treas. Reg. § 1.641(b)-3.

984. *Westphal v. Comm'r*, 37 T.C. 340 (1961), *petition to review dismissed*, 317 F.2d 365 (8th Cir. 1963) (not terminated so long as a taxable entity under I.R.C. § 641). The separate-share rule of I.R.C. § 663(c) does not extend so as to make I.R.C. § 642(h) applicable merely upon termination of a separate share in the trust. Treas. Reg. § 1.663(c)-1(b)(3). See ESTATE TAX TECHNIQUES §§ 32.03[4]-32.04[3] (J. Lasser ed., 1989) (stating, in part, that the Service has indicated in a private ruling that the remainder

net-operating-loss carryover or capital-loss carryover of the estate or trust.⁹⁸⁵ The characterization of capital losses as short-term or long-term in the hands of the beneficiary is the same as it was for the trust, except if the beneficiary is a corporation, in which case all capital losses are short-term.⁹⁸⁶

The Tax Court, in *Nemser v. Commissioner*,⁹⁸⁷ held that a purchaser of interest in a testamentary trust was not a beneficiary succeeding to property of estate or trust under section 642(h).⁹⁸⁸

The excess deductions are allowed only in computing the beneficiary's taxable income; that is, the deductions are itemized deductions (and not adjustments to gross income). This means that the deductions may be subject to the rules of sections 67 and 68.⁹⁸⁹ Moreover, the excess deductions are taken into account in computing the beneficiary's tax preference items.⁹⁹⁰ The excess deductions are allowed only for the taxable year of the beneficiary in which or with which the estate or trust terminates.⁹⁹¹

Excluded from the carryout of excess deductions rule is the trust or estate's personal exemption under section 642(b) and the charitable deduction under section 642(c). When the deductions in the final year include the personal exemption, a charitable deduction and other deductions, a question arises as to which deductions offset the income of the trust or estate and which deductions are the "excess." The Tax Court in *O'Bryan v. Commissioner*,⁹⁹² ruled that the charitable deduction is deemed the last deduction used to offset income of the estate or trust. This means that if the deductions do not exceed income without the charitable deduction, there is no excess to flow out under section 642(h), and if the other deductions exceed income,

beneficiary is entitled to deduct under I.R.C. § 642(h) the full amount by which the deductions for his separate share of the remainder exceed the income of his separate share); *Kitch v. Comm'r*, 104 T.C. 1 (1995), *aff'd*, 103 F.3d 104 (10th Cir. 1996) (beneficiaries of mother's estate could not deduct loss in father's estate where mother not beneficiary of father's estate); *O'Bryan v. Comm'r*, 75 T.C. 304 (1980) (excess deductions computed without regard to charitable deduction under I.R.C. § 642(c) or personal exemption under I.R.C. § 642(b)).

985. I.R.C. § 642(h)(1).

986. Treas. Reg. § 1.642(h)-1(b).

987. *Nemser v. Comm'r*, 66 T.C. 780 (1976), *aff'd*, 556 F.2d 558 (2d Cir. 1977), *cert. denied*, 434 U.S. 855 (1979).

988. *See* Rev. Rul. 87-97, 1987-2 C.B. 155 (distributions of funds by perpetual care trust to cemetery corporation for care/maintenance of gravesites not deductible under I.R.C. § 651 or § 661 because not made to corporation as beneficiary but as compensation for services).

989. Treas. Reg. § 1.642(h)-2(a).

990. *Id.*

991. *Id.*

992. *O'Bryan v. Comm'r*, 75 T.C. 304 (1980).

then the pass-out of excess deductions is limited to the amount the other deductions exceed income.

When an estate terminates and pays over to a trust, the estate's excess deductions pass out to the trust. However, the excess deductions will not be available to the trust's beneficiary unless the trust terminates as well.⁹⁹³

A trust's operating loss carryback permits the recomputation of the beneficiaries' income for the earlier year because the carryback affects distributable net income.⁹⁹⁴

The regulations contain rules for the allocation of these items to the succeeding beneficiaries, and they attempt to allocate them to the beneficiaries who bear the burden of the loss.⁹⁹⁵ An example in the regulations provides the following:

A decedent's will leaves \$100,000 to *A*, and the residue of his estate equally to *B* and *C*. His estate is sufficient to pay only \$90,000 to *A*, and nothing to *B* and *C*. There is an excess of deductions over gross income for the last taxable year of the estate or trust of \$5,000, and a capital loss carryover of \$15,000, to both of which section 642(h) applies. *A* is a beneficiary succeeding to the property of the estate to the extent of \$10,000, and since the total of the excess of deductions and the loss carryover is \$20,000, *A* is entitled to the benefit of one half of each item, and the remaining half is divided equally between *B* and *C*.⁹⁹⁶

In Chief Counsel Advice 201047021, the Service distinguished the regulation when an estate was insolvent and no assets passed to the estate's beneficiaries.⁹⁹⁷ It ruled that the estate's capital loss carryover did not pass out.

At the time an estate or trust closes, the unused credits of an estate or trust probably are not available to the beneficiaries of the estate or trust pursuant to section 642(h) as do most deductions in excess of income and to unused capital-loss and net-operating carryovers. Without statutory authority to support the use of excess credits by the beneficiaries, the credits probably are not unavailable to the beneficiaries, except as generally available under the rules discussed in section 3:2.1[K], *supra*.

993. Rev. Rul. 57-31, 1957-1 C.B. 201.

994. Rev. Rul. 61-20, 1961-1 C.B. 248.

995. Treas. Reg. §§ 1.642(h)-4, -5.

996. Treas. Reg. § 1.642(h)-4, ex.

997. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

When a trust terminates, the issue has arisen of whether and how to allocate expenses to tax-exempt income and the application of the disallowance rule of section 265.⁹⁹⁸ For example, in Revenue Ruling 77-466, the Service ruled that a reasonable part of some expenses paid in the year of termination must be disallowed under section 265 if the trust owned tax-exempt bonds at some time during the term of trust, even if the exempt bonds were not held in trust during its final year.⁹⁹⁹ On the termination of any portion (which, presumably, includes all) of an electing small business trust described in section 1361(e), the loss carryover or excess deductions referred to in section 642(h) are taken into account by the entire trust.¹⁰⁰⁰

In *L.P. Whitehead Foundation, Inc. v. United States*,¹⁰⁰¹ the court held that a private foundation that was a remainder beneficiary of a trust could not use excess deductions in the year of termination in computing its excise tax liability under section 4940 on its net investment income.

Upon termination of an ESBT, or upon revocation of an ESBT election, the NOL deduction carryover under section 172, capital loss carryover under section 1212, and excess deduction are governed by the provisions of section 642(h).¹⁰⁰² This means that the deductions

998. See section 3:2.1[I] for a discussion of I.R.C. § 265.

999. Rev. Rul. 77-466, 1977-2 C.B. 83. See also *Comm'r v. Wade*, 155 F.2d 918 (2d Cir. 1946); cf. *Whittemore v. United States*, 383 F.2d 824 (8th Cir. 1967); Chapman & Strassler, *How to Reap the Fullest Tax Advantages from an Estate or Trust on Termination*, 5 EST. PLAN. 2, at n.15 (1978). See also *Case v. United States*, 66-2 U.S. Tax Cas. (CCH) ¶ 9764 (D. Wyo. 1966) (not finding unreasonable Commissioner's allocation of trustees' termination commissions on basis of ratio of value of tax-free assets to value of total corpus at time of termination and disallowance of executors' and attorneys' fees on the ratio of total claimed as deductions as value of tax-free assets disbursed or distributed plus accrued interest bears to total assets disbursed or distributed); *Fabens v. Comm'r*, 519 F.2d 1310 (1st Cir. 1975) (Commissioner's disallowance of trustees' termination commissions on ratio of tax-exempt income over life of trust to total income should have considered unrealized gains); Rev. Rul. 77-355, 1977-2 C.B. 82 (simple trust may not consider capital gains not included in distributable net income to allocate indirect expenses to tax-free income) (distinguishing Rev. Rul. 73-565, 1973-2 C.B. 90); Rev. Rul. 80-165, 1980-1 C.B. 134 (same as to tax-free dividend that reduces basis).

1000. I.R.C. § 641(c)(4). Treas. Reg. § 1.641(c)-1(j) confirms the application of I.R.C. § 642(h) if the entire ESBT election terminates or is revoked and raises a question if the rule is applicable if only a portion of the ESBT election terminates or is revoked. A partial termination might occur if the trust owns stock in more than one S corporation and disposes of the stock in one S corporation but retains stock in another S corporation.

1001. *L.P. Whitehead Found. v. United States*, 606 F.2d 534, 539 (5th Cir. 1979).

1002. Treas. Reg. § 1.641(c)-1(j).

are taken into account by the entire trust or the trust beneficiaries if the trust terminates.¹⁰⁰³ The regulations provide an example.¹⁰⁰⁴

In Chief Counsel Advice 200734019, a testamentary ESBT trust succeeded to an estate's NOL resulting from S corporation losses.¹⁰⁰⁵ The Service ruled that section 642(h)(1) permitted the non-S portion a deduction for the NOL, but section 642(c)(2)(C) did not permit the S portion of the ESBT to use the NOL because the deduction was not specifically included in the list of permitted deductions for ESBTs. For additional discussion of ESBTs see section 8:7.

1003. *Id.*

1004. Treas. Reg. § 1.641(c)-1(l), exs. 2 & 3(i)-(ii).

1005. Chief Couns. Adv. 200734019.

Chapter 5

Grantor Trusts^{*}

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* Portions of this chapter appeared in Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L.J. 207 (2009), copyright Bessemer Trust Company, N.A.; Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009); and in Jonathan Blattmachr & Bridget Crawford, *Grantor Trusts and Income Tax Reporting: A Primer*, 13 PROB. PRAC. REP., May 2001, at 1, and appear herein with permission.

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§ 5:1 **Introduction**

§ 5:1.1 **Overview**

The taxation of trusts discussed in chapter 3 applies generally when the grantor has parted with all interests in the trust corpus and income, as well as control over both. This scheme of taxation does not apply, however, to revocable trusts or other trusts if the grantor is considered to be the owner for tax purposes because of retained interests or powers or because of certain interests or powers granted to other people. Moreover, it is possible for a third party to be deemed the owner of a trust because of certain interests in or powers over a trust. Instead, in these circumstances, subpart E of subchapter J applies. These rules contained in sections 671–79 are commonly known as the grantor trust rules.

When the grantor trust rules apply, section 671 provides in part that:

there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.¹

Only the income of a trust not subject to the grantor trust rules is governed by the remainder of subchapter J. Nevertheless, it is possible for a grantor to be taxed under assignment of income principles² or family partnership rules.³ The assignment of future trust income by a trust beneficiary may not effectively transfer the tax liability to the assignee unless the assignment is of such a permanent nature that a grantor would be relieved of tax on creation of a similar trust.⁴ For example, the assignment of interest accruing on a bond to a non-grantor trust may not transfer the income tax liability to the trust.⁵ In addition, the regulations provide that an assignment of income from an employment contract to a non-grantor trust may not relieve the assignor of the tax liability.⁶

In Revenue Ruling 85-13,⁷ the Service ruled that all transactions between the grantor and a grantor trust should be disregarded for all income tax purposes and expressly rejected the U.S. Court of Appeals for the Second Circuit's then-recent decision in *Rothstein v. United States*.⁸ The Service re-applied its position in Revenue Ruling 2007-13, which reached a similar conclusion.⁹ In the 2007 ruling, the Service held that the income tax transfer-for-value rule of section 101

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1. I.R.C. § 671 (2006).
 2. Compare *Blair v. Comm'r*, 300 U.S. 5 (1937), with *Helvering v. Horst*, 311 U.S. 112 (1940). For a general discussion of assignment of income principles, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962); supplemented in Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964).
 3. Treas. Reg. § 1.671-1(c); H.R. REP. NO. 83-1337, at A212 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4089; S. REP. NO. 83-1622, at 365 (1954), reprinted in 4 U.S.C.C.A.N. 4621, 4719; see *Hogle v. Comm'r*, 132 F.2d 66, 71 (10th Cir. 1942); see also I.R.C. § 704(e) concerning family partnerships.
 4. Rev. Rul. 55-38, 1955-1 C.B. 389; *Helvering v. Wood*, 309 U.S. 344 (1940); *Blair v. Comm'r*, 300 U.S. 5 (1937).
 5. Treas. Reg. § 1.671-1(c).
 6. *Id.*
 7. Rev. Rul. 85-13, 1985-1 C.B. 184.
 8. *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).
 9. Rev. Rul. 2007-13, 2007-1 C.B. 684. See also IRS INFO 2009-0120, in which the Service determined that the transfer of Series I bonds to a

does not apply when one grantor trust created by the insured purchases an insurance policy from another grantor trust created by the same grantor, and the transfer for value rule does not apply when the purchasing trust is a grantor trust, even though the selling trust is not a grantor trust.¹⁰

In Chief Counsel Advice 201343021, the Service reviewed the general application of Revenue Ruling 85-13.^{10.1} The chief counsel advisory states that: “We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner.” Nevertheless, the chief counsel advisory noted that a few courts and the Service on occasions have treated a grantor trust and its owner as separate entities for income tax purposes. First, *Rothstein*^{10.2} has never been overruled, and in theory it is still good law in the Second Circuit. Nevertheless, only one court decision followed *Rothstein* and then only in dicta.^{10.3} Second, Revenue Ruling 74-243^{10.4} has not been specifically modified or revoked. Third, the Tax Court’s opinion in *Textron v. Commissioner*^{10.5} “was arguably inconsistent with Rev. Rul. 85-13. . . . The issue before the Tax Court was whether Textron was taxable on the foreign corporation’s subpart F income during the existence of the voting trust; the Court

grantor trust does not result in the realization of income and the grantor may continue to defer reporting of interest each year. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

10. Under I.R.C. § 101(a)(1), life insurance proceeds payable by reason of the death of the insured are not, as a general rule, included in gross income. However, under I.R.C. § 101(a)(1), the proceeds are included in gross income to the extent they exceed the policy owner’s income tax basis in the policy when that policy has been purchased often being issued or otherwise transferred for value (as opposed, for example, to having been transferred gratuitously). Nevertheless, among other exceptions, the transfer for value rule of I.R.C. § 101(a)(2) does not apply to the policy’s acquisition by the insured. Where the insured under the policy, which is purchased by a trust, is treated as the trust’s owner, the insured is treated as acquiring the policy becomes, under Rev. Rul. 85-13, the existence of the trust for income tax purposes (and the transfer for value rule is an income tax provision) is ignored.
- 10.1. Chief Couns. Adv. 201343021. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
- 10.2. See note 8 and accompanying text.
- 10.3. *Zand v. Comm’r*, T.C. Memo. 1996-19.
- 10.4. Rev. Rul. 74-243, 1974-1 C.B. 106.
- 10.5. *Textron v. Comm’r*, 117 T.C. 67 (2001).

found that the trust, not Textron, was the shareholder for purposes of §§ 951 (a) and 958(a)” Finally, a few private letter rulings seem to be inconsistent with Revenue Ruling 85-13,^{10.6} but these rulings concerned the transfer of an IRA to a grantor trust of the IRA owner.

More recently, the Service privately ruled that the sale of life insurance policies, both joint life policies and single life policies, from a grantor trust owned by a husband and a wife to a grantor trust deemed wholly owned by the husband were not transfers for value of the life insurance policies under section 101(a)(2).^{10.7} The portion of the sale from the selling joint grantor trust attributable to the grantor of the buying trust is not recognized under the rationale of Revenue Ruling 85-13 and the portion of the sale from the selling joint grantor trust attributable to the grantor’s wife (that is, not the grantor of the purchasing trust) is deemed a gift by section 1041(a) so that the policy has a carryover adjusted basis under section 1041(b) and was not transferred for value.

It is possible that a trust is a grantor trust in some tax years and not a grantor trust in other years. This switch from grantor trust status to non-grantor trust status may occur, for example, when a power that causes a trust to be deemed a grantor trust is released. Sometimes, switching back and forth between grantor trust status and non-grantor trust status is employed to achieve favorable tax results. In Notice 2007-73,¹¹ the Service expressed interest in a transaction that apparently is designed to cause a loss recognition to a taxpayer without a corresponding economic cost or gain recognition to that taxpayer by changes in the status of a trust from grantor trust status to non-grantor trust status and then back to grantor trust status. The Notice does not indicate that the “togglng” of grantor trust status is itself of concern to the Service.

§ 5:1.2 History

The early structure of the income tax did not permit joint income tax returns for married couples and the tax rate structure was very progressive. These aspects encouraged taxpayers to reduce taxes by deflecting income to other taxpayers who were in lower income tax brackets. The advantage of splitting income between spouses was

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- 10.6. Priv. Ltr. Ruls. 20117042, 201129045 (not allowing an IRA to be transferred to a grantor trust). *But see* Priv. Ltr. Ruls. 200620025, 200826008, 201116005 (which permit such a transfer).
 - 10.7. Priv. Ltr. Rul. 201423009. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 11. I.R.S. Notice 2007-73, 2007-36 I.R.B. 545.

obvious: If income could be spread between two tax returns with two uses of lower income tax brackets and personal exemptions, less overall tax was due. Another method used to deflect income from higher tax brackets to potentially lower tax brackets was to shift income to trusts or beneficiaries of trusts.

Attempts to lower income taxes by deflecting income to other taxpayers have not always been successful. The Supreme Court's landmark decision in *Lucas v. Earl*¹² is the classic example of courts not permitting income earned by one taxpayer to be taxed to another through a contractual assignment of income.¹³

Deflecting income from higher tax brackets to potentially lower tax brackets was contested by the Service. The landmark decision *Helvering v. Clifford*¹⁴ is an example of an attempted assignment of income between spouses, in the pre-joint return era, with the creation of a short-term trust that did not pass judicial scrutiny to effect a shift of income to a lower bracket.

Motivated by *Clifford*, the Treasury Department adopted regulations under the 1939 Code's definition of gross income¹⁵ that provided guidelines for when trusts would be recognized as taxpayers separate from their grantors and when trust income would be taxed to the grantor. The regulations were commonly known as the *Clifford* regulations. These rules taxed the grantor rather than the trust if any one of a number of lines were crossed. In 1954, Congress adopted the "grantor trust" provisions of Internal Revenue Code (Code) sections 671 through 679¹⁶ that generally followed the *Clifford* regulations.

The 1948 adoption of joint returns for married couples¹⁷ eliminated the income tax incentives to divide income between spouses, but the Code's highly progressive rate structure continued to motivate income splitting between grantors and trusts created for others and the beneficiaries of those trusts. For example, the pre-1987 "ten-year and a

12. *Lucas v. Earl*, 281 U.S. 111 (1930).

13. *Lucas v. Earl* involved a contract assigning income between spouses that predated the 16th Amendment by twelve years. Thus, the contract likely was not tax motivated; however, the Court determined the contract was nevertheless an assignment of income. *See id.* at 114.

14. *Helvering v. Clifford*, 309 U.S. 331 (1940).

15. *See* Treas. Reg. § 9.22(a)-1 (1939) (defining gross income); Treas. Reg. § 29.22(a)-21 (1946) (stating trust income taxable to grantor as substantial owner following provisions of T.D. 5488, 1946-1 C.B. 19).

16. *See* I.R.C. §§ 671-79. Unless otherwise noted, "Code" and "I.R.C." refer to the Internal Revenue Code of 1986, and "section" refers to a section of the Code. Note that I.R.C. § 679 was added to the Code in 1976.

17. *See* Revenue Act of 1948, Pub. L. No. 80-471, ch. 168, sec. 303, § 51(b), 62 Stat. 110, 115.

day trusts," also called "*Clifford* trusts," were in wide use to shift income to taxpayers in lower marginal brackets.¹⁸

The Tax Reform Act of 1986,¹⁹ with much-less-progressive income tax rates, fundamentally changed the incentive to divide income among several taxpayers. Individual tax brackets became relatively flat: the great disparity of tax rates among individuals was eliminated.²⁰ In addition, the 1986 Act all but eliminated lower tax brackets for trusts.²¹ For example, in 1987 a trust reached the top income tax bracket at \$5,000 of taxable income. Thus, for a separate trust, the use of a trust's lower brackets saved only \$650 in income taxes.²² In 2009, a trust reaches the top income tax bracket at about \$11,150 of taxable income.²³ As a result, the use of a trust's lower brackets will save something in the neighborhood of \$1,000. Neither sum likely would justify the planning and administration expenses of creating a separate trust.

§ 5:1.3 **Intentional Grantor Trusts—The Big Picture**

With no significant income tax savings to be achieved by diverting income from a taxpayer with substantial income to trusts or trust beneficiaries in non-existing lower brackets, some taxpayers switched directions and sought to invoke the grantor rules so that the grantor is treated as owning the trust (or its assets) for income tax purposes—in other words, to make each trust a grantor trust. For a taxpayer-grantor to be obliged to pay taxes on income that belongs to another (that is, income that belongs to the grantor trust or a beneficiary of the grantor trust) generally is desirable from a gift and estate tax perspective. The tax savings goal no longer is achieved by avoiding grantor trust status;

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18. Section 673, before amendment in 1986, permitted a trust to avoid grantor trust status as to tax income allocable to the fiduciary income portion of the trust if the grantor's reversionary interest in principal was delayed more than ten years. *See* I.R.C. § 673 (1954).
 19. Pub. L. No. 99-514, 100 Stat. 2085.
 20. The "kiddie" tax has de-incentivized diverting income to children. Under Code section 1(g), the unearned income of a minor child may be taxed at the parent's marginal income tax bracket. In addition, unearned income of dependent students under the age of twenty-four similarly may be taxed under I.R.C. § 1(g)(2)(A)(ii)(I).
 21. *See id.* § 1(e). Section 643(f) was enacted in 1984 (Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 599) to treat multiple trusts created by a taxpayer or the taxpayer's spouse as one trust in some instances if avoidance of income tax was the purpose in creating the trusts.
 22. Under section 1(e) for 1987, the tax on the first \$5,000 of income was \$750. A "straight" 28% tax (the higher bracket in 1987) on \$5,000 would be \$1,400, with the difference being \$650. *See* I.R.C. § 1(e) (1987).
 23. Under section 1(e) for 2014, the tax on the first \$12,150 of income is \$3,141. A "straight" 39.6% tax on \$12,150 would be \$4,811, with the difference being \$1,670. *See* I.R.C. § 1(e) (2014).

rather, it is achieved by obtaining grantor trust status with an “intentional grantor trust,” and that has become a holy grail of tax and estate planning.²⁴ Taxpayers seek to use the grantor trust rules to their advantage to save estate, gift, and generation-skipping transfer taxes.

The term *defective* was applied first to grantor trusts when the grantor trust rules originally were adopted because, as a general matter, a grantor trust classification prevented income splitting. Avoiding grantor trust status was the typical taxpayer goal. Thus, before 1987 the trust was “defective” from the perspective that the trust income was taxable to the grantor instead of the trust or a trust beneficiary. That label has carried over to today, although now grantor trust status usually is viewed as beneficial. Many planners, however, avoid using the word *defective* when describing the trust because of negative connotations to clients who are unaware of the historical background. In any event, a grantor trust, whether or not it is viewed as defective, has potential planning opportunities presented by that tax status.²⁵

Grantor trusts are used affirmatively to enhance many common estate planning strategies by:

permitting the income earned by the trust to grow free of income tax because the tax burden is imposed upon the grantor, and the payment of the trust’s income tax liability by the grantor is not a gift;²⁶

permitting assets to be sold by the grantor to the trust for fair market value without the imposition of gift tax²⁷ or income tax, even if the assets sold are appreciated;²⁸ and

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24. The income tax status of a grantor trust is the same whether or not achieved intentionally.
 25. See Howard M. Zaritsky, *Open Issues and Close Calls—Using Grantor Trusts in Modern Estate Planning*, 43 ANN. HECKERLING INST. ON EST. PLAN. ¶ 300 (2009).
 26. See Rev. Rul. 2004-64, 2004-2 C.B. 7; see also *infra* notes 37–42 and accompanying text.
 27. An individual makes a gift only to the extent the taxpayer receives back consideration in money or money’s worth that is less than the value of what the taxpayer transferred. See I.R.C. § 2512(b); see also Treas. Reg. § 25.2512-8.
 28. No capital gain or loss should be recognized on sales between the trust and the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor). In that ruling, the Service indicated it would not follow *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), to the extent it would require a different result. In *Rothstein*, the Second Circuit concluded that a taxpayer could enter into a sales transaction for income tax purposes with a grantor trust because the trust was a separate taxpayer. See *id.* at 709; see also Rev. Rul. 2007-13, 2007-1 C.B. 684 (ruling in Situation 1 that the sale of a life insurance policy

permitting the purchase or exchange of low basis assets in exchange for higher basis assets, such as cash, by the grantor shortly before death without the imposition of an income tax.²⁹

Grantor trusts have other beneficial uses. For example, a trust is a permissible shareholder of S corporation stock if the trust is a grantor trust (with respect to a taxpayer who is an eligible shareholder of an S corporation) as to income and corpus.³⁰ In addition, the \$250,000 (\$500,000 for joint returns) exclusion from income under section 121 for the sale of a principal residence by an individual is available if the residence is owned by a grantor trust with respect to that individual.³¹

Grantor status is not always beneficial, however. In Chief Counsel Advice 201343021,^{31.1} the Service concluded that sections 267 (disallowance of losses) and 707(b)(1)(A) (disallowance of losses between partnerships and partners owning directly or indirectly more than 50% of the partnership) applies to grantor trusts. The Service relied heavily on Revenue Ruling 85-13, stating: “We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner.”

The affirmative use of grantor trusts as a tax planning tool has been aided by several published rulings. In Revenue Ruling 85-13,³² the Service concluded that transactions between a grantor and his or her grantor trust have no income tax effect. This position disagreed with a decision of the Court of Appeals for the Second Circuit,³³ but until revoked the

from one “wholly owned” grantor trust to another “wholly owned” grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts); Rev. Rul. 92-84, 1992-2 C.B. 216 (gain or loss on sale of asset by Qualified Subchapter S Trust, which is grantor trust as to its S corporation stock, is treated as gain or loss of the grantor or other person treated as owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to trust corpus rather than to trust income).

29. The subsequent inclusion of the low basis assets in the grantor’s gross estate at death generally will result in a new basis equal to the estate tax values. *See* I.R.C. § 1014(a).
30. *See* I.R.C. § 1361(c)(2)(A)(i); *see, e.g.*, Priv. Ltr. Rul. 200001015 (Jan. 7, 2000). For a more extensive discussion, *see* section 7:3.
31. *See* Rev. Rul. 85-45, 1985-1 C.B. 183; Priv. Ltr. Rul. 9118017 (May 3, 1991) (prior section 121 provision excluding gain on sale of residence by individual over age fifty-five).
- 31.1. Chief Couns. Adv. 201343021. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
32. 1985-1 C.B. 184.
33. *See* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).

Service is obligated to follow its own published ruling.³⁴ Moreover, the Service more recently has reaffirmed its Revenue Ruling 85-13 position in Revenue Ruling 2004-64³⁵ and Revenue Ruling 2007-13.³⁶

For many years, some tax advisors were concerned that a gift might occur if the grantor paid income taxes on income that belonged to another; that is, gross income otherwise received by a trust or its beneficiaries. In a private letter ruling, the Service required the grantor of a grantor trust to be reimbursed for income taxes paid by the grantor on trust income. That ruling raised the issue of whether the failure to reimburse the grantor for income taxes paid might be a gift by the grantor.³⁷ The Service has since changed its position, however. In Revenue Ruling 2004-64,³⁸ the Service concluded that the payment by a grantor of taxes on income earned by a trust is not a gift if the tax reimbursement is not required under the terms of the trust or required by state law.³⁹ In addition, the Service ruled similarly in Revenue Ruling 2004-64, if the reimbursement is in the discretion of an independent trustee.⁴⁰ If the trust mandates that the grantor be reimbursed for paying the income taxes attributable to the grantor trust, the ruling indicates that there are no gift tax consequences to the grantor or the trust beneficiaries upon the grantor's initial payment of the tax and the trust's reimbursement to the grantor (although quite obviously, the benefit of having the trust grow on an income tax-free

34. See *Rauenhorst v. Comm'r*, 119 T.C. 157 (2002).

35. See Rev. Rul. 2004-64, 2004-2 C.B. 7; see also *supra* note 26.

36. Rev. Rul. 2007-13, 2007-1 C.B. 684.

37. In Priv. Ltr. Rul. 9444033 (Nov. 4, 1994), the Service stated in dicta that the failure of the trust to reimburse the grantor for income taxes paid by the grantor would be considered a gift by the grantor to the remainderpersons. The Service subsequently reissued the ruling without that dicta in Priv. Ltr. Rul. 9543049 (Oct. 27, 1995). Rulings have approved various types of reimbursement provisions. See, e.g., Priv. Ltr. Ruls. 9415012 (Apr. 15, 1994), 9416009 (Apr. 22, 1994), 9451056 (Dec. 23, 1994). The Service's position created a dichotomy because including an income tax reimbursement provision would seem to create some risk that the trust would be included in the grantor's estate under Code section 2036 by providing for payment of legal obligations of the grantor. However, because of its prior insistence that trusts provide that the grantor be reimbursed for income taxes, the application of section 2036 on account of such reimbursement was made prospective only in Rev. Rul. 2004-64, 2004-2 C.B. 7. See Treas. Reg. § 20.2036-1(b)(2). Various Service private rulings previously held no inclusion would be found under Code section 2036(a); see, e.g., Priv. Ltr. Ruls. 200120021 (May 18, 2001), 199922062 (June 4, 1999), 199919039 (May 14, 1999), 9710006 (Mar. 7, 1997), 9709001 (Feb. 28, 1997), 9413045 (Apr. 1, 1994).

38. Rev. Rul. 2004-64, 2004-2 C.B. 7.

39. See *id.* (Situation 1).

40. See *id.* (Situation 3).

basis would be lost).⁴¹ The ruling also addressed whether either a mandatory or discretionary reimbursement clause would cause inclusion of trust assets in the grantor's estate under section 2036.⁴²

41. *See id.* (Situation 2).

42. If neither state law nor the governing instrument contains any provision requiring or permitting the trustee to reimburse the grantor for paying income taxes attributable to the trust, the grantor's payment of the tax is not a gift by the grantor, and no portion of the trust is includible in the grantor's estate under section 2036. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7 (Situation 1).

If the trust mandates that the grantor be reimbursed for paying the income taxes attributable to the grantor trust, the ruling indicates that there are no gift tax consequences to the grantor or the trust beneficiaries upon the grantor's initial payment of the tax or the trust's reimbursement to the grantor, but "the full value of the trust assets" would be included in the grantor's estate under section 2036. *See id.* (Situation 2). (The statement that the "full value" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death.) The ruling says that full estate inclusion would also be required if state law requires reimbursement of the grantor's payment of the income tax and if the instrument did not override that requirement. *See id.* If state law gives the grantor the right to be reimbursed, language in the trust instrument must *negate* the reimbursement right to avoid inclusion of the trust's assets in the grantor's estate under I.R.C. § 2036. That provision, perhaps, should be included in all trusts, because the drafter does not know if the trust situs might change in the future.

If the trust instrument authorizes the trustee, in the exercise of discretion, to reimburse the grantor for any income taxes of the grantor attributable to the trust, any such reimbursement is not treated as a gift by the beneficiaries, unless, perhaps, a beneficiary is the trustee making the distribution. Giving the trustee the discretion to reimburse the grantor for income taxes attributable to the income of the grantor trust may risk estate inclusion under I.R.C. § 2036 if an understanding or preexisting arrangement between the trustee and the grantor regarding reimbursement existed, or if the grantor could remove the trustee and appoint himself or herself as successor trustee, *cf.* Rev. Rul. 95-58, 1995-2 C.B. 191, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7 (Situation 3). Some states have passed statutes specifically providing that a settlor's right in the trustee's discretion to be reimbursed for income taxes does not permit the settlor's creditors to reach the trust's assets. *See, e.g.,* TEX. PROP. CODE ANN. § 112.035(d) (Vernon 2004); N.H. REV. STAT. ANN. § 564-B:5-505(a)(2) (2006).

Revenue Ruling 2004-64 deals with a fact situation in which the trust agreement requires that the trustee be a person who is not related or subordinate to the grantor of the trust. The ruling does not address the issue of when the reimbursement is discretionary and the trustee is related or subordinate to the grantor. In that situation, the Service might argue that an implied agreement to reimburse might exist that would then cause estate inclusion under section 2036.

The “spousal-unity” rule enacted by Congress in 1986 broadens the potential scope of the grantor trust rules.⁴³ Under section 672(e), as amended in 1988,⁴⁴ a grantor is “treated as holding any power or interest held by (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest” even if there is a subsequent divorce,⁴⁵ “or (B) any individual who [subsequently] became the spouse of the grantor, but only with respect to periods after such individual became the spouse of the grantor.”⁴⁶ This spousal-unity rule has its positive side, however, as it makes the creation of a grantor trust possible in situations in which the grantor’s retention of the same power or interest would not be possible without creating estate, gift, or generation-skipping transfer tax problems for the grantor, and it comes into play with a number of the grantor trust rules. Note that grantor trust treatment may continue even following a divorce if the prior spouse retains the grantor-trust power or interest, such as serving as trustee in some circumstances.⁴⁷

Section 671 provides that when a grantor is “treated as the owner of any portion of a trust,” the grantor must include the “income, deductions, and credits against tax” from that portion when computing his or her taxable income.⁴⁸ Only the portion of the trust that remains is subjected to the remaining rules concerning the income taxation of trusts and their beneficiaries.⁴⁹ This aspect of the grantor trust rules, known as the “portion rule,” means that a trust may be a grantor trust in whole or only in part. Whether a trust is wholly a grantor trust or partially a grantor trust may depend on which section or sections of the Code make the trust a grantor trust and which power or interest is involved. When grantor trust treatment status is sought, it is common for the grantor to want the trust to be wholly a grantor trust. Thus, care must be taken to determine if a trust is entirely a grantor trust or one only for some lesser portion. The application of

43. See Tax Reform Act of 1986, Pub. L. No. 99-514, tit. XIV.A, sec. 1402, § 672(e), 100 Stat. 2085, 2711 (effective for transfers after Mar. 1, 1986).

44. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1014, § 672(e), 102 Stat. 3342, 3559.

45. See I.R.C. § 672(e) (the spousal identity rule does not apply if the grantor and his spouse were divorced or legally separated at the time the power or interest was created).

46. *Id.*

47. Under section 672(e)(1)(A), if the grantor and the spouse are married at the time the power is created, divorce does not terminate the grantor being deemed to have all powers the spouse has, and divorce does not terminate grantor trust status.

48. I.R.C. § 671.

49. See *id.*

the portion rule is discussed below in section 5:2.2 and in the context of the various grantor rules.

Making a trust a grantor trust usually is quite easy because the grantor trust rules were written with that goal in mind,⁵⁰ but grantor trust status raises a minefield of situations that may cause wealth transfer tax problems—that is, gift, estate, and generation-skipping transfer tax problems. A grantor trust does not preclude estate, gift, and generation-skipping transfer tax consequences.⁵¹ Extreme caution must be used to avoid adverse wealth transfer tax issues; every transfer to a trust has potential gift, estate, and generation-skipping transfer tax consequences besides the income tax status issues.⁵²

Discussed below with the analysis of each grantor trust Code are various grantor trust rules that may be used to achieve grantor trust status.

§ 5:2 General Rules

Any discussion of the grantor trust rules must start with the general rules applicable to grantor trusts and the controlling definitions.

§ 5:2.1 Who Is a Grantor?

The identification of a trust's grantor was determined under case law until regulations were issued in 2000. The regulations are applicable to transfers to trusts or transfers of interests in trusts made after the 1999 effective date of the regulations.⁵³ Obviously, a person who creates a trust and funds it is the grantor. The issue is no less clear if the person who creates a trust is not the same person who transfers property to the trust: the property transferor is the grantor. For example, in *Moore v. Commissioner*,⁵⁴ a state court order set up a trust to hold the residue of a decedent's estate and the residual beneficiaries of the estate consented to the creation of the trust. The Tax Court ruled that each beneficiary was the grantor to the extent of each beneficiary's interest in the trust. Similarly, in Revenue Ruling 83-25,⁵⁵ the Service ruled a minor was the grantor of a trust

50. See section 5:1.2.

51. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

52. It may also raise income tax issues. For example, the transfer of an asset that is subject to debt in excess of its income tax basis generally causes the transferor to recognize gain even if the transfer is gratuitous. *Crane v. Comm'r*, 331 U.S. 1 (1947). However, no such gain is recognized if the transfer is a grantor trust. See Treas. Reg. § 1.1001-2.

53. T.D. 8890, 2000-2 C.B. 122 (effective after Aug. 9, 1999).

54. *Moore v. Comm'r*, 23 T.C. 534 (1954).

55. Rev. Rul. 83-25, 1983-1 C.B. 116.

that was created for the minor by a court order to hold a personal injury award.⁵⁶

In Private Letter Ruling 200620025,⁵⁷ a decedent's disabled son was one of four designated beneficiaries of the decedent's IRA. Because the disabled son was eligible for Medicaid, his guardian sought permission of a local court to create a special needs trust for the son and to transfer his interest in the IRA to the trust. The Service ruled that the court-created special needs trust was a grantor trust of the decedent's son under sections 671 and 677(a) and that the transfer of the IRA to the trust was not a taxable disposition under section 691(a)(2).⁵⁸ The Service ruled similarly in Private Letter Ruling 200826008, in which an IRA beneficiary was a minor.⁵⁹

Trusts created by court orders are distinguishable from trusts created by the government, however. For example, in Revenue Ruling 77-230,⁶⁰ the United States was determined to be the grantor of a trust set up in settlement of a claim against it, because income in excess of expenses were accumulated and corpus reverted to the United States when the trust terminated.⁶¹

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56. See also Priv. Ltr. Rul. 9502019 (same where parent as guardian for incompetent creates trust for incompetent with court approval); see, e.g., I.R.C. § 646 (Alaska Native Settlement Trusts); Priv. Ltr. Rul. 9713011 (Alaskan Native Corporation apparently treated as grantor of state-chartered settlement trust created with the approval of its shareholders even though the transfer of cash and other assets, other than Alaska Native Claims Settlement Act land, by the corporation to the trust treated as distribution of an economic benefit by the corporation to the shareholders); Rev. Proc. 2003-14, 2003-1 C.B. 319 (providing safe harbor for each American Indian tribe, as therein defined, to be treated as the owner of certain trusts under the grantor trust rules for receipt of revenues under the Indian Gaming Regulatory Act; the trust beneficiaries will not be required to include payments received by the trust in gross income until the taxable year the beneficiaries actually or constructively receive the amounts pursuant to the tax accounting principles of I.R.C. § 451). See also Priv. Ltr. Ruls. 200835029, 200927022. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
57. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
58. See section 2:3.1 for an explanation of I.R.C. § 691(a)(2).
59. Priv. Ltr. Rul. 200826008. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
60. Rev. Rul. 77-230, 1977-2 C.B. 214.
61. Priv. Ltr. Rul. 8943083 (similar as to a county government). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

The 2000 regulations apply to gratuitous transfers and transfers of trust interest made after August 9, 1999.⁶² The regulations provide that “a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of . . . [Treasury Regulation section 1.671-2(e)(2)]) of property to a trust.”⁶³ The regulations provide three applicable examples:

Example 1. *A* creates and funds a trust, *T*, for the benefit of her children. *B* subsequently makes a gratuitous transfer to *T*. Under [Treasury Regulation section 1.671-2(e)(1)], both *A* and *B* are grantors of *T*.⁶⁴

...

Example 7. *A*, *B*'s brother, creates a trust, *T*, for *B*'s benefit and transfers \$50,000 to *T*. The trustee invests the \$50,000 in stock of Company *X*. *C*, *B*'s uncle, purportedly sells property with a fair market value of \$1,000,000 to *T* in exchange for the stock when it has appreciated to a fair market value of \$100,000. Under [Treasury Regulation section 1.671-2(e)(2)(ii)], the \$900,000 excess value is a gratuitous transfer by *C*. Therefore, under [Treasury Regulation section 1.671-2(e)(1)], *A* is a grantor with respect to the portion of the trust valued at \$100,000, and *C* is a grantor of *T* with respect to the portion of the trust valued at \$900,000. In addition, *A* or *C* or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if *A* or *C* or both retain powers over or interests in such portions under sections 673 through 677.⁶⁵

...

Example 9. *G* creates and funds a trust, *T1*, for the benefit of *B*. *G* retains a power to revest the assets of *T1* in *G* within the meaning of section 676. Under the trust agreement, *B* is given a general power of appointment over the assets of *T1*. *B* exercises the general power of appointment with respect to one-half of the corpus of *T1* in favor of a trust, *T2*, that is for the benefit of *C*, *B*'s child. Under [Treasury Regulation section 1.671-2(e)(1)], *G* is the grantor of *T1*, and under [Treasury Regulation 1.671-2(e)(1) and (5)], *B* is the grantor of *T2*.⁶⁶

Entities such as partnerships and corporations may be trust grantors.⁶⁷ Nevertheless, if the transfer is not for a business purpose of the

62. Treas. Reg. § 1.671-2(e)(7).

63. Treas. Reg. § 1.671-2(e)(1).

64. Treas. Reg. § 1.671-2(e)(6).

65. *Id.*

66. *Id.*

67. Treas. Reg. § 1.671-2(e)(4).

entity, but rather is for a personal purpose of a shareholder or a partner, the transfer may be reclassified as a constructive distribution to the shareholder or partner. The regulations provide an example: “if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.”⁶⁸

The regulations define a gratuitous transfer as any transfer that is not a transfer for fair market value, whether or not the transfer is a transfer for gift tax purposes.⁶⁹ Consideration received by the transferor includes services rendered by the trust, property, or the use of property, but only to the extent of the arm’s-length value of the services or property received.⁷⁰ Consideration does not include an interest in the trust.⁷¹ Distributions on property owned by a trust, such as a dividend on stock, are not gratuitous transfers.⁷²

If, however, a person establishes a trust but does not make gratuitous transfers to the trust, that person is not treated as the owner, nor is a person considered an owner even if that person transfers property to the trust if the transferor is reimbursed within a reasonable period of time.⁷³ The regulations provide an example:

Example 3. *A*, an attorney, creates a foreign trust, *FT*, on behalf of *A*’s client, *B*, and transfers \$100 to *FT* out of *A*’s funds. *A* is reimbursed by *B* for the \$100 transferred to *FT*. The trust instrument states that the trustee has discretion to distribute the income or corpus of *FT* to *B* and *B*’s children. Both *A* and *B* are treated as grantors of *FT* under [Treasury Regulation section 1.671-2(e)(1)]. In addition, *B* is treated as the owner of the entire trust under section 677. Because *A* is reimbursed for the \$100 transferred to *FT* on behalf of *B*, *A* is not treated as transferring any property to *FT*. Therefore, *A* is not an owner of any portion of *FT* under sections 671 through 677 regardless of whether *A* retained any power over or interest in *FT* described in sections 673 through 677. Furthermore, *A* is not treated as an owner of any portion of *FT* under section 679. Both *A* and *B* are responsible parties for purposes of the requirements in section 6048.⁷⁴

68. *Id.*

69. Treas. Reg. § 1.671-2(e)(2)(i).

70. Treas. Reg. § 1.671-2(e)(2)(ii).

71. *Id.*

72. Treas. Reg. § 1.671-2(e)(2)(iii).

73. Treas. Reg. § 1.671-2(e)(1).

74. Treas. Reg. § 1.671-2(e)(6). I.R.C. § 6048 imposes certain reporting requirements for foreign trusts.

The trust created in the example is a foreign trust, but for the general principle, it should not matter whether the trust is foreign or domestic.^{74.1}

Nevertheless, if a “person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust.”⁷⁵ When a grantor’s interest in a trust is acquired by another, the transferee becomes the grantor. The regulations provide an example:

Example 2. *A* makes an investment in a fixed investment trust, *T*, that is classified as a trust under [Treasury Regulation section 301.7701-2(c)(1)]. *A* is a grantor of *T*. *B* subsequently acquires *A*’s entire interest in *T*. Under [Treasury Regulation section 1.671-2(e)(3)], *B* is a grantor of *T* with respect to such interest.⁷⁶

Borrowing from a trust will not make the borrower the grantor of the trust if the loan is at arm’s length. The regulations provide:

Example 6. *A* borrows cash from *T*, a trust. *A* has not made any gratuitous transfers to *T*. Arm’s length interest payments by *A* to *T* will not be treated as gratuitous transfers under [Treasury Regulation section 1.671-2(e)(2)(ii)]. Therefore, under [Treasury Regulation section 1.671-2(e)(1)], *A* is not a grantor of *T* with respect to the interest payments.⁷⁷

However, borrowing by the grantor from the trust may result in grantor trust status if section 675 applies.⁷⁸

The regulations address the status of a trust that is the grantor of another trust. Generally, when a trust gratuitously transfers property to another trust, the grantor of the transferor trust is deemed the grantor of the transferee trust. An exception from this general rule occurs if a person exercises a general power of appointment over the transferor trust in favor of the transferee trust. When that occurs, the person with the general power of appointment is treated as the grantor of the transferee trust, although the grantor of the transferor trust may be treated as the owner of the transferor trust.^{78.1} However, as

74.1. In *Sec. & Exch. Comm’n v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014), the SEC sued the Wyly Brothers for civil enforcement of securities violations. A measure for a portion of damages was unpaid income taxes. The SEC alleged that the trusts were grantor trusts. One issue before the court was “who is the grantor” of a series of trusts (called the Bessie Trusts). The court determined that the putative grantors were not the grantors, but the Wyly’s were and thus the trusts were grantor trusts.

75. Treas. Reg. § 1.671-2(e)(1).

76. *Id.*

77. *Id.* Special rules may apply if it is a foreign trust. *See* section 6:2.

78. *See* I.R.C. § 675(2)–(3); *infra* section 5:6.3.

78.1. Treas. Reg. § 1.671-2(e)(5).

illustrated by Example 8 in Treasury Regulations section 1.671-2(e)(6), one trust may be the owner, for income tax purposes, of another trust it creates. It provides:

Example 8. *G* creates and funds a trust, *T1*, for the benefit of *G*'s children and grandchildren. After *G*'s death, under authority granted to the trustees in the trust instrument, the trustees of *T1* transfer a portion of the assets of *T1* to another trust, *T2*, and retain a power to revoke *T2* and revest the assets of *T2* in *T1*. Under paragraphs (e)(1) and (5) of this section, *G* is the grantor of *T1* and *T2*. In addition, because the trustees of *T1* have retained a power to revest the assets of *T2* in *T1*, *T1* is treated as the owner of *T2* under section 678(a).

The regulations distinguish between being the grantor and the owner when a beneficiary of a trust is taxed under the grantor trust rules because of section 678.⁷⁹ In this circumstance, the beneficiary is the deemed owner, but not the grantor. The regulations provide:

Example 4. *A* creates and funds a trust, *T*. *A* does not retain any power or interest in *T* that would cause *A* to be treated as an owner of any portion of the trust under sections 671 through 677. *B* holds an unrestricted power, exercisable solely by *B*, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in *B*. *B* is treated as an owner of the portion of *T* that is subject to the withdrawal power under section 678(a)(1). However, *B* is not a grantor of *T* under [Treasury Regulation section 1.671-2(e)(1)] because *B* neither created *T* nor made a gratuitous transfer to *T*.⁸⁰

Thus, the beneficiary of a “Crummey” trust or an irrevocable life insurance trust (ILIT) with annual exclusion withdrawal powers will become the owner of a trust to the extent of the Crummey withdrawal power, but the beneficiary is not deemed the grantor even after the Crummey withdrawal right expires.⁸¹

In some cases, a trust may be set up indirectly. For example, a reciprocal trust may be set up in which *A* creates a trust for *B* in return

79. I.R.C. § 678 is discussed in section 5:5.5.

80. Treas. Reg. § 1.671-2(e)(6).

81. However, the Service has continuously ruled that such a beneficiary is not deemed the owner if the grantor is treated as the owner. See generally Jonathan G. Blattmachr & Frederick Sembler, *Crummey Powers and Income Taxation*, CHASE REV., July 1995; Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009).

for *B*'s creation of a trust for *A*.⁸² Estate tax authority on reciprocal trusts is plentiful and would probably apply to income tax cases. Other indirect transfers may occur. For example, *A* may furnish other consideration to *B* to create a trust. In such case, *A*, the indirect grantor of the trust for the grantor or the benefit of the grantor's family, is still treated as the grantor for purposes of these rules.⁸³

The Service has rarely applied the reciprocal trust doctrine, however, when each trust was a grantor trust for its nominal grantor,⁸⁴ but it has in at least one letter ruling⁸⁵ and argued successfully in one case.⁸⁶ The nominal grantor should not be treated as the grantor where another provides the consideration.⁸⁷ A second person who makes contributions to a trust originally created by another is treated as the grantor of an appropriate portion of the trust.⁸⁸

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82. See Howard O. Colgan & Robert T. Molloy, *Converse Trusts: The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271 (1948); cf. *United States v. Estate of Grace*, 395 U.S. 316 (1969), *reh'g denied*, 396 U.S. 881 (1969) (estate tax: interrelationship is sufficient without subjective "consideration"); *Meek v. Comm'r*, T.C. Memo. 1996-236 (although governing California law provides a trust is created only if it has corpus, such corpus can be provided by a *quid pro quo* sale, making the seller the grantor for purposes of I.R.C. § 267, where trust does not otherwise have gratuitously provided corpus). *But cf.* *Estate of Newberry v. Comm'r*, 201 F.2d 874 (3d Cir. 1953) (estate tax: independent cross trusts); *Estate of Ruxton v. Comm'r*, 20 T.C. 487 (1953) (estate tax: same); *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (estate tax: independent cross trusts with naked I.R.C. § 2036(a)(2) and I.R.C. § 2038 powers without economic interests); *Krause v. Comm'r*, 497 F.2d 1109 (6th Cir. 1974), *aff'g* 57 T.C. 890 (1972), *cert. denied*, 419 U.S. 1108 (1975).
83. See *Jackson v. Comm'r*, 64 F.2d 359 (4th Cir. 1933); *Krause v. Comm'r*, 497 F.2d 1109 (6th Cir. 1974), *aff'g* 57 T.C. 890 (1972); Priv. Ltr. Rul. 8813039; Chief Couns. Adv. 200445025 (individual who created corporation treated as the grantor of trust to which corporation issued stock). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
84. See, e.g., Priv. Ltr. Rul. 9508007; Priv. Ltr. Rul. 200340015. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
85. See Priv. Ltr. Rul. 98813039. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
86. *Krause v. Comm'r*, 497 F.2d 1109 (6th Cir. 1974), *aff'g* 57 T.C. 890 (1972), *cert. denied*, 419 U.S. 1108 (1975).
87. *Stern v. Comm'r*, 137 F.2d 43 (2d Cir. 1943). See also *Mosby v. United States*, 42 A.F.T.R. (P-H) 1095 (W.D. Tenn. 1949); *Nicollet Cty. Bank v. Comm'r*, B.T.A.M. (P-H) ¶ 39,097 (1939).
88. See *Stavroudis v. Comm'r*, 27 T.C. 583 (1956). *But see Stern v. Comm'r*, 747 F.2d 555 (9th Cir. 1984), *rev'g* 77 T.C. 614 (1981). Field Service Adv. 99-52-114 (although concluding that neither trust was a grantor trust

§ 5:2.2 Portion Rule

Section 671 provides that where the grantor is “treated as the owner of any portion of a trust,” the income, deductions, and credits of “that portion of the trust” are taken into account in computing the taxable income of the owner.⁸⁹ This application of the grantor trust rules is carried out in the operative provisions of sections 673 to 679. As a result of the portion rule, it is possible for a grantor to be taxed on some, but not necessarily all, of the income of a trust. The regulations provide that a portion may be ordinary income of a trust, income allocable to corpus, income related to specific trust property, or a fractional share of the income of a trust.⁹⁰ The portion rule will tax the grantor on the ordinary income of a trust if the grantor has a sections 674–78 power over only ordinary income portion of a trust.⁹¹ A grantor with a reversionary interest in the principal of a trust under section 673 will be taxed on the gains allocable to principal, even if not taxed on the ordinary income.⁹²

The portion rule is discussed in greater depth with each grantor trust rule below.

The Code provides in detailed sections that, where various powers and controls exist over portions of a trust, the grantor or another person shall be treated “as the owner” of that portion. This is specified to mean that

there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.⁹³

Thus, for example, if a revocable trust pays a portion of its income to charity, an individual grantor will include the income in his or her

with respect to certain trust beneficiaries because they “neither created . . . nor made any gratuitous transfer to the trusts,” it added “[w]here settlors only nominally fund a trust they create, and other persons make large gratuitous transfers to the trust, the subsequent transfers may be considered grantors for purposes of the grantor trust rules”). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

89. I.R.C. § 671.

90. Treas. Reg. § 1.671-3.

91. Treas. Reg. § 1.671-3(b)(1).

92. Treas. Reg. § 1.671-3(b)(1)(2).

93. I.R.C. § 671.

own return and can add the charitable payments with his or her other charitable gifts for purposes of the charitable deduction under section 170.⁹⁴ This rule (treat like an individual) should not be taken too literally in the case of a revocable trust created by a corporation.⁹⁵

No such specific rule applies to estates. A grantor's estate is not deemed taxable on trust income, such as capital gain, currently accumulated for distribution to it even where trust income of this nature was taxable to the grantor during the grantor's lifetime.⁹⁶

Similarly, where income from corpus is taxable to the grantor by reason of a power to revoke, the grantor is allowed the same deductions related to corpus as would be allowed had the trust not been created.⁹⁷ The grantor of such a revocable trust has been allowed to deduct losses on the sale of securities by the trustee.⁹⁸ The theory of continued ownership in a revocable trust has been extended to preserve the basis of property transferred in trust, even when special rules exist that normally would change the basis.⁹⁹

The taxable year of the grantor, even in connection with a partial grantor trust, will govern the year in which the grantor must pick up his or her portion of the income.¹⁰⁰

The regulations describe in detail the rules on the necessary allocation of the appropriate income, deductions, and credits to be made in the case of a grantor who is treated as owner of only a portion of a trust.¹⁰¹ If

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94. Treas. Reg. § 1.671-2(c); H.R. REP. NO. 83-1337, at 4084 (1954); S. REP. NO. 83-1622, at 4719 (1954). The language of these authorities may suggest that it was intended to permit such a deduction even if the charitable payment was not out of income: a situation in which individuals can take deductions but trusts may not.
95. Treas. Reg. § 1.671-2(e); Rev. Rul. 57-390, 1957-2 C.B. 326 (also holding that the grantor's fiscal year and method of accounting both apply).
96. Rev. Rul. 75-267, 1975-2 C.B. 254.
97. See *Miller v. Comm'r*, 12 T.C.M. (CCH) 506 (1953).
98. *Stoddard v. Eaton*, 22 F.2d 184 (D. Conn. 1927); *Cochran v. United States*, 62 F. Supp. 872 (Ct. Cl. 1945); *Catlin v. Comm'r*, 25 B.T.A. 834 (1932); *Boynton v. Comm'r*, 11 B.T.A. 1352 (1928).
99. *Welch v. Bradley*, 130 F.2d 109 (1st Cir.), *cert. denied*, 317 U.S. 685 (1942); see also I.T. 3207, 1938-2 C.B. 181 (nature of income as fixed or determinable, annual or periodical).
100. *Scheft v. Comm'r*, 59 T.C. 428 (1972).
101. Treas. Reg. § 1.671-3; see Treas. Reg. § 1.677(a)-1(g); Rev. Rul. 66-161, 1966-1 C.B. 164 (grantor could demand payment over of capital gains added to corpus, which reverts, and must therefore include income attributable to that portion of corpus); see also Rev. Rul. 67-241, 1967-2 C.B. 225 (nongrantor "owner" of portion may be taxed less on actual invasion than if she had been ordinary beneficiary); Schmolka, *Selected Aspects of the Grantor Trust Rules*, 9 INST. ON EST. PLAN. ¶ 1400 (1975). In regard to special problems raised by the presence of annuities or capital gains, see respectively, Louis A. Del Cotto & Kenneth F. Joyce, *Taxation of the Trust*

any part of the income of a trust is taxable to the grantor or to another person under these sections, it should not be reported on the trust's return, but such income and the applicable deductions and credits should be shown in a separate statement attached to the trust return.¹⁰²

When real property is transferred to a trust with a leaseback option, the transfer to the trust is not sufficient to enable the grantor to deduct the rental payments to the trust.¹⁰³

Annuity: The Unitrust Under the Constitution and the Internal Revenue Code, 23 TAX L. REV. 257, 317-59 (1968); John J. Costello, *Capital Gains Realized by Trusts: Taxation to Persons Other than the Trustee*, 22 TAX LAW 495, 503-27 (1969); *see also* Note, *Taxation of Capital Gains Realized by Trusts*, 12 TAX L. REV. 99, 103-09 (1956); John R. Howard, *Discretionary Distributions of Current Capital Gains Realized by Trusts*, 116 TR. & EST. 301 (1977). As to determining the portion over which the grantor is the owner, *see* the estate tax cases of *Ne. Pa. Nat'l Bank & Trust Co. v. United States*, 387 U.S. 213 (1967) (a "specific portion" qualifying for marital deduction can be computed from a fixed monthly stipend payable to widow) (overruled by Pub. L. No. 102-486, § 1941(a) by adding I.R.C. § 2056(b)(10)); *Estate of Tomec v. Comm'r*, 40 T.C. 134 (1963) (capitalizes amount needed to produce the first \$10,000 of income payable to other beneficiaries, and the rest is for the grantor); *see also* *Crane v. Comm'r*, 368 F.2d 800 (1st Cir. 1966) (reversionary interest sufficient to require grantor's inclusion of entire income rather than "elaborate calculations"); *Benson v. Comm'r*, 76 T.C. 1040 (1981) (grantor who borrows past and current years' income of trust treated as owner of entire trust under I.R.C. § 675); *Bennett v. Comm'r*, 79 T.C. 470 (1982) (grantor who borrows some of prior years' income of trust treated as owner under I.R.C. § 675 of that fractional portion of trust whose numerator is amount of loan at beginning of year and whose denominator is all years' income).

102. *See infra* section 5:8; *see also* Treas. Reg. § 1.671-4; Rev. Rul. 61-175, 1961-2 C.B. 128 (with several grantors). *See also* Rev. Rul. 60-370, 1960-2 C.B. 203, treating a sale of appreciated property as having been made directly by the grantor where grantor, who had an income interest in a trust, had given the property to trustee-remainderman—a tax-exempt university—with instructions to sell the property and reinvest. Some private letter rulings state that inherent gain on property contributed to a charitable remainder trust described in I.R.C. § 664 realized by the trust will be attributed to the grantor if there was an express or implied obligation on the trustee to sell the contributed assets. *See, e.g.*, Priv. Ltr. Rul. 9225063. However, more recent private letter rulings state that the gain will not be attributed to the grantor unless the trustee is legally bound or can be compelled to sell the contributed property, *citing* *Palmer v. Comm'r*, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975), *acq.* 1978-2 C.B. 2, and Rev. Rul. 78-197, 1978-1 C.B. 83. *See, e.g.*, Priv. Ltr. Ruls. 9452026, 9452020, 9413020. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

103. Treas. Reg. § 1.671-1(c); H.R. REP. NO. 83-1337, at 4084; S. REP. NO. 83-1622, at 4719.

§ 5:2.3 Tax Year

A trust that is entirely a grantor trust is not required to file returns on a calendar year as required generally for non-charitable trusts by section 644, at least if the grantor is a corporation. Instead, the trust's tax year and accounting method for a wholly grantor trust must be the same as the grantor.¹⁰⁴ While it is possible for individuals to be fiscal-year taxpayers, it is not common; thus, grantor trusts with individuals as owners will generally be required to file a calendar-year return.¹⁰⁵ For corporations filing on a fiscal-year basis, a grantor trust created by the corporation must use the same reporting year as the corporation, if it is a wholly grantor trust.

§ 5:2.4 Definitions

As in most areas of the tax law, definitions are key to the application of the grantor trust rules. Each significant term of art is discussed below.

[A] Adverse Party and Non-Adverse Party

Section 672(a) defines adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust," and includes a person who holds a general power of appointment over the trust property.¹⁰⁶ The term is largely a replacement for references in the 1939 Code and regulations to persons not having a "substantial adverse interest," and the meaning is probably much the same.¹⁰⁷ The use of the word "beneficial" introduced a requirement that an adverse interest be economic.¹⁰⁸ Probably, the power is "exercisable" by such persons whenever the conditions as to decision-making give them power to act without the approval or consent of others. This conclusion is specified in other sections in the subpart on grantor trusts.¹⁰⁹

104. Rev. Rul. 90-55, 1990-2 C.B. 161.

105. However, as explained in section 5:8, some grantor trusts need not file income tax returns.

106. I.R.C. § 672(a).

107. Gift and estate tax cases are also relevant on adverse interest. In general, on trustee selection, see Steven A. Winkelman, *The Trust and the Trustee*, 38 TAXES 569 (1960).

108. See 2 A.L.I. FED. INCOME TAX STAT. 454 (Draft Feb. 1954); Baer, *Keeping Control of the Spray Trust in the Family: Income Tax Problems*, 34 TAXES 734 (1956).

109. I.R.C. §§ 674(a), 674(d), 675(1), 675(4), 677; see also I.R.C. § 675(3). A special rule is provided for I.R.C. § 674(c); see also 2 A.L.I. FED. INCOME TAX STAT. 454 cmt. 3 (Draft Feb. 1954). The Code sections in this whole

A non-adverse party is anyone who is not an adverse party.¹¹⁰

The question of adverse interest is essentially one of fact to be determined by considering in each case the particular interest created by the trust instrument and the relative size of that interest. For example, an interest in income of \$X a year may be regarded as substantial in one situation, in another it may not be. The regulations provide that an interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant."¹¹¹ In one case, a remainder interest which the court took to be under 4% was held to be too "slim a restraint" to be adverse as to the entire trust.¹¹² A beneficiary of the income or corpus ordinarily possesses a substantial beneficial interest that would be adversely affected by a revocation of the trust because revocation would cut off the rights to the property or income.

A trustee is not considered an adverse party solely because of being in the position of trustee.¹¹³ The right of a trustee to commissions so long as the trust exists does not make the interest substantially adverse to that of the grantor.¹¹⁴

Generally, the grantor is treated as holding any power or interest that the grantor's spouse holds.¹¹⁵

If a person, particularly the grantor, has the power to make himself or herself the trustee, or perhaps even merely to be a substitute trustee

area are largely taken from the American Law Institute provisions. These sections could be avoided if the powers could be exercised, for example, only with the consent of any one out of ten adverse parties.

110. I.R.C. § 672(b).

111. Treas. Reg. § 1.672(a)-1(a); *see Paxton v. Comm'r*, 57 T.C. 627 (1972), *aff'd*, 520 F.2d 923 (9th Cir. 1975), *cert. denied*, 423 U.S. 1016 (1976). As a result of amendments, however, a trustee-son may come to have a substantial adverse interest, so the grantor is not taxed. *Estate of Paxton v. Comm'r*, T.C. Memo. 1982-464, *appeal dismissed* (9th Cir. 1983) (some amendments were nullities as there was no reservation of power to make them); *Vercio v. Comm'r*, 73 T.C. 1246, 1258 (1980) ("Congress effectively ruled out the possibility of a spouse being treated as an adverse party when a provision in the trust allows for the income to be used for that spouse's benefit.").

112. *Paxton v. Comm'r*, 520 F.2d 923 (9th Cir. 1975), *cert. denied*, 423 U.S. 1016 (1976); *see Paxton v. Comm'r*, T.C. Memo. 1982-464 (reported but unauthorized changes by trustees to create adverse interest ignored; but son found to have adverse interest in another trust); *see also May v. United States*, 40-2 U.S. Tax Cas. (CCH) ¶ 9725, 27 A.F.T.R. (P-H) 1167 (W.D. Pa. 1940) (\$350 a year out of several thousand).

113. Treas. Reg. § 1.672(a)-1(a).

114. *Reinecke v. Smith*, 289 U.S. 172 (1933); *Morton v. Comm'r*, 109 F.2d 47 (7th Cir. 1940) (even though the annual fee was about \$700); *cf. Miller v. Comm'r*, 12 T.C.M. (CCH) 506 (1953).

115. I.R.C. § 672(e) (for transfers in trust after March 31, 1986); Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1019(a), 102 Stat. 3342, 3593 (1988).

(other than substituting one independent trustee for another), it is possible that the person could be treated as having all the powers that normally belong to others as trustee.¹¹⁶ In at least one case, such a contention for taxability was rejected in view of a “savings clause” in the instrument (perhaps more commonly used as administrative “boilerplate”) to the effect that any provisions determined to cause taxability to the grantor would not be operative.¹¹⁷

In *Securities & Exchange Commission v. Wyly*,^{117.1} the SEC sued the Wyly Brothers for civil enforcement of securities violations. A measure for a portion of damages was unpaid income taxes. The SEC alleged that the trusts were grantor trusts. One issue before the court was the Wyly’s control of a series of trusts (called the Bulldog Trusts). The trusts provided for trust protectors. The court concluded that:

[t]he Wyls, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wyls expected that the trustees would execute their every order, and that is exactly what the trustees did.

Thus, in the court’s opinion, the Wyly’s control of the trustees negated the section 674(c) independent trustee exception so that the Wyly’s were the grantors and the trusts were grantor trusts.

A person may be an adverse party as to one power over the trust, but not as to another power: a person may have a substantial beneficial

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116. Treas. Reg. § 1.674(d)-2(a); Treas. Reg. § 20.2038-1(a)(3) (estate tax); Rev. Rul. 73-21, 1973-1 C.B. 405 (estate tax); *Walter v. United States*, 295 F.2d 720 (6th Cir. 1961) (estate tax); *Van Beuren v. McLoughlin*, 262 F.2d 315 (1st Cir. 1950) (estate tax), *cert. denied*, 359 U.S. 991 (1959); *Corning v. Comm’r*, 239 F.2d 646 (6th Cir. 1956), *aff’g* 24 T.C. 907 (1955); *Loughridge’s Estate v. Comm’r*, 183 F.2d 294, 299–300 (10th Cir.) (estate tax), *cert. denied*, 340 U.S. 830 (1950); *Stockstrom v. Comm’r*, 151 F.2d 353 (8th Cir. 1945), *aff’g* 4 T.C. 5 (1944); *cf.* *United States v. Byrum*, 408 U.S. 125 (1972), *aff’g* 404 F.2d 949 (6th Cir. 1971) (estate tax: may substitute corporate trustee) (but this case was reversed, in part, by the Tax Reform Act of 1976 by amendment of I.R.C. § 2036); *Mathey v. United States*, 491 F.2d 481 (3d Cir. 1974) (estate tax); *Clark v. United States*, 267 F.2d 501 (1st Cir. 1959), *on remand*, 180 F. Supp. 696 (D. Me. 1960) (estate tax); Ernest E. Monrad, *Power of Disposition*, 34 TAXES 693, 699 (1956). In Rev. Rul. 79-353, 1979-2 C.B. 325, *modified*, Rev. Rul. 81-51, 1981-1 C.B. 458, the Service held that for certain estate tax purposes powers held by a corporate trustee are attributable to grantor whose only power or interest in the trust is to substitute another corporate trustee. This position was explicitly rejected in *Estate of Wall v. Comm’r*, 101 T.C. 300 (1993), and then to a large degree disavowed by the Service in Rev. Rul. 95-58, 1995-2 C.B. 191.
117. *Oakes v. Comm’r*, 44 T.C. 524, 531 (1965); *see also* *Estate of Goodwyn v. Comm’r*, 1976-238 (not taxable with only “persuasive control”). *But cf.* Rev. Rul. 65-144, 1965-1 C.B. 442.
- 117.1. *Sec. & Exch. Comm’n v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014).

interest that is adverse to only part of a trust or of its income. For example, an ordinary income beneficiary with a life interest, remainder to the grantor, has an adverse interest as to ordinary income but not as to income allocable to corpus. A remainderman's interest is normally adverse as to powers over corpus but not as to powers over any income interest preceding the remainder. In such cases, there is excluded from attribution to the grantor only that part of the trust as to which the person's exercise or nonexercise of a power would adversely affect the person's own interest.¹¹⁸ The regulations provide an example:

[I]f *A*, *B*, *C*, and *D* are equal income beneficiaries of a trust and the grantor can revoke with *A*'s consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.¹¹⁹

The following are examples of cases in which a substantial adverse interest was held to exist where the grantor, together with the persons indicated, retained a power of revocation:

- (1) The grantor reserved the power to revoke the trust with the consent of her husband, who was named as a cotrustee. After the wife's death, the husband was to receive the income and also such amounts of corpus as the trustees deemed necessary for the grantor's support and maintenance. It was held that although the grantor's interest was contingent upon the grantor's spouse predeceasing the grantor, the grantor nevertheless had a substantial adverse interest.¹²⁰
- (2) The grantor's spouse was named the life beneficiary of a trust, with a limited power of appointment over the remainder. The spouse was also one of the trustees. The trust agreement required the consent of all the trustees to revest the corpus in the grantor. It was held that the spouse had a substantial adverse interest, and therefore, the capital gains of the trust, which were to be added to corpus, were not taxable to the grantor.¹²¹
- (3) The trust agreement provided that if the grantor predeceased his or her spouse, the grantor might cancel the agreement, in which event the grantor would be entitled to receive absolutely

118. Treas. Reg. § 1.672(a)-1.

119. Treas. Reg. § 1.672(a)-1(b).

120. *Shiverick v. Comm'r*, 37 B.T.A. 454 (1938).

121. *Estate of Childs v. Comm'r*, 44 B.T.A. 1191 (1941).

the corpus of the trust fund and any undistributed income. The husband was held to have a substantial adverse interest.¹²²

- (4) The grantor created a trust primarily for the grantor's children, reserving a power to revoke with grantor's spouse. Thereafter the parties were divorced. It was held that the income was not taxable to the grantor because the spouse, being liable for the support of the children, had a substantial adverse interest in the trust.¹²³ Subsequent cases cast doubt on this rule, at least where the income is not actually needed to meet the obligation.¹²⁴ As a result, it is not clear whether an indirect interest of this type will suffice, even if the interest has some potential economic significance. But it would appear, at least, from the above examples, that a contingent interest can sometimes suffice.

In the following cases, no substantial adverse interest was found to exist:

- (1) A brother and sister were joint grantors and joint beneficiaries, with equal rights. The trust could be terminated by their joint action as beneficiaries. If either should die without leaving lawful issue, the entire interest would pass to the survivor. There were no children, and there was no indication of any special factors making survival of one beneficiary more likely than the other except for normal actuarial differences.¹²⁵

122. *Stetson v. Comm'r*, 27 B.T.A. 173 (1932).

123. *Savage v. Comm'r*, 82 F.2d 92 (3d Cir. 1936); *Fleischmann v. Comm'r*, 40 B.T.A. 672 (1939).

124. *Comm'r v. Caspersen*, 119 F.2d 94 (3d Cir.), *cert. denied*, 314 U.S. 643 (1941); *Loeb v. Comm'r*, 113 F.2d 664 (2d Cir.), *cert. denied*, 311 U.S. 710 (1940); *cf.* Treas. Reg. § 1.662(a)-4, which provides, in part, that any amount which, pursuant to the terms of the will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under I.R.C. § 662(a)(1) or § 662(a)(2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which I.R.C. § 71 (relating to alimony payments) or I.R.C. § 682 (relating to income of a trust in case of divorce, etc.) applies.

125. *De Amodio v. Comm'r*, 299 F.2d 623 (3d Cir. 1962) (the distributability of the income to the grantors was a separate ground under I.R.C. § 677). The sister was five years older than the brother and was not currently married. *De Amodio v. Comm'r*, 34 T.C. 894, 898, 902 (1960). *But cf.* Priv. Ltr. Rul. 9016079 (other trustees, who also are discretionary beneficiaries, are adverse parties as to grantor-trustee where the trustees and others can receive income and corpus in absolute discretion of trustees; direction that there must always be an adverse party trustee ensures grantor-trustee

- (2) The grantor named the grantor's mother and a trust company as trustees. By direction of the mother any part, or all, of the corpus could be transferred to the grantor. It was held that the mother did not have a substantial adverse interest, although under local law she could, if destitute, demand support from the grantor; and if the grantor died intestate, she would have an interest in the grantor's estate. The mother's right to the property was considered to be too remote.¹²⁶
- (3) A trust instrument provided that the trust could be revoked by a committee with the consent of the grantor's spouse. The committee had no interest in the trust. The spouse's only interest was that the trustees in their discretion might pay to her any part of the principal or accumulated income. It was held that the spouse's interest was not substantially adverse because the trustees were not required to pay her anything, and even that right could have been destroyed by an exercise of the power to amend, given to the committee by the trust instrument.¹²⁷
- (4) The grantor's divorced spouse, with whom the grantor could revoke, had a remainder that would take effect upon the death of either of the spouse's children before age thirty-five without issue; the children each had one child at the time. The spouse's interest was deemed to be too remote.¹²⁸
- (5) The grantor reserved the right to revoke with the consent of any beneficiary having "a substantial adverse interest." Nevertheless, the income was held taxable to the grantor on the ground that: "In view of the broad powers of the donor, as trustee, and the family relation, we think it may be reasonably assumed that such a consent would be freely given."¹²⁹

The latter case may reflect a tendency to presume that beneficiaries of a trust who are members of the grantor's family are under his domination and control and, consequently, do not have a substantial

cannot act independently of an adverse party). *See also* Priv. Ltr. Rul. 200148028; Priv. Ltr. Rul. 200247013 (similar). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

126. *Cushing v. Comm'r*, 38 B.T.A. 948 (1938).

127. *Fulham v. Comm'r*, 110 F.2d 916 (1st Cir. 1940).

128. *D.G. McDonald Trust v. Comm'r*, 19 T.C. 672 (1953), *aff'd sub nom. Chase Nat'l Bank v. Comm'r*, 225 F.2d 621 (8th Cir. 1955).

129. *Cox v. Comm'r*, 110 F.2d 934, 936 (10th Cir.), *cert. denied*, 311 U.S. 667 (1940).

adverse interest in the trust. Even without a presumption, the cases at least indicate that arrangements under family trusts will be scrutinized carefully to determine whether the beneficial interests of persons who are members of the grantor's family are, in fact, adverse.

It has been held under case law before the 1954 Code, that a wife's interest in a trust created by her husband was not substantially adverse, because of "the normal consequences of family solidarity."¹³⁰ But consideration must still be given to the explicit definition in section 672 of nonadverse party enacted by the 1954 Code. On the other hand, it is certainly still a possibility that a wife may have a substantial adverse interest.¹³¹

[B] Related or Subordinate Party

A related or subordinate party is a nonadverse party who is:

1. the grantor's spouse if living with the grantor;
2. the grantor's father, mother, issue, brother, or sister;
3. an employee of the grantor;
4. a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or
5. a subordinate employee of a corporation in which the grantor is an executive.¹³²

In addition, for purposes of sections 672(f),¹³³ 674,¹³⁴ and 675,¹³⁵ related or subordinate persons are "presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on [them] unless such [person] is shown not to be subservient by a preponderance of the evidence."¹³⁶

130. *Altmaier v. Comm'r*, 116 F.2d 162 (6th Cir.), *cert. denied*, 312 U.S. 706 (1940); *see* J. RABKIN & M. JOHNSON, *FEDERAL INCOME, GIFT AND ESTATE TAXATION* § 55.04 (1973).

131. *Laganas v. Comm'r*, 281 F.2d 731, 735 (1st Cir. 1960); *Comm'r v. Katz*, 139 F.2d 107 (7th Cir. 1943); *Phipps v. Comm'r*, 137 F.2d 141 (2d Cir. 1943); *Camp v. Comm'r*, 195 F.2d 999, 1004 (1st Cir. 1952) (gift tax: extraneous factors do not enter, unless there is some advance agreement to acquiesce). *But see infra* section 5:2.4[D].

132. I.R.C. § 672(c); *Treas. Reg.* § 1.672(c)-1.

133. I.R.C. § 672(f) concerns foreign trusts. *See* discussion at section 6:4.

134. I.R.C. § 674 concerns powers over beneficial interests. *See* discussion at section 5:6.2.

135. I.R.C. § 675 concerns administrative powers. *See* discussion at section 5:6.3.

136. I.R.C. § 672(c); *see* *Treas. Reg.* § 1.672(c)-1.

[C] Powers Subject to a Condition Precedent

A person is considered to have power that is subject to a condition precedent if the condition is giving notice or the expiration of a period of time.¹³⁷ Nevertheless, a grantor will not be treated as an owner by reason of such a power if the exercise effects only the beneficial enjoyment of income to be received after a period of time expires, but only if the grantor would not be treated as the owner under section 673, if the power is a reversionary interest.¹³⁸ The regulations provide an example:

[I]f a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of [the period of time necessary to satisfy the 5% rule of section 673] . . . , the power does not cause him to be treated as an owner with respect to ordinary income during [the period of time necessary to satisfy the 5% rule of section 673,] has expired.¹³⁹

[D] Powers and Interest of the Grantor's Spouse

Section 672(e), added to the Code in the Tax Reform Act of 1986¹⁴⁰ and expanded by the Technical and Miscellaneous Revenue Act of 1988,¹⁴¹ provides that any power or interest in a trust that is held by the grantor's spouse is considered an interest or power held by the grantor. This rule applies if the grantor was married to the spouse at the time the power or interest was created and is not affected by a subsequent divorce.¹⁴² However, if the grantor and spouse are legally separated "under a decree of divorce or of separate maintenance," at the time the power or interest is created, they are not considered married for purposes of the section.¹⁴³ In addition, if a person with a power or interest in a trust and the grantor of the trust marry after the trust is created, the grantor is considered to have the interests or powers of the

137. I.R.C. § 672(d).

138. Treas. Reg. § 1.672(d)-1.

139. *Id.*

140. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1402, 100 Stat. 2085, 2711 (1986).

141. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1014, 102 Stat. 3342, 3559 (1988).

142. I.R.C. § 672(e)(1)(A).

143. I.R.C. § 672(e)(2).

spouse, but only with respect to periods after the marriage.¹⁴⁴ This rule applies for transfer made to trusts after March 1, 1986.¹⁴⁵

No regulations have been promulgated for section 672(e). The legislative history of the Technical and Miscellaneous Revenue Act of 1988 provides:

In addition, the grantor is treated as owner of a trust by virtue of certain powers exercisable by trustees if the grantor's spouse is a trustee or more than half of the trustees are related or subordinate parties subservient to the wishes of the spouse. The grantor also is treated as the owner where the trust makes certain loans to the grantor's spouse.¹⁴⁶

[E] Foreign Trust Limitation

Section 672(f) provides a special rule applicable to foreign trusts. It is discussed in detail in section 6:4.

§ 5:3 Revocable Trusts—Trusts in Which the Grantor Has Retained a Beneficial Interest or Power—Sections 676 and 673¹⁴⁷

Section 676(a) provides the general rule that a grantor of a trust is considered to be the owner of any portion of a trust if the grantor or a nonadverse party, or both, or the grantor's spouse¹⁴⁸ have the power to revert title to the portion.¹⁴⁹ Section 676(a) does not apply, however, in situations where the corpus will revert to the grantor automatically at the expiration of a term certain.¹⁵⁰ In that circumstance, the income may be taxed to the grantor under section 673. It is possible also that revocable trusts might fall under section 674,¹⁵¹ dealing with power to control beneficial enjoyment. However, perhaps reflecting historical distinctions, revocable trusts are separately treated under section 676.

In Private Letter Ruling 200128028, the Service ruled that section 676 was not applicable when trust distributions could be made to the

144. I.R.C. § 672(e)(1)(B).

145. See Tax Reform Act of 1986 § 1401, 100 Stat. 2085, 2711; see Technical and Miscellaneous Revenue Act of 1988 § 1014, 102 Stat. 3342, 3559.

146. S. REP. NO. 100-445, at 387 (1988).

147. For an additional discussion of the tax consequences of revocable trusts, see chapter 9, *infra*.

148. For transfers in trust after March 1, 1986, the grantor is treated as holding powers that the grantor's spouse holds, under I.R.C. § 672(e). See section 5:2.4[D], *supra*, for a discussion of when I.R.C. § 472(e) is not applicable. I.R.C. § 676(a).

149. I.R.C. § 676(a).

150. *Helvering v. Wood*, 309 U.S. 344 (1940).

151. See *Batson v. Comm'r*, T.C. Memo. 1983-545, *aff'd*, 758 F.2d 652 (6th Cir. 1985).

grantor or the grantor's spouse, among other beneficiaries, but only as instructed by a distribution committee consisting of two beneficiaries, other than the grantor or the grantor's spouse, eligible to receive distributions, if they both act jointly or if one acts with grantor because distribution committee members were deemed to have substantial adverse interests to distributions to any beneficiary and to accumulation of income when grantor held testamentary power of appointment.¹⁵²

Section 676 applies if the power to revest exists, even though it is not exercised in the taxable year. The grantor may be taxed under this section, even if the power is not immediately operative and, thus, the revesting can take effect only in a subsequent year.¹⁵³

It does not apply if the exercise of the power to revest affects "the beneficial enjoyment of the income" for the period that correlates in general with the section 673 rule that permits a reversion after a period of time.¹⁵⁴ Thereafter, the grantor may be treated as the owner if the power has not been relinquished.¹⁵⁵

The regulations state that a power to revest can be present "regardless of whether the power is a power to revoke, terminate, alter or amend, or appoint."¹⁵⁶ The device or mechanics by which a power to revest may be exercised is immaterial in determining the taxability of the income to the grantor. For example, if the grantor reserves the power to purchase the trust corpus for a nominal consideration, the

152. Priv. Ltr. Ruls. 201310002, 200148028; *see also* Priv. Ltr. Ruls. 200731019 (similar), 200715005 (similar), 200502014 (similar), 200247013 (same). Under I.R.C. § 6110(k)(3), neither a National Officer Memorandum nor a Private Letter Ruling may be cited or used as precedent.

153. I.R.C. §§ 672(d), 676(b); Treas. Reg. §§ 1.672(d)-1, 1.676(b)-1.

154. The measurement of this period, when it is not specifically measured by a term of years or when it is subsequently extended or when the income is payable to charity, is discussed *infra* at section 5:5.1.

155. I.R.C. § 676(b). The Committee Reports (H.R. REP. NO. 83-1337, at 4089, S. REP. NO. 83-1622, at 4714) indicate that the non-taxability of a power to revoke in over ten years (now a much longer period of time under section 673 as amended in 1986) is a change in the law, and the regulations under the 1939 Code (Treas. Reg. 118, § 39.166-1(b)(1)(ii) (1939)).

156. Treas. Reg. § 1.676(a)-1; *see* *Krag v. Comm'r*, 8 T.C. 1091 (1947) (revocable despite state court); Rev. Rul. 71-548, 1971-2 C.B. 250 (right to cause sale of trust assets, which triggers reversion). In general, however, the appropriate state law governs the trust relationships. *See Helvering v. Stuart*, 317 U.S. 154 (1942); Rev. Rul. 62-148, 1962-2 C.B. 143 (savings bank deposit "as trustee," so-called New York Totten trust, is revocable); *Estate of Stewart v. Comm'r*, 436 F.2d 1281 (3d Cir.), *cert. denied*, 404 U.S. 828 (1971) (estate tax: limitations under state law then applicable did not sufficiently prevent discretionary powers from being power to invade charitable remainder).

trust is revocable to the extent of the excess of the value of the property that can be reacquired over the amount to be paid.¹⁵⁷ Similarly, the reservation of broad powers of sale, under which the grantor may buy from or sell to the trust at his own price, is substantially equivalent to a power to revest.¹⁵⁸ The income is likewise taxable to the grantor if a power to terminate the trust is reserved through the retention of a power to appoint an individual other than the grantor to exercise the right to terminate the trust.¹⁵⁹

Nevertheless, a contingent power is not necessarily covered.¹⁶⁰ Also, a power to substitute securities producing a substantially equal income for securities¹⁶¹ that constitute the corpus of the trust is not a power to revest, nor is it a power to purchase trust assets at a fair price.¹⁶² The grantor is not taxable under section 676 if the only power retained is the right to direct investments.¹⁶³ A power to appoint the remainder by deed or will does not constitute a power to revest.¹⁶⁴ Similarly, a provision that reserves to the grantor a power to change the beneficiaries or to modify the distributive shares is not a power to revest if power cannot be exercised to revest the corpus in the grantor.¹⁶⁵ However, depending upon the existence or absence of other material circumstances, the income of such trusts may be included in the grantor's income under other grantor trust sections of the Code.¹⁶⁶

A so-called Totten trust is a revocable trust taxable to the grantor under section 676.¹⁶⁷

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157. Fisher v. Comm'r, 28 B.T.A. 1164 (1933); *see also* I.R.C. § 675(1) (treating this as a taxable administrative power).
158. Chandler v. Comm'r, 119 F.2d 623 (3d Cir. 1941); *cf.* Heyman v. Comm'r, 44 B.T.A. 1009 (1941).
159. Pulitzer v. Comm'r, 36 B.T.A. 964 (1937).
160. Comm'r v. Betts, 123 F.2d 534 (7th Cir. 1941); Comm'r v. O'Keefe, 118 F.2d 639 (1st Cir. 1941); Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939). Coverage may depend upon the likelihood of the contingency. *See* I.R.C. § 673(a); Treas. Reg. § 1.673(a)-1(c), (d). *But cf.* Treas. Reg. 118, § 39.166-1(b)(1)(ii) (1939). *See also* Mills v. Comm'r, 39 B.T.A. 798 (1939); *cf.* I.R.C. § 675(4)(c).
161. Frick v. Driscoll, 41-1 U.S. Tax Cas. (CCH) ¶ 9187, 29 A.F.T.R. (P-H) 1298 (W.D. Pa. 1941), *rev'd on other grounds*, 129 F.2d 148 (3d Cir. 1942).
162. Palmer v. Comm'r, 40 B.T.A. 1002 (1939), *aff'd*, 115 F.2d 368 (2d Cir. 1940).
163. Maloy v. Comm'r, 45 B.T.A. 1104 (1941).
164. Comm'r v. Bateman, 127 F.2d 266 (1st Cir. 1942).
165. Knapp v. Hoey, 104 F.2d 99 (2d Cir. 1939); Donner v. Comm'r, 40 B.T.A. 80 (1939); Downs v. Comm'r, 36 B.T.A. 1129 (1937). *But cf.* Todd v. Comm'r, 32 B.T.A. 1067 (1935), *aff'd*, 82 F.2d 1020 (2d Cir. 1936).
166. This subject is discussed *infra* in section 5:5.
167. Rev. Rul. 62-148, 1962-2 C.B. 143; *see also* Oppenheimer v. Comm'r, T.C. Memo. 1986-536.

Whether a trust is revocable or not is a state law issue. The Uniform Trust Code section 602 creates a basic presumption that a trust is revocable unless the trust expressly provides otherwise.¹⁶⁸ This reverses the common law rule that trusts are presumed irrevocable unless a power to revoke was reserved at the time of creation.¹⁶⁹

§ 5:3.1 Grantor Trust Status

A section 676 power likely will cause estate tax problems for the grantor under sections 2036 and 2038, and thus a section 676 power to revoke held by the grantor is not a choice for creating a grantor trust if there is an intention to exclude the property from the grantor's gross estate.¹⁷⁰ Moreover, if the power is not held by the grantor, but the existence of power subjects the trust assets to claims of the grantor's creditors, a section 676 power to revoke is not a choice for creating a grantor trust if either excluding the assets from the grantor's gross estate or avoiding making the subject to claims of the grantor's creditors is a goal. Such a power held by the grantor's spouse would cause the trust to be a grantor trust—because of the spousal unity rule of section 672(e)—but the power would likely be a general power of appointment and result in the inclusion of the property in the gross estate of the spouse under section 2041 (unless the power is limited by an ascertainable standard, in which event there is uncertainty as to whether section 676 would apply).¹⁷¹

§ 5:4 Trusts with Income for Benefit of Grantor or Spouse

Section 676 deals with the possible return to the grantor of the corpus of a trust. On the other hand, section 677 deals with the situation in which the income of a trust may be distributed to or used for the benefit of the grantor or accumulated for the grantor—including distribution, use, or accumulation to or for the grantor's spouse.¹⁷² The two provisions complement each other in that they both attempt to tax to the grantor the income of a trust in which the grantor has not surrendered substantially all interest or control. In their construction, therefore, the two sections are governed "by similar considerations."¹⁷³

168. UNIF. TRUST CODE § 602 (2005), 7C U.L.A. 546 (2006).

169. 76 AM. JUR. 2D *Trusts* (2005).

170. See I.R.C. §§ 2036, 2038.

171. See I.R.C. § 2041. As to the impact of an ascertainable standard or distribution, see *infra* notes 346–50 and accompanying text.

172. The provisions concerning the grantor's spouse apply to transfers in trust after October 9, 1969. Treas. Reg. § 1.677(a)-1(a)(1). For the definition of income, see note 207, *infra*, and accompanying text.

173. *Frost v. Comm'r*, 38 B.T.A. 1402, 1404 (1938), *nonacq.* 1939-1 C.B. 48.

§ 5:4.1 Discretionary Distribution of Income to Grantor or Spouse

Section 677(a) of the Code provides in part that the grantor shall be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or may be, in the discretion of the grantor or a nonadverse party or both, either (1) distributed to the grantor or the grantor's spouse, or (2) held or accumulated for future distribution to the grantor or the grantor's spouse. Four possibilities are covered, all assuming no approval or consent of an adverse party:

- (1) income is distributed to the grantor or the grantor's spouse;
- (2) in the discretion of the grantor, or nonadverse parties, income may be distributed to the grantor or the grantor's spouse;
- (3) income is accumulated for future distribution to the grantor or the grantor's spouse; and
- (4) in the discretion of the grantor, or nonadverse parties, income may be accumulated for future distribution to the grantor or the grantor's spouse.¹⁷⁴

This analysis suggests, as does a literal reading of the Code, that section 677 would except situations where income is actually distributed or accumulated for future distribution to the grantor or his spouse, provided that the distribution or accumulation has to be, and is, with the consent of an adverse party.¹⁷⁵ However, the

174. See *LaFargue v. Comm'r*, 689 F.2d 845 (9th Cir. 1982) (annuitant treated as creditor and not grantor with retained interest for the trust with which taxpayer had exchanged property for lifetime annuity); cf. *Horstmier v. Comm'r*, 46 T.C. Memo. 1983-409 (taxpayer's sale to trust for annuity and trust's creation treated as shams); *Lazarus v. Comm'r*, 513 F.2d 824 (9th Cir. 1975); *Bixby v. Comm'r*, 58 T.C. 757 (1972); see *Priv. Ltr. Rul.* 200407002 (transfer of liquidating trust assets to a trust will be treated for all federal tax purposes as a transfer from the bankruptcy estate to the beneficiaries, who apparently are the creditors, followed by a deemed transfer by the beneficiaries to the trust which will be considered a grantor trust; the beneficiaries will be treated as the owners under I.R.C. § 677 where trust agreement provides that the liquidating trustee will make annual distributions to its beneficiaries). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

175. 1939 I.R.C. § 167(a)(2) failed even to specify that it applied to income that is distributed to the grantor. See H.R. REP. NO. 83-1337, at 4089, S. REP. NO. 83-1622, at 4719. The 1954 Code corrected this, at least apart from the adverse party consent situation. Of course, if any actual distribution to a grantor were excepted from the grantor trust rules, presumably

Committee Reports do not so specify, and the regulations take the opposite view.¹⁷⁶

For post-October 9, 1969 transfer to trusts, the grantor's spouse cannot be an adverse party.¹⁷⁷ The regulations provide, however, that section 677's coverage of income to or for a spouse applies to the income solely during the period of the marriage of that person to the grantor.¹⁷⁸ Generally, the grantor is treated as holding any power or interest that the grantor's spouse holds if the individual was grantor's spouse at the time of the creation of such power or interest or the individual became the grantor's spouse after the creation of the power or interest (but in this latter case only as to periods after such individual became the grantor's spouse).¹⁷⁹

It appears that the words "may be" have a double function in categories (2) and (4) above. They cover both discretion and contingencies. First, the words appear to cover income that is subject to distribution to the grantor (or accumulation for the grantor)¹⁸⁰ at the discretion of the grantor or a nonadverse party. Second, in category (2) the words also seem to encompass income that in certain contingencies would have been distributable to the grantor. Similarly, in category (4) they seem to cover income that is (or discretionarily can be) accumulated if accumulated income can in the future be distributed to the grantor either at someone's discretion or upon the happening of a contingency.

The discretionary aspect is most clearly illustrated for category (2) above, which applies to income that is currently subject to discretion. One court stated in regard to the predecessor section: "Section 167 is not concerned with what is done under a trust agreement but with what might be done. The controlling statutory consideration is the existence of the described discretion, not the way in which that discretion is actually exercised."¹⁸¹

the normal rules of taxability of a trust beneficiary would apply to the grantor.

176. See Treas. Reg. § 1.677(a)-1(b)(1), (2). However, see *supra* note 149 and accompanying text.

177. Treas. Reg. § 1.677(a)-1(b)(2).

178. *Id.*

179. I.R.C. § 672(e) (for transfers in trust after March 1, 1986). For purposes of determining whether the individual is married to the grantor at the time of the creation of the interest or power, the individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.

180. The latter is category (4) above, and led to taxation of grantors in *Humphrey v. Comm'r*, 39 T.C. 199 (1962).

181. *Rollins v. Helvering*, 92 F.2d 390, 395 (8th Cir.), *cert. denied*, 302 U.S. 763 (1937); see also *Greenough v. Comm'r*, 74 F.2d 25 (1st Cir. 1934).

Therefore, if the trustees are persons not having a substantial adverse beneficial interest in the disposition of the income and if the income may, in their discretion, be distributed to the grantor or, alternatively, accumulated for someone else, all of such income is taxable to the grantor. Trust instruments frequently provide that the trustees have power to determine which receipts are capital and which are income. However, the relevant test is whether the item is income in the income tax sense.¹⁸² A grantor who is entitled to the income is taxable on the capital gains of a trust if the gains could have been distributed as income, even though nonadverse trustees, in the exercise of their discretion, determine to treat the gains as an addition to corpus.¹⁸³ Similarly, even though the trust instrument directs capital gains to be treated as corpus, the grantor is taxable on such gains if the trustees, in their discretion, can invade corpus for the grantor's "proper education, care, comfort and support."¹⁸⁴

The grantor is taxable even though the discretionary power cannot be exercised except in the contingent event that "accident, sickness, calamity, misfortune, adversity, bereavement or loss, financially or otherwise, shall visit" the grantor.¹⁸⁵ The question of how remote the contingency must be before the grantor can escape tax on income that "may be" distributed to the grantor arises also for income that "may be" accumulated for the grantor. The question is discussed below. As to this income that can be distributed to the grantor upon a nonremote contingency, apparently the fact that the contingency has not occurred will not prevent the grantor from being taxed.¹⁸⁶

Further, similar to the case with revocable trusts, indirect devices by which income may be distributable to the grantor will not overcome the substance. The grantor will be treated as the owner.¹⁸⁷

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182. See Treas. Reg. §§ 1.671-2(b), -3(b). I.R.C. § 677 provides the reason why the grantor of a reversionary trust that meets the criteria of I.R.C. § 673 is taxed on most capital gain. See Rev. Rul. 81-98, 1981-1 C.B. 40 (no disposition of installment note accelerating gain under I.R.C. § 453 by transfer of note to ten-year-and-one-month trust because taxpayer to receive deferred profit and return of capital, but not interest); cf. Springer v. United States, 69-2 U.S. Tax Cas. (CCH) ¶ 9567 (N.D. Ala. 1969); Rev. Rul. 67-70, 1967-1 C.B. 106; Rev. Rul. 67-167, 1967-1 C.B. 107.
183. Greenough v. Comm'r, 74 F.2d 25 (1st Cir. 1934); Sharp v. Comm'r, 42 B.T.A. 336 (1940); cf. Comm'r v. O'Keefe, 118 F.2d 639 (1st Cir. 1941) (general power to allocate does not give trustees discretion as to ordinary dividends).
184. Rollins v. Helvering, 92 F.2d 390 (8th Cir.), cert. denied, 302 U.S. 763 (1937).
185. Wenger v. Comm'r, 42 B.T.A. 225 (1940), aff'd, 127 F.2d 523 (6th Cir.), cert. denied, 317 U.S. 646 (1942).
186. Helvering v. Evans, 126 F.2d 270 (3d Cir.), cert. denied, 317 U.S. 638 (1942).
187. Rev. Rul. 68-183, 1968-1 C.B. 308 (sale of stock for lifetime private annuity in amount equal to projected income yield). See *supra* note 174.

Although section 677(a) provides that a grantor is treated as the owner of any portion of a trust if the income *may* be paid to the grantor or the grantor's spouse without the consent of an adverse party,¹⁸⁸ the regulations under section 677(a) provide that such a trust is a grantor trust only as to the income portion if the interest of the grantor or the grantor's spouse is limited to ordinary (or fiduciary accounting) income.¹⁸⁹

Despite the very clear example in the regulations, the Service has issued several private letter rulings holding that both the income and corpus portion of a so-called grantor-retained annuity trust, or GRAT, would be treated as owned by the grantor; that is, the trust would be a grantor trust, because the annuity amount would be payable from principal to the extent that income was insufficient.¹⁹⁰ However, the Service has taken the position in other private rulings that a retained annuity alone does not confer grantor trust status as to both the income and corpus portion of a GRAT.¹⁹¹

Various rulings indicate that a combination of sections 677 and 674(b)(3) can be used to confer grantor trust status as to income and corpus for a GRAT. The authority to make distributions of the annuity payments would result in grantor trust treatment as to the ordinary income under section 677. If the grantor retains a testamentary power of appointment to appoint the trust assets (in the event the grantor dies before the stated termination of the GRAT), this power will result in grantor trust treatment as to the corpus under sections 674(a) and 674(b)(3).¹⁹² This result is acceptable for a GRAT, assuming the power of appointment ends when the grantor's retained annuity interest terminates but likely is not acceptable for other grantor trusts where

188. See I.R.C. § 677(a) ("grantor shall be treated as the owner of any portion of a trust . . . whose income . . . is, or . . . may be" distributed or accumulated for future distribution to the grantor or the grantor's spouse).

189. See Treas. Reg. § 1.677(a)-1(g), ex. 1.

190. See Priv. Ltr. Ruls. 9504021 (Jan. 27, 1995); 9451056 (Dec. 23, 1994); 9449012 (Dec. 9, 1994), *modified by* 199951031 (Dec. 24, 1999); 9444033 (Nov. 4, 1994), *modified by* 9543049 (Oct. 27, 1995); 9415012 (Apr. 15, 1994). See also Priv. Ltr. Rul. 9501004 (Jan. 6, 1995) (CRUT treated as grantor trust as to income and corpus under section 677(a) because of the possibility that income allocable to principal could be used to satisfy the unitrust payment). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

191. See Priv. Ltr. Rul. 9625021 (June 21, 1996). For a description of a GRAT, see Treasury Regulation section 25.2502-3. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

192. See Treas. Reg. § 1.674(b)-1(b)(3) ("[I]f a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the

the purpose is to exclude the trust assets from a grantor's estate, unless some other trust provision causes grantor trust status after the power expires.¹⁹³

In Private Letter Ruling 200842007, the Service ruled that a trust was a grantor trust because the trustees, who were not adverse parties, could distribute income or principal of the trust to the grantor's spouse. In the ruling, the grantor proposed to use a power to substitute the assets of the trust for other assets of equivalent value. Because the trust was a grantor trust, the exchange of assets was not a taxable exchange to either the grantor or the trust because of the application of Revenue Ruling 85-13.¹⁹⁴

[A] Grantor Trust Status

A grantor trust may be created under section 677 without significant concerns about the trust being included in the grantor's gross estate with a trust that includes the grantor's spouse (but not the grantor) as a discretionary beneficiary of income and principal. The trustee should not be the grantor, the grantor's spouse, or any adverse party. Possible concerns with this approach are that keeping flexibility to end grantor trust status is difficult and that grantor trust status would end at the spouse's death, unless some other interest or power results in continuing grantor trust status.

A section 677 grantor trust might be created by parents engaged in asset transfer planning if one of the parents transfers his or her separate property into a trust that would include the spouse as a discretionary beneficiary. Each spouse should not name the other as beneficiary of trusts each creates for the other, as the reciprocal trust

trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.”); *see also* Priv. Ltr. Ruls. 200001013 (Jan. 7, 2000); 200001015 (Jan. 7, 2000) (grantor trust treatment as to income because trustee had discretion to pay all of GRAT's income—if any is remaining after payment of the annuity payments—to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 9707005 (Feb. 14, 1997) (GRAT is a grantor trust as to income and corpus under sections 674(a) and 677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder); 9625021 (June 21, 1996). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

193. If grantor trust status is desirable after the retained interest terminates, the continuing trust will need alternative provisions to make the trust a grantor trust. A continuing power of appointment held by the grantor would cause estate tax problems under Code sections 2036 and 2038.

194. Rev. Rul. 85-13, 1985-1 C.B. 184.

doctrine may apply.¹⁹⁵ By including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the event the spouse ever needed distributions from the trust.

If the spouse is included as a beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift by the spouse may result, unless the relinquishment is a qualified disclaimer—one made within nine months of the creation of the interest.¹⁹⁶ Alternately, someone other than the grantor could be given the power to eliminate the spouse as a beneficiary.

As long as the spouse does not make any contribution to the trust, including the spouse as a beneficiary will not cause the trust to be included in the spouse's gross estate for estate tax purposes, as long as the spouse does not have a general power of appointment under section 2041. Neither section 2036 nor 2038 should apply because the spouse is not a grantor of the trust. This tax result is true even if the split gift election is made because the split gift election under section 2513 applies only for gift tax and generation-skipping transfers (GST) exemption allocation purposes and not for estate tax purposes.¹⁹⁷ Note, however, that the split gift election is not available if the spouse's interest in the trust cannot be quantified.¹⁹⁸

If the grantor, rather than the grantor's spouse, is a discretionary beneficiary, there is some likelihood that the trust assets would be included in the grantor's estate under section 2036, unless the trust is formed in a state where a grantor can be a discretionary beneficiary without subjecting the trust assets to the grantor's creditors.¹⁹⁹ Even in such a "self-settled trust" state, however, if the trustee actually makes distributions to the grantor, a concern may arise under section 2036 as to whether there was an implied agreement about distributions to the grantor, which could trigger section 2036 inclusion even apart from creditors' rights.²⁰⁰

195. See *United States v. Estate of Grace*, 395 U.S. 316 (1969), *reh'g denied*, 396 U.S. 881 (1969).

196. See Treas. Reg. § 25.2518-2 (requirements for a qualified disclaimer).

197. See I.R.C. §§ 2513(a)(1); 2652(a)(2). No analogous estate tax provision exists. See, e.g., Rev. Rul. 74-556, 1974-2 C.B. 300 (no section 2038 inclusion for spouse of grantor).

198. See generally Diane S.C. Zeydel, *Gift Splitting—A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

199. Compare *Outwin v. Comm'r*, 76 T.C. 153 (1981) (applying Massachusetts law), with *Estate of German v. United States*, 7 Cl. Ct. 641 (1985) (applying Maryland law).

200. Cf. Rev. Rul. 2004-64, *supra* note 35 (estate tax inclusion if the trust may reimburse the grantor for income taxes on trust income imputed to

If section 677 is being used to confer grantor trust status by including the grantor's spouse as a potential beneficiary, the death of the spouse would result in the trust no longer being a grantor trust unless one of the other grantor trust provisions applies.

§ 5:4.2 Accumulation of Income for Future Distribution to Grantor or Spouse

Under section 677, the income of a trust is taxable to the grantor if, without the approval or consent of an adverse party, it "is" or, in the discretion of the grantor or of a nonadverse party, "may be" held or accumulated for future distribution to the grantor or his spouse in the case of a post-October 9, 1969, transfer in trust. Thus, if the trust instrument provides for the distribution of accumulated income to the grantor upon the happening of some event in the future, the statute presents the problem of whether the nature or the remoteness of the contingency is to be taken into account, or whether the statutory language referring to income that "is" or "may be . . . held or accumulated for future distribution to the grantor" covers every contingent accumulation, regardless of its nature or however remote.

The regulations take the broad position that the grantor is treated as the owner if "he has retained any interest which might, without the approval or consent of an adverse party, enable the grantor to have the income from that portion distributed to the grantor at some time either actually or constructively."²⁰¹ The First Circuit has said: "the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to the grantor."²⁰² The instrument in that case provided that the corpus and any accumulated income was to revert to the grantor if he survived his wife, who was named life beneficiary.

the grantor under the grantor trust rules if there is an understanding that the trustee will reimburse the grantor). *Cf.* Priv. Ltr. Rul. 200944002 (no estate tax inclusion in gross estate of grantor who is a discretionary beneficiary under "self-settled" Alaska trust because, under Alaska law, creditors of the grantor cannot attach the trust assets and grantor had no other interest or power that would cause estate tax inclusion). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

201. Treas. Reg. § 1.677(a)-1(c). This language is buttressed by I.R.C. § 672(d). The regulation makes exception for little more than the possibility of voluntary return by inheritance; *cf.* *Rosenblatt v. Comm'r*, 8 T.C. 1245 (1947), *acq.* 1947-2 C.B. 4.

202. *Kaplan v. Comm'r*, 66 F.2d 401, 402 (1st Cir. 1933).

But the Board of Tax Appeals declared that it did not think

that the language of this section covers or was intended to cover the situation where there is no definite provision for such future distribution to the grantor, but only the bare possibility that upon certain contingencies over which the grantor has no control the corpus and accumulations may revert to him.²⁰³

In that case the corpus and any accumulated income was to revert to the grantor if the grantor's son died before the age of thirty and the grantor survived him. Apparently, the rule is that the grantor will be taxable if an eventual distribution to the grantor (personally, during the grantor lifetime) depends upon a contingency but not if the occurrence of the contingency is highly unlikely.²⁰⁴

The regulations imply that an accumulation solely for the grantor's estate is permissible: a sentence specifies that the grantor may be deemed the owner, in the case of a post-October 9, 1969, trust, on an accumulation for the spouse during grantor's lifetime, even where the spouse cannot receive it before the grantor's death.²⁰⁵ No such statement is extended to possible receipt by grantor's estate. Contrast this with the taxability of a grantor whose estate may enjoy a reversionary interest.²⁰⁶

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203. *Boeing v. Comm'r*, 37 B.T.A. 178, 185 (1938), *rev'd on other grounds*, 106 F.2d 305 (9th Cir.), *cert. denied*, 308 U.S. 619 (1939). *But cf.* *Estate of Wadewitz v. Comm'r*, 32 T.C. 538 (1959) (taxable where grantor had to outlive spouse to receive reversion).
204. *Kent v. Rothensies*, 120 F.2d 476 (3d Cir.), *cert. denied*, 314 U.S. 659 (1941); *Moore v. Comm'r*, 39 B.T.A. 808 (1939), *acq.* 1939-2 C.B. 25; *May v. Comm'r*, 3 T.C.M. (CCH) 733 (1944); *Downie v. Comm'r*, 46 B.T.A. 937 (1942), *aff'd*, 133 F.2d 899 (6th Cir. 1943); *Ayer v. Comm'r*, 45 B.T.A. 146 (1941); *Baker v. Comm'r*, 43 B.T.A. 1029, 1035 (1941) (and cases cited); *Ward v. Comm'r*, 40 B.T.A. 225 (1939), *rev'd on other grounds*, 119 F.2d 207 (3d Cir. 1941); *Rev. Rul.* 54-306, 1954-2 C.B. 240; *Rev. Rul.* 77-230, 1977-2 C.B. 214 (United States held owner of trust it created and over which it had possibility of reverter on accumulated income without discussing probabilities of accumulation or reverter). If eventual distribution will be to the grantor's appointees or heirs, apparently the grantor is not taxable. *Comm'r v. Bateman*, 127 F.2d 266 (1st Cir. 1942); *Goodan v. Comm'r*, 12 T.C. 817 (1949), *aff'd*, 195 F.2d 498 (9th Cir. 1952); *cf.* I.R.C. § 674(b)(3).
205. *Treas. Reg.* § 1.677(a)-1(f) (last sentence).
206. *See Priv. Ltr. Rul.* 200234054 (trust formed by REIT's limited partnership and partnership's wholly owned management corporation to avoid value of securities rule for REITs under I.R.C. § 856(c)(4)(B)(iii)(III), where partnership is trustee and corporation is sole beneficiary apparently not a grantor trust, because ruling holds assets owned by trust are treated as owned by it for purposes of that section and not by REIT). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

The “income” referred to by section 677 is taxable income. Thus, if capital gains are treated as corpus in a particular trust, and if corpus may eventually be distributed to the grantor, the grantor is taxable on the capital gain.²⁰⁷

The regulations indicate that it does not matter when presently accumulated income will be distributed to the grantor or his spouse.²⁰⁸ However, it does acknowledge one exception: the Code makes section 677 inapplicable “to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after a period such that” a reversionary interest would be permissible under section 673 (in general, where, as of the inception of the trust, the value of the reversionary interest is not greater than 5% for transfers in trust after March 1, 1986, as discussed below and after ten years, for transfers in trust before March 2, 1986).²⁰⁹ Thereafter, the grantor may be taxable unless the power is relinquished. This exception from section 677 means that for transfers in trust after March 1, 1986, if the power cannot be exercised before the initial time period that satisfied the 5% rule to cause the income to be distributed to the grantor or his spouse, or to be accumulated for distribution to the grantor or his spouse, the grantor is not taxable on the income for the time period.²¹⁰ Note that the exception is phrased only as to a power, and not as to a requirement of distribution to or accumulation for a grantor or his spouse after the period.²¹¹ The exception does not apply where income of the actual year is accumulated and will be distributed to the grantor or his spouse even only after the qualifying term expires.²¹²

It is questionable whether section 677 should be construed to tax the grantor on current income for transfers in trust that cannot be distributed to or accumulated for the grantor or the grantor’s spouse

207. Treas. Reg. § 1.677(a)-1(g), ex. (2); Rev. Rul. 75-267, 1975-2 C.B. 254; Rev. Rul. 66-161, 1966-1 C.B. 164; *Samuel v. Comm’r*, 306 F.2d 682 (1st Cir. 1962) (rejecting contention that taxpayer sold the “Dead Sea Scrolls” for an annuity); *De Amodio v. Comm’r*, 299 F.2d 623 (3d Cir. 1962), *aff’g* 34 T.C. 894 (1960); Rev. Rul. 58-242, 1958-1 C.B. 251; *Comm’r v. Wilson*, 125 F.2d 307 (7th Cir. 1942); *Graff v. Comm’r*, 117 F.2d 247 (7th Cir. 1941); *cf.* *Comm’r v. Jergens*, 127 F.2d 973, 974-75 (5th Cir. 1942) (not taxable on accumulations whose income might go to grantor). *See* N.Y. EST. POWERS & TRUSTS LAW § 7-1.11 (McKinney Supp. 2002) (adjustment to grantor who is taxed on trust principal); *cf.* Rev. Rul. 75-267, 1975-2 C.B. 254 (capital gains realized after grantor’s death are taxable to the trust and not the grantor’s estate).

208. Treas. Reg. § 1.677(a)-1(c).

209. *See* section 5:6.1.

210. Treas. Reg. § 1.677(a)-1(e); S. REP. NO. 83-1622, at 4719.

211. *See* Treas. Reg. § 1.677(a)-1(e), ex.

212. *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); *Humphrey v. Comm’r*, 39 T.C. 199 (1962); Treas. Reg. § 1.677(a)-1(f); Rev. Rul. 57-363, 1957-2 C.B. 326.

even though income of some later year may be so distributed or accumulated (for example, when, upon the grantor's death, after a short life expectancy, income becomes currently distributable to the grantor's widow). Taxing the grantor may in fact be the regulatory intention of the phrase treating the grantor as owner if the grantor or the grantor's spouse may get income "for the taxable year or for a period not within the exception" in the regulations.²¹³ An implication to the same effect may exist in the last sentence of Treasury Regulations section 1.677(a)-1(e).²¹⁴

§ 5:4.3 Satisfaction of Legal Obligations of Grantor or Spouse

The income of a trust may be considered distributable to the grantor and may be taxed to the grantor under section 677 if that income is or may be devoted by the grantor or by nonadverse parties to the discharge of an obligation of the grantor or the grantor's spouse. The Supreme Court applied this rule to income that could be used for the support, education, and maintenance of the grantor's minor children.²¹⁵ To reverse this decision, Congress added a provision that trust income is not taxable to the grantor merely because, in the discretion of another person, the trustee or the grantor acting as trustee or cotrustee, it may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or the grantor's spouse is legally obligated to support, except to the extent that such income is actually so applied or distributed.²¹⁶ In other words, such undistributed income is not treated as income when it may be indirectly distributed to the grantor. It should be noted that this provision applies only if the income, "in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or

213. Treas. Reg. §§ 1.677(a)-1(b)(1), 1.677(a)-1(b)(2). For related discussion, see *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

214. As to the particular textual example of a change becoming effective upon the grantor's death, compare I.R.C. § 673(c), which excepts short-term reversionary interests taking effect at the death of an income beneficiary.

215. *Helvering v. Stuart*, 317 U.S. 154, 169-71 (1942). Taxation to the grantor of income that could be used to discharge his obligations also was sustained under 1939 I.R.C. § 22(a), which defined gross income. See *Douglas v. Willcuts*, 296 U.S. 1 (1935); *Helvering v. Schweitzer*, 296 U.S. 551 (1935); *Helvering v. Blumenthal*, 296 U.S. 552 (1935), *rev'g* 76 F.2d 507 (2d Cir. 1935); *Anesthesia Serv. Med. Grp. v. Comm'r*, 825 F.2d 241 (9th Cir. 1987) (trust established by corporation to obtain malpractice insurance to pay claims against grantor's employees is grantor trust and no current deduction for contributions to it).

216. I.R.C. § 677(b). Or required to be distributed. Treas. Reg. § 1.677(b)-1(f).

maintenance of a beneficiary (other than grantor's spouse) whom the grantor is legally obligated to support or maintain." If the grantor, individually and not as trustee, retains the right to require that income be expended for the interests of his children, he may be taxed upon the entire trust income.²¹⁷

The exception for support obligations of the spouse is covered in the regulations, perhaps emphasizing that grantor is taxable as to other possible obligations of the spouse.²¹⁸ If a distribution is made out of other than current income, it may be taxed to the grantor under the rules as to distributions out of other than income by ordinary trusts.²¹⁹

217. Treas. Reg. § 1.677(b)-1(e). As to the determination of the amount of legal obligation of support in this situation, see *Hopkins v. Comm'r*, 144 F.2d 683 (6th Cir. 1944). The case also suggests that where the grantor is taxed because of actual distributions to the beneficiary, it will be difficult for him to show that the obligation was in an amount less than the distribution. See also *Morrill v. United States*, 228 F. Supp. 734 (D. Me. 1964); *Peierls v. Comm'r*, 12 T.C. 741 (1949). But cf. *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972) (no obligation under circumstances under Montana law to furnish private school tuition and music, swimming, and public speaking lessons); *Estate of Hamiel v. Comm'r*, 253 F.2d 787 (6th Cir. 1958); *Wyche v. United States*, 36 A.F.T.R.2d (RIA) ¶ 75-5816 (Ct. Cl. Trial Judge's Op. 1974) (no obligation under South Carolina law under circumstances to furnish private school education or music or dance lessons); *Braun v. Comm'r*, 48 T.C. Memo. 1984-285 (obligation for private high school for minor children and college for adult children under the circumstances under New Jersey law); *Stone v. Comm'r*, T.C. Memo. 1987-454 (similar under California law, noting that although questions of parent's obligation to support child generally occur in divorce setting, child's rights are not limited to that context); see Stanley Nitzburg, *The Obligation of Support: A Proposed Federal Standard*, 23 TAX L. REV. 93 (1967); David L. Samuels, *Beware of Trusts for Dependents!*, 37 TAXES 1009 (1959); Tomlinson, *Support Trusts and Gifts to Minors*, 1958 A.B.A. SEC. REAL PROP. PROB. & TR. PROC. 82; Wood, *Taxability of the Income from a Federal Tax Aspects of the Obligation to Support*, 74 HARV. L. REV. 1191 (1961). See also Treas. Reg. § 1.662(a)-4 (last four sentences). See generally Marvin Goodson, *When Is Payment In Discharge of Parent's Legal Obligation?*, 99 TR. & EST. 17 (1960); Pearle, *Income Tax Consequences of the Support Obligation*, EST., GIFTS & TR. J., Mar.-Apr. 1978, at 4; Note, *The Taxation of Educational Trust Funds: Private Schools and Lessons*, 37 TAX LAW 205 (1983); Jonathan G. Blattmachr, *Family Income Shifting Techniques*, 43 INST. ON FED. TAX'N ¶ 45.00 (1985).

In considering the effect of "shifting" tax income to a child, it is important to note that under I.R.C. § 1(g), generally, unearned income of a child under age eighteen (and sometimes age twenty-one) is taxed at the higher of the marginal rate of the child or of the child's parents. Note that gain taxed to a trust, of which a parent is the transferor, under I.R.C. § 644 is added to the parent's income for this purpose. I.R.C. § 1(g)(3)(c).

218. Treas. Reg. § 1.677(b)-1(a), (d).

219. Treas. Reg. § 1.677(b)-1(b), (c); Rev. Rul. 74-94, 1974-1 C.B. 26. Rev. Rul. 61-223, 1961-2 C.B. 125, distinguishes this rule requiring actual

The extent of the legal obligations of a grantor is generally determined by local law. The obligation that may be discharged need not be an obligation of support. The income of a trust may be taxable to the grantor if, pursuant to a contract or otherwise, the income may be used, for example, to discharge encumbrances on real estate by paying creditors' claims,²²⁰ to discharge a debt of the grantor,²²¹ or to pay gift or estate taxes on the grantor's estate.²²²

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- distributions for taxability from the rule of I.R.C. § 170(b)(1)(D) (before the 1969 amendments), under which a probability or possibility of such a distribution could be deemed a reversionary interest sufficient to prevent a charitable deduction.
220. See *Wiles v. Comm'r*, 59 T.C. 289 (1972), *aff'd*, 491 F.2d 1406 (5th Cir. 1974); Rev. Rul. 54-516, 1954-2 C.B. 54 (grantor remaining liable on mortgage on real estate transferred to trust); *Gayton v. Comm'r*, B.T.A.M. (P-H) ¶ 87,702. *But cf.* Rev. Rul. 64-240, 1964-2 C.B. 172 (charitable pledges are not legal obligations for this purpose); Priv. Ltr. Rul. 8242043 (similar as to binding charitable pledge made by corporate grantor before trust created); Rev. Rul. 55-286, 1955-1 C.B. 75 (recognizing a trust that paid annuities and/or gifts to the grantor's employees). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
221. *Helvering v. Blumenthal*, 296 U.S. 552 (1935), *rev'g* 76 F.2d 507 (2d Cir. 1935); *Knight v. Comm'r*, 39 B.T.A. 436 (1939).
222. *Sheaffer v. Comm'r*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963); *Estate of Sheaffer v. Comm'r*, 25 T.C. Memo. 1966-126 (related case); *Krause v. Comm'r*, 56 T.C. 1242 (1971), *aff'd*, 497 F.2d 1109 (6th Cir. 1974), *cert. denied*, 419 U.S. 1108 (1975); *Hirst v. Comm'r*, 63 T.C. 307 (1974); *Downie v. Comm'r*, 46 B.T.A. 937, 942-43 (1942), *aff'd*, 133 F.2d 899 (6th Cir. 1943); Rev. Rul. 57-564, 1957-2 C.B. 328 (gift taxes of grantor on creation of trust itself). *But cf.* *Comm'r v. Goodan*, 195 F.2d 498 (9th Cir. 1952), *aff'd*, 12 T.C. 817 (1949); *Estate of Morgan v. Comm'r*, 37 T.C. 981, *aff'd*, 316 F.2d 238 (6th Cir. 1962), *cert. denied*, 375 U.S. 825 (1963) (trust agreement required trustees to pay gift tax, which is usually donor's obligation and they had done so by borrowing from a bank; repayment to bank out of income held, with three dissents, not to be payment of grantor's obligation); *Estate of Davis v. Comm'r*, 30 T.C. Memo. 1971-318, *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1973) (not taxable); Priv. Ltr. Rul. 9713011 (neither the Alaskan Native Corporation nor its shareholders treated as owners of a state-chartered settlement trust by the corporation, pursuant to federal law, with the consent of its shareholders, where the assets of the trust are not available to the creditors or to the corporation's creditors other than those creditors of the corporation before the transfer to the trust where corporation expected that its retained assets would be sufficient to discharge existing liabilities and under federal law trust assets are liable to existing creditors only if the corporation's other assets are inadequate). Michael M. Sachs, *Assumption of Indebtedness by a Donee: Income Tax Consequences*, 17 STAN. L. REV. 98 (1964); Peter Somers, *Short-Term and Other Inter Vivos Trusts: Avoiding Current Problems*, 31 J. TAX'N 224, 227 (1969). Neither a Private Letter Ruling nor a Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).

[A] Grantor Trust Status

Section 677(b) limits the application of section 677(a) in situations in which payment of income or principal are made for support or maintenance obligations of the grantor.²²³ This section 677(b) exception does not apply to payments that may be made to support or maintain the grantor's spouse; thus grantor trust status is possible until the spouse dies. However, for estate tax purposes, any payments for the support of a beneficiary whom the grantor has a legal obligation to support should be prohibited to avoid section 2036.²²⁴

§ 5:4.4 Insurance Trusts

Section 677(a)(3) specifically provides that the grantor is treated as the owner of any portion of a trust from which income, without the approval or consent of any adverse party, is, or in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums upon policies of insurance on the life of the grantor or, in the post-1969 case, his spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c), defining charitable contributions). The constitutionality of the predecessor provision to section 677(a)(3) was established in *Burnet v. Wells*.²²⁵ Currently, the Service will not issue rulings or determination letters as to whether the grantor will be considered the owner of any portion of a trust where, among other cases, the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse.²²⁶

The purpose of section 677 is to prevent the avoidance of income tax by the use of trusts created with income-producing properties to pay the premiums necessary to keep in force insurance policies owned by the same trust.²²⁷ The section makes no distinction between endowment policies and other kinds of policies, such as ordinary life insurance policies, but is equally applicable to all.²²⁸

223. When such amounts are actually paid, the grantor is taxed on the income under section 662 rather than under the grantor trust rules. See I.R.C. § 677(b) (last sentence).

224. See Treas. Reg. § 20.2036-1(b)(2).

225. *Burnet v. Wells*, 289 U.S. 670 (1933).

226. Rev. Proc. 2009-3, 2009-1 C.B. 107, § 3.01 (53); see Priv. Ltr. Rul. 9009047 (income-only charitable remainder trust described in I.R.C. § 664(d)(3) is not grantor trust where proceeds of insurance on life of first of two life recipients, who is the grantor, will be allocable to corpus). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

227. See Randolph E. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 71 (1937).

228. *Heffelfinger v. Comm'r*, 32 B.T.A. 1232, *aff'd*, 87 F.2d 991 (8th Cir. 1935), *cert. denied*, 302 U.S. 690 (1937).

The section refers to any portion of a trust from which income is or may be applied to the payment of premiums for policies of insurance "on the life of the grantor." Thus, the section has been inapplicable unless the insurance policies in the trust cover the grantor's life. Because the 1969 amendments to section 677 apply only in respect of property transferred in trust after October 9, 1969, policies on the grantor's spouse can remain significant in old trusts. The effect of the section has been avoided by arrangements under which the grantor of the trust was not the insured under the policies placed in the trust. For example, the Board of Tax Appeals held that a grantor-wife was not taxable where the trust was set up by her under an agreement that provided that current dividends should be used to pay the premiums on life insurance policies on the life of her husband, when the husband had the policies placed in a separate trust.²²⁹

Notwithstanding the technical creation of a pre-1969 trust by the wife, a husband may be taxable on the income if he is found to be the real grantor. Thus, a husband was held taxable on the income of a funded insurance trust holding policies on his life where shortly before the trust was created he transferred to his wife the property used by her in creating the trust.²³⁰

Although under section 677(a)(3) the grantor could not be taxed upon trust income used or available for the payment of premiums on policies that did not cover the grantor's life, the grantor may nevertheless be taxed on such income under other provisions of the Code.

In one case,²³¹ a wife created two trusts from which income was to be used by the trustee to pay premiums on life insurance policies on the life of her husband. She was sole beneficiary of eight policies involved in one of the trusts, and she also had the right to change the beneficiary and could exercise for her own benefit the right to their cash surrender or loan value. The proceeds of the policies in the second trust were

229. *Blumenthal v. Comm'r*, 30 B.T.A. 591, *rev'd on other grounds*, 76 F.2d 507 (2d Cir. 1934), *rev'd*, 296 U.S. 552 (1935); *see also Barbour v. Comm'r*, 39 B.T.A. 910 (beneficiary may use income by premiums), *rev'd on other grounds*, 122 F.2d 165 (2d Cir. 1939), *cert. denied*, 314 U.S. 691 (1941); *Baldwin v. Comm'r*, 36 B.T.A. 364 (1937).

230. *Whiteley v. Comm'r*, 120 F.2d 782 (3d Cir.), *cert. denied*, 314 U.S. 657 (1941). On indirect grantors, *see supra* text accompanying note 82. *Cf. Bel v. United States*, 452 F.2d 683 (5th Cir. 1971); *Detroit Bank & Trust Co. (Ritter Estate) v. United States*, 467 F.2d 964 (6th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); *Leder v. Comm'r*, 89 T.C. 3468 (1987); *Ronk v. Comm'r*, T.C. Memo. 1988-432.

231. *Comm'r v. Morton*, 108 F.2d 1005 (7th Cir. 1940); *see Priv. Ltr. Rul.* 8014078 (grantor gets interest deduction of trust). *But see Rev. Proc.* 81-37, 1981-2 C.B. 592 (IRS will not rule). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling can be cited or used as precedent.

payable, via the trustee, to the grantor if she survived her husband. Power to terminate the trusts was vested in the husband. Upon termination of the trusts during the grantor's life, the corpus was to revert to the grantor, and any accumulated income was to go to the husband. The Seventh Circuit held that because the grantor directly or indirectly was the beneficiary under the insurance policies on the life of her husband and was entitled to the cash surrender and loan value of the policies, the income remained, in substance, that of the grantor, being used to purchase property for her, and consequently was taxable to her under section 167(a)(1) and (2) of the 1939 Code, relating generally to income distributed to or accumulated for the grantor.

Somewhat similarly, it has been held that the grantor-wife is taxable upon the income of a funded insurance trust if the insurance policies on her husband's life are to be used to pay inheritance taxes on her share of her husband's estate with any balance to be paid to her after her husband's death.²³²

Because of the 1969 change in section 677(a)(3) to include the grantor's spouse in the scope of the section, the cases acknowledging the distinctions discussed above will still be potentially applicable when the grantor of the trust is the insured and not husband and wife. For example, similar situations could arise in parent-child arrangements or with domestic partners who are not married but that have significant personal relationships.

It should also be noted that under section 677(a)(3) the grantor is to be taxed not only if the income "is" but also if it "may be" applied to the payment of premiums on policies of insurance on the life of the grantor. Thus, the trust income need not actually be applied to the payment of premiums. It is sufficient if, in the discretion of the grantor or some person without an adverse interest,²³³ the income may be applied to the payment of the premiums upon existing policies. However, the policies probably must be in existence during the year.²³⁴ And it seems likely that there must be some positive suggestion by the grantor that

232. *Phipps v. Helvering*, 124 F.2d 288 (D.C. Cir.); *see also* *Comm'r v. Van Dusen*, 138 F.2d 510 (6th Cir.), *cert. denied*, 321 U.S. 776 (1943) (invoking old I.R.C. § 22(a)).

233. *Rieck v. Comm'r*, 41 B.T.A. 457 (1940) (indirectly paid via beneficiaries), *aff'd*, 118 F.2d 110 (3d Cir. 1941); *cf.* *Todd v. Comm'r*, 32 B.T.A. 1067, 1070 (1935), *aff'd*, 82 F.2d 1020 (2d Cir. 1936).

234. *Comm'r v. Mott*, 85 F.2d 315 (6th Cir. 1936); *Weil v. Comm'r*, 3 T.C. 579 (1944); *Moore v. Comm'r*, 39 B.T.A. 808 (1939). *But cf.* *Priv. Ltr. Rul. 8852003* (indicates that merely authorizing the trustee in the trust instrument to purchase policies on the life of the grantor and pay premiums from income or corpus, or both, causes I.R.C. § 677(a)(3) to apply). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

income be so used.²³⁵ However, this is not necessary if income is actually so used.²³⁶

However, the Service has not always agreed with the courts. In a ruling involving a foreign trust where it was in the Service's interest for the trust to be a grantor trust, a Field Attorney Advice Memorandum²³⁷ took the position that the power to purchase life insurance on a grantor causes grantor trust treatment. It provides: "Article II of B Trust Agreement authorizes the trustee to purchase life insurance on taxpayer. There does not appear to be any limit on the amount the trustee may apply to the payment of premiums. Therefore, pursuant to section 677(a)(3), taxpayer is treated as the owner of B."²³⁸

One private letter ruling held that grantor trust status arises only to the extent of premiums payable by the trust for the current year.²³⁹ Another private letter ruling provides that a power to pay premiums alone causes the entire trust to be a grantor trust.²⁴⁰

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235. See *Corning v. Comm'r*, 104 F.2d 329, 333 (6th Cir. 1939); *Foster v. Comm'r*, 8 T.C. 197, 205 (1947); cf. *Dunning v. Comm'r*, 36 B.T.A. 1222 (1937) (taxable where grantor's suggestion to beneficiary was not in trust instrument), *appeal dismissed*, 97 F.2d 999 (4th Cir. 1938). *But cf.* *Cent. Hanover Bank & Trust Co. v. Hoey*, 74 F. Supp. 770 (S.D.N.Y. 1947); *Booth v. Comm'r*, 3 T.C. 605 (1944) (not taxable where independent act of beneficiary); Rev. Rul. 66-313, 1966-2 C.B. 245 (second trust, whose beneficiaries were the grantor's children and who agreed to have that trust pay life insurance premiums on policy owned by first trust created by same grantor, was grantor trust under I.R.C. § 677(a)(3) to the extent so paid despite no provision in second trust to so pay); see also Priv. Ltr. Rul. 8839008 (taxable "because the insurance premiums paid by . . . Trust . . . exceeds . . . the taxable income of . . . Trust," despite prohibition that trust accounting income could not be used to pay premiums and corpus did not consist of policies). *But cf.* Priv. Ltr. Rul. 8701007 (not a grantor trust under I.R.C. § 677(a)(3) where trust includes policy on grantor's life but trust agreement prohibits use of ordinary income or gain for payment of premiums). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
236. *Foster v. Comm'r*, 8 T.C. 197, 205 (1947); *Rand v. Comm'r*, 40 B.T.A. 233 (grantor was trustee), *aff'd*, 116 F.2d 929 (8th Cir. 1939), *cert. denied*, 313 U.S. 594 (1941).
237. I.R.S. Field Att'y Adv. Mem. 20062701F (July 7, 2006).
238. *Id.* at 10.
239. See Priv. Ltr. Rul. 6406221750A (June 22, 1964). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
240. See Priv. Ltr. Rul. 88-52-003 (Dec. 30, 1988); see also Priv. Ltr. Rul. 8839008 (Sept. 30, 1988) (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income and trust accounted payments as paid from corpus). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

[A] Grantor Trust Status

The net effect of the cases and letter rulings leaves the power to pay life insurance premiums a not-so-useful tool to assure that a trust will be treated as a grantor trust. However, a drafter may wish to use this power as one of multiple grantor trust triggers by providing in the trust agreement that the trustee may pay insurance premiums from income or principal, so as to build the best possible argument that the trust is a grantor trust as to both income and principal.

§ 5:5 Other Grantor Trusts

Before the enactment of the 1954 Code, the grantor trust statute only contained specific provisions for revocable trusts and retained-income trusts. The 1954 Code added provisions for the taxability of grantors of certain other types of trusts.²⁴¹

The 1954 Code provisions were taken with relatively little change from the detailed *Clifford* regulations²⁴² under the 1939 Code. The regulations resulted from *Helvering v. Clifford*,²⁴³ in which the Supreme Court applied the broad definition of taxable income then contained in section 22(a) of the 1939 Code and taxed to the grantor the income of a five-year trust created for the benefit of his wife, for which he retained broad powers of management and control. On the basis of the grantor's retained "bundle of rights" and "in the absence of . . . appropriate regulations," the Court declared that the grantor "retained the substance of full enjoyment of all the rights which previously he had in the property."²⁴⁴

In *Helvering v. Stuart*,²⁴⁵ the Supreme Court remanded to the Tax Court for a determination, on the facts, whether the grantor was similarly taxable, although it recognized "the impossibility of reversion to the grantors." Thus, a reversion to the grantor after a short term seemed unessential as a reason to tax the grantor.

Both *Clifford* and *Stuart* indicated that no single factor was to be considered controlling, and the two cases did not set up precise standards. A great number of cases were decided by the lower federal courts, variously applying the doctrine of the *Clifford* case.²⁴⁶ The result was confusion and uncertainty.

241. See section 5:1.2.

242. Treas. Reg. 118, § 39.22(a)-21 (1939).

243. *Helvering v. Clifford*, 309 U.S. 331 (1940).

244. *Id.* at 335-36.

245. *Helvering v. Stuart*, 317 U.S. 154 (1941); *cf.* *Hormel v. Helvering*, 312 U.S. 552 (1941); *Helvering v. Fuller*, 310 U.S. 69 (1940).

246. Erwin R. Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337, 339 (1942).

This uncertainty was considerably reduced by the Treasury's so-called *Clifford* regulations, which have now largely been incorporated into the Code.²⁴⁷ There was not much litigation under the *Clifford* regulations, although the U.S. Court of Appeals for the Seventh Circuit in *Commissioner v. Clark*²⁴⁸ rejected them partly on constitutional grounds, stating that even Congress would be without power to create a conclusive presumption that the short-term trust there involved was taxable. Nevertheless, it was clear that the *Clifford* regulations, and the Code, should be carefully followed by taxpayers' attorneys. The 1954 Code sections made little change from the regulations, and most of the changes were liberalizations; on the other hand, it should have been noted that it is sometimes possible for the new sections to

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247. T.D. 5488, 1946-1 C.B. 19; T.D. 5567, 1947-2 C.B. 9, *amending* Treas. Reg. 111, §§ 29.22(a)-21, 29.161-1, 29.162-1, 29.166-1, 29.166-2 (1939); *see also* Lazarus v. Comm'r, 513 F.2d 824 (9th Cir. 1975) ("sale" for private annuity deemed creation of trust with reserved life interest); Krause v. Comm'r, 497 F.2d 1109 (6th Cir. 1974) (trusts not bona fide family partners), *aff'g* 57 T.C. 890 (1972), *cert. denied*, 419 U.S. 1108 (1975); Van Zandt v. Comm'r, 341 F.2d 440, 444 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965) (trust factors, while permissible, can bear upon business purpose: taxpayer cannot deduct rent on business premises in building he gave to ten-year reversionary trust); Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (holding similar rent deductible); Iber v. United States, 409 F.2d 1273 (7th Cir. 1969); Mathews v. Comm'r, 520 F.2d 323 (5th Cir. 1975); Thomas D. Aitkin, *Coping with the Tough New Court Tests for Deductions in Leaseback Situations*, 44 J. TAX'N 47 (1976); Quinlivan v. Comm'r, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Lerner v. Comm'r, 71 T.C. 290 (1978), *acq. in result* 1984-1 C.B. 1; May v. Comm'r, 76 T.C. 7 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984); Rosenfeld v. Comm'r, 43 T.C. Memo. 1982-263, *aff'd*, 706 F.2d 1277 (2d Cir. 1983); Evans v. United States, 572 F. Supp. 74 (C.D. Ill. 1983); *see* Orbach & Reiner, *IRS Approves Third-Party Gift Leasebacks*, TAX HOTLINE, Jan. 1985, at 6 (suggesting that the "IRS has now taken the position that it will no longer litigate gift-leaseback transactions where the lessee is a third party—i.e., a corporation—unless the third party is a partnership or an S corporation," apparently on the basis of the Service's acquiescence in the result in *Lerner*); *cf.* Gatto v. Comm'r, 1 F.3d 826 (9th Cir. 1993) (taxpayer who created reversionary trust and immediately borrowed trust fund for note could not deduct interest because debt not genuine).
248. Comm'r v. Clark, 202 F.2d 94, 100 (7th Cir. 1953), *aff'g* 17 T.C. 1357 (1952) (upholding short-term charitable trust that antedated the regulations), *limited in* Rev. Rul. 54-48, 1954-1 C.B. 24, *and questioned in* Note, *The Seventh Circuit v. The Clifford Regulations: "Due Process" Emancipates the Tax Avoider*, 62 YALE L.J. 1236 (1953); *see* Thuet v. Riddell, 104 F. Supp. 521 (S.D. Cal. 1952); Estate of Stockstrom v. Comm'r, 7 T.C. 251, 254-55 (1946), 6 T.C.M. (CCH) 268 (1947), *vacated*, 164 F.2d 697 (8th Cir. 1947). *But cf.* Kay v. Comm'r, 178 F.2d 772, 773 (3d Cir. 1950); Farkas v. Comm'r, 170 F.2d 201, 204-05 (5th Cir. 1948); Shapero v. Comm'r, 165 F.2d 811 (6th Cir.), *cert. denied*, 334 U.S. 844 (1948); George E. Cleary, *The Clifford Regulations Reexamined*, 12 INST. ON FED. TAX'N 741 (1954).

tax the grantor of a trust on income that was not taxable to the grantor under the regulations. For example, the broad powers over beneficial enjoyment permitted by section 674(c) were not available in some instances that the *Clifford* regulations would have permitted if the power could not affect the interests of the spouse or a child of the grantor.²⁴⁹ Moreover, half of the trustees who can exercise such power must be independent, whereas under the *Clifford* regulations one independent trustee with veto power was apparently sufficient.²⁵⁰ Under changes made by the Tax Reform Acts of 1969, 1976, and 1986, there are additional circumstances not provided for in the *Clifford* regulations in which the grantor may be treated as the owner of a portion of the trust.

The *Clifford* regulations and the 1954 and 1986 Code sections depart from the cases in that they make single factors sufficient for taxation of the grantor. The Code thus sets forth three categories in which trust income will be held taxable to the grantor even if the trust is not revocable and income cannot be distributed to or accumulated for the grantor. These three categories are discussed below.

§ 5:5.1 Reverter to Grantor

Before the enactment of the Tax Reform Act of 1986, section 673 of the Code provided that the grantor was treated as the owner of any portion of a trust, regardless of who the beneficiaries may be, if, as of the inception of that portion of the trust, the corpus or the income therefrom “will or may reasonably be expected” to revert to the grantor within ten years commencing with the date of the transfer of that portion of the trust.²⁵¹ This provision continues to apply to transfers in trust made before March 2, 1986.²⁵²

Under section 673, for transfers in trust made after March 1, 1986, subject to one special rule, the grantor is treated as the owner of any

249. Treas. Reg. 118, § 39.22(a)-21(d)(2)(iv)(a)(2) (1939).

250. See generally James P. Johnson, *Trusts and the Grantor*, 36 TAXES 869 (1958); Anderson A. Owen, *Tax Planning for the Beneficiary*, 36 TAXES 876 (1958).

251. See generally and in particular with regard to a device that the 1969 amendments to section 677 will now restrict, Maurice S. Spanbock & Israel Katz, *An Attractive Trust Proposal: The Short-Term Accumulation for a Spouse*, 14 J. TAX’N 258 (1961); Harry Yohlin, *The Short-Term Trust—A Respectable Tax-Saving Device*, 14 TAX L. REV. 109 (1958).

252. Section 1402(a) of the Tax Reform Act of 1986. Apparently, it also continues to apply to any transfer in trust made after March 1, 1986, pursuant to a binding property settlement agreement entered into on or before March 1, 1986, to the extent it required the taxpayer to establish a grantor trust and for the transfer of a specified sum of money or property to the trust by the taxpayer. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1402(c)(2), 100 Stat. 2085.

portion of the trust in which he has a reversionary interest in either corpus or income, if, as of the inception of that portion of the trust, the value of the interest exceeds 5% of the value of that portion.²⁵³ This means, in effect, that regardless of the length of time before property will revert to the grantor, if the value of the grantor's interest exceeds 5% of the value of the portion, the income, deductions, and credits of the portion will be attributed to the grantor. However, under a special rule, in the case of a beneficiary who is a lineal descendant of the grantor (such as a child) who holds all the "present" interests²⁵⁴ in any portion of the trust, the grantor is not treated as the owner solely by reason of a reversion to take effect upon the death of that lineal descendant before that beneficiary attains the age of twenty-one years.²⁵⁵ Conforming amendments were made by the 1986 Act to other grantor trust provisions that substitute the 5% valuation and lineal descendant beneficiary rules for the ten-year rule used previously under the grantor trust provision.²⁵⁶

When interest rates are low, section 673 is avoided only if the term of a trust is quite long. For example, if the applicable rate under section 7520²⁵⁷ is 4%, the trust must last more than seventy-six years before the reversion may take effect to avoid section 673.²⁵⁸ This rule means a trust of a slightly shorter duration will invoke grantor trust status. The 5% rule is based on the value determined at the time the trust is created, and a subsequent decline in value of the reversionary interest as a result of increasing interest rates or an extension of the term does not appear to alter the grantor trust status.²⁵⁹

The portion rule when applied to section 673 will make a trust a grantor trust as to income if the grantor retains a reversionary interest after the term interest expires and the value exceeds 5%. Whether section 673 is applicable or not, if a reversionary interest is retained,

253. As a result of changes, discussed above, to I.R.C. § 672 made by the Tax Reform Act of 1986, the grantor generally is treated as the owner of any portion of the trust (contributed after March 1, 1986) in which the value of the grantor's spouse's interest in corpus or income exceeds 5% of the value of such portion.

254. No definition of "present interests" is provided under I.R.C. § 673. It may or may not have the same meaning as for gift tax purposes. *See* I.R.C. § 2503(b).

255. I.R.C. § 673(b).

256. *See* I.R.C. §§ 674(b)(2), 676(b), 677(a).

257. *See* I.R.C. § 7520 (providing the methodology to value term, life, and remainder interests).

258. Using a 4% interest rate, the actuarial value of a remainder interest is 5.0754% following a term certain of seventy-six years; the actuarial value of a remainder interest is 4.8801% following a term certain of seventy-seven years.

259. This interpretation is based on a literal reading of the statute. No authority exists to suggest otherwise. *See* I.R.C. § 673.

section 677(a)(2) will invoke grantor trust status as to income allocable to principal because of the reversionary interest.²⁶⁰

As to the duration question, the test is: What is the expectation as of the time of transfer of each particular portion of or addition to the trust?²⁶¹ In determining if the value of the grantor's reversionary interest exceeds 5%, it is assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest.²⁶² Also, any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is treated as a new transfer in trust commencing on the date the postponement is effective and ending on the date prescribed by the postponement.²⁶³ However, income for any such period is not to be attributed to the grantor under this postponement-of-date rule if the income would not be attributed to the grantor in the absence of the postponement.²⁶⁴

For transfers in trust before March 2, 1986,²⁶⁵ it should be noted that the expiration of a specific term of years is not considered necessary to measure the reverter. Section 673, in effect as to transfers in trust before March 2, 1986, is applicable if the reversion of the trust

260. See *supra* section 5:4.

261. Rev. Rul. 56-601, 1956-2 C.B. 458; see also *Bibby v. Comm'r*, 44 T.C. 638 (1965) (period does not commence until valid conveyance of the property). *But see* Priv. Ltr. Rul. 9906015 (minor member of Indian tribe is owner of trust to receive, hold and invest payments for tribal members for gaming proceeds and the tribe is not the owner pursuant to I.R.C. § 673, because, despite the possibility of reverter to the tribe, no reasonable assumption exists that the possibility that the minor having issue who would succeed to interest upon minor's death may be ignored or discounted). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

262. I.R.C. § 673(c).

263. I.R.C. § 673(d).

264. *Id.* See Priv. Ltr. Rul. 9152034 (indicating that if total actuarial interests of grantor in trust of which grantor retained right to annuity payments for a term and contingent reversion to take effect only if grantor died during annuity term exceeds 5%, the grantor is the owner of the entire trust); see also Priv. Ltr. Rul. 8923017 (grantor taxed on trust income where payment (1) to trust to prepay cost of funeral would revert if funeral business company ends or (2) is used to pay grantor's funeral expenses); cf. Priv. Ltr. Rul. 9906015 (minor beneficiary, who is a member of Indian tribe that creates trust, is treated as trust owner under I.R.C. § 677, and not tribe under I.R.C. § 673, because, despite reversionary interest to tribe, no reasonable assumption exists that would permit possibility of minor dying without issue who could take remainder). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

265. Which applies after 1969 (except generally for transfers in trust after March 1, 1986), even if there is a charitable beneficiary.

depends upon contingencies that may reasonably be expected to occur in less than ten years.²⁶⁶ But by specific provision a grantor is not taxable on trust income merely because he has a reversionary interest in the corpus which “is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable,” whatever the life expectancy of such person or persons at the time of the creation of the trust.²⁶⁷ The rule concerning reversion at the death of the grantor illustrates that the grantor may be taxable even if only the grantor’s estate, and not the grantor, can receive the reversion. The test in such a case is the time at which the estate may reasonably be expected to enjoy the reversion.²⁶⁸

It should be noted that section 673 refers to a reversionary interest in the income itself as well as to a reversionary interest in the corpus. Section 677 specifically covers income that may be accumulated for the grantor, although there is some doubt as to what this means. Likely, the duplication is just a case of overlap between the sections. The term “income” as here used probably should not be taken to mean future income, but it is possible that an attempt will be made to tax the grantor on the income of the first years of the trust if the trust’s income for a later year within the current greater than 5% in value test is to be distributed to the grantor. A different possible view might be that the term “income” means past income, so that if 2013’s income is accumulated to go to the grantor in less than the period applicable to the current greater than 5% in value test, then in 2014 the income earned on the 2013 accumulated income will be taxable to the grantor, even if the 2014 income is not distributed to or accumulated for the grantor.²⁶⁹

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266. It seems that similar rules should apply to the not more than 5% reversionary value rule in effect for transfers in trust after March 1, 1986. Note, however, that, in determining if the value exceeds 5%, it is assumed that any discretionary powers are exercised so as to maximize the value of the reversionary interest. I.R.C. § 673(c).
267. I.R.C. § 673(c) as in effect for transfers in trust before March 2, 1986. Where reversion will be at the death of a grantor whose own expectancy is less than ten years, the grantor is taxable. *Treas. Reg. § 1.673(a)-1(c)*; *Rev. Rul. 73-251, 1973-1 C.B. 324*; *Rev. Rul. 75-267, 1975-2 C.B. 254*.
268. *Rev. Rul. 58-567, 1958-2 C.B. 365*; *Rev. Rul. 56-601, 1956-2 C.B. 458*. Both revenue rulings were modified by *Rev. Rul. 73-251, 1973-1 C.B. 324*, solely as to the appropriate actuarial table. *Cf. Thuet v. Riddell, 104 F. Supp. 521 (S.D. Cal. 1952)*, which held that an eighty-four-year-old grantor who was entitled to \$300 annually from the corpus of a \$5,000 trust was not taxable.
269. *Cf. Comm’r v. Jergens, 127 F.2d 973 (5th Cir. 1942)*. See also *supra* text accompanying notes 207–14 (as to the possibility of taxation of the grantor if income of a later year can go to him). Compare the different language of I.R.C. § 2037(b) as to reversionary interests under the estate tax.

[A] Grantor Trust Status

A grantor’s reversionary interest causes an estate inclusion for the date of death value of the grantor’s reversionary interest determined at that time under section 2033.²⁷⁰ In addition, section 2702 will treat the entire transfer to the trust for the benefit of a “member of the transferor’s family”²⁷¹ as a gift, unless structured as a Grantor-Retained Annuity Trust (GRAT) or a Grantor-Retained Unitrust (GRUT) as described under section 2702 and applicable regulations.²⁷² Thus, grantor trust status under section 673 is generally not a choice.

§ 5:5.2 Control over Beneficial Interests

Section 674(a) provides broadly that the grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party.²⁷³ For example, if one of two co-trustees is a beneficiary who would be adverse to the exercise of the power and if the co-trustees must act by unanimous agreement, thus requiring the consent of both trustees, section 674(a) would not apply.

Many trusts will initially fall under the general rule of section 674(a), although various exceptions in sections 674(b), 674(c), and 674(d) can negate grantor trust treatment.²⁷⁴ To rely on a trustee’s general power of

270. See I.R.C. §§ 673(c), 2033.

271. See I.R.C. § 2702(a)(1). For the definition of *family member*, see section 2704(c)(2).

272. See I.R.C. § 2702; Treas. Reg. § 25.2702-3.

273. *Wysong v. Comm’r*, T.C. Memo. 1988-344 (grantor who borrows funds from banks, loans same to trust, is taxable on trust’s income under I.R.C. § 674(a), because loan is repayable to grantor upon demand, which court states enables “him to exercise complete control over the beneficial enjoyment of corpus at any time”); *Kushner v. Comm’r*, T.C. Memo. 1991-26 (similar); *Batson v. Comm’r*, T.C. Memo 1983-545, *aff’d*, 758 F.2d 652 (6th Cir. 1985) (applying I.R.C. § 674(a) to revocable trust nominally for grantor’s daughter); *Carson v. Comm’r*, 92 T.C. 72 (1989) (grantor taxable where a trustee made unequal distributions to his children when the instrument was silent as to each child’s share, despite grantor’s claim that they had to be equal); see also Priv. Ltr. Rul. 91-26-015 (trust will be grantor trust under I.R.C. § 674(a) only after the nonadverse party becomes empowered under trust terms to affect beneficial enjoyment of trust property without consent of any adverse party, and not before); Priv. Ltr. Rul. 9315010 (direction that trustee, who will later have power to control beneficial enjoyment, must be subservient, related or subordinate party will make a trust a grantor trust at that time). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

274. See I.R.C. § 674(a).

disposition to trigger grantor trust status requires very careful navigation through *all* of the many exceptions.

Application of the portion rule to section 674(a) varies depending on the nature of the power. Some powers may affect only income or only principal, but others affect both and will result in grantor trust status for the entire trust.

The broad exceptions to this sweeping provision determine its real substance. The existence of certain powers will not cause the trust income to be taxed to the grantor. These powers are divisible generally into three groups—those permitted to be held by anyone, those that may be held solely by trustees not including the grantor or the grantor’s spouse, and those broadest powers permitted to be held only by certain people.

[A] Powers Permitted to Be Held by Anyone

The powers permitted to be held by anyone, whether or not as trustee, are:

- (1) a power exercisable only by will, except where the income is accumulated for the grantor to appoint or may be accumulated by nonadverse parties for the grantor to appoint; for example, where the trust provides for income to be accumulated during the life of the grantor, then to go to the grantor’s appointees by will, the grantor is taxable on the income;²⁷⁵
- (2) a power to determine the recipients of the corpus or income, if the corpus or income is irrevocably payable to charitable beneficiaries, as specified in section 170(c);²⁷⁶
- (3) a power to pay out corpus to or for any current-income beneficiary, provided the payment is chargeable against the beneficiary’s share held in trust as if it constituted a separate trust or to or for any beneficiary (whether or not an income beneficiary),

275. I.R.C. § 674(b)(3). In a number of Private Letter Rulings, the Service concluded that the trusts in the rulings were not grantor trusts, but the transfers were not completed gifts. In the rulings, distributions could be made to grantor or grantor’s spouse, among other beneficiaries, only as instructed by a distribution committee consisting of at least two beneficiaries, eligible to receive distributions, if they act jointly or if one acts with grantor. *See* Priv. Ltr. Ruls. 201310002, 200731019, 200715005, 200502014, 200247013, 200148028. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

276. I.R.C. § 674(b)(4). *See* Winthrop v. Meisels, 281 F.2d 694 (2d Cir. 1960) (gift to such trust deductible by individual); John Danz Charitable Trust v. Comm’r, 18 T.C. 454, 461–62 (1952), *aff’d*, 231 F.2d 673 (9th Cir. 1955), *cert. denied*, 352 U.S. 828 (1956); Rev. Rul. 53-194, 1953-2 C.B. 128.

provided that the power is limited by “a reasonably definite standard,” which must be set forth in the trust instrument;²⁷⁷

- (4) a power to distribute or apply income to or for any current income beneficiary, or alternatively, to accumulate the income for the beneficiary, provided the beneficiary (or the beneficiary’s estate, or appointees) must ultimately get the income accumulated or provided that it must ultimately be payable in fixed shares to current-income beneficiaries, under rules specified in the Code and regulations;²⁷⁸ and
- (5) a power to distribute or apply income to or for a beneficiary, or alternatively, to accumulate and add the income to the corpus, provided the power is exercisable only during (a) the existence of a legal disability of any current-income beneficiary or (b) the period in which the beneficiary is under the age of twenty-one.²⁷⁹

The general rule of section 674(b) provides that certain powers may be held by anyone as a trustee or not as a trustee, without creating a grantor trust.²⁸⁰ Nevertheless, the relevant Treasury regulation provides that the exception under section 674(b)(1) is available for the grantor—and the grantor’s spouse because of section 672(e)—only when the power is held as a trustee.²⁸¹

Section 677(b)(1) provides that a trust is not a grantor trust as to income merely because some other person, the trustee, or the grantor acting as a trustee or co-trustee may apply or distribute income for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support or maintain, except to the extent that income is so applied or distributed.²⁸² Section 674(b)(1) also provides that section 677(b) preempts the general rule of section 674(a) when a trustee has discretion to use income of a trust to support someone the grantor has an obligation to support.²⁸³ In other words, when section 677(b) applies, section 674 is not applicable.²⁸⁴ A section 674(b)(1) power might cause an estate tax problem for a grantor and should be avoided

277. I.R.C. § 674(b)(5)(A). The Code does not contain the *Clifford* regulations requirement that the standard “must consist of needs and circumstances of the beneficiaries.” Treas. Reg. 118, § 39.22(a)-21(d)(2)(iv)(b)(1) (1939); see Treas. Reg. § 1.674(b)-1(b)(5) (contains examples of what is deemed a reasonably definite standard).

278. I.R.C. § 674(b)(6). See Treas. Reg. § 1.674(b)-1(b)(6).

279. I.R.C. § 674(b)(7).

280. See I.R.C. § 674(b)(1)–(8).

281. See Treas. Reg. § 1.674(b)-1.

282. See I.R.C. § 674(b)(1).

283. See *id.*

284. See *supra* section 5:4 for a detailed discussion of Code section 677.

because of section 2036(a)(2) and section 2038²⁸⁵ if distributions are mandatory or are subject to an ascertainable standard.²⁸⁶

Section 674(b)(2) provides a rule similar to section 673, so that powers are not within section 674(a) if the exercise is so far in the future that the 5% rule of section 673 would not apply to a retained interest.²⁸⁷ Because this rule is a time limit on powers that otherwise must trigger the grantor trust rules, section 674(b)(2) offers no real alternative to the other grantor powers, unless avoiding grantor trust status is actually desirable. Moreover, any such power retained by the grantor likely will be a section 2036 power because of the retained interest or power, and section 2036 ignores conditions precedent.²⁸⁸

Section 674(b)(3) excepts a testamentary power of disposition over a trust from section 674(a) grantor trust status.²⁸⁹ Excepted from the section 674(b)(3) exception is a power held by the grantor to appoint the income of a trust.²⁹⁰ Thus, retention by the grantor of a testamentary power to appoint accumulated trust income would create a grantor trust (assuming the power is not just to appoint accumulated income among charitable beneficiaries, in which event, the exception in section 674(b)(4) would apply). The “exception to the exception” for a grantor testamentary power, thereby triggering grantor trust status, applies only if the power to accumulate income must be in the discretion of the grantor or a nonadverse party or is mandatory and does not require the consent of an adverse party.²⁹¹ However, such an *inter vivos* power for the grantor to accumulate income will cause section 2036 and section 2038 to apply, and the gift *may* be incomplete in part or whole depending on the terms of the trust.²⁹² But to create a grantor trust, the power to accumulate income could be mandatory or could be held by anyone else who is not adverse to the

285. See Treas. Reg. § 20.2036-1(b)(3).

286. A mandatory requirement to pay support obligations would be a section 2036 problem; discretion to pay support obligations is less clear unless under state law, but if the trustee could be required to make payments to someone because of an ascertainable standard, section 2036 will apply. See *Estate of Gokey v. Comm’r*, 72 T.C. 721 (1979) (holding irrevocable *inter vivos* trusts for children were support trusts and included in decedent’s gross estate).

287. See I.R.C. § 674(b)(2).

288. See Treas. Reg. § 20.2036-1(b)(3).

289. See I.R.C. § 674(b)(3). Note that a power exercisable by a writing other than a will does not come under the section 674(b)(3) exception.

290. See *id.*

291. See *id.*

292. A gift is incomplete to the extent the donor does not release dominion and control. See Treas. Reg. § 25.2511-2(c). In addition, section 2702 may apply if the gift is complete in part, and incomplete in part, and the completed gift portion is to a family member. See I.R.C. § 2702.

accumulation of income.²⁹³ An income beneficiary of the trust should not be given the power to accumulate income because such a power might cause the powerholder to be treated as making a gift of income that is accumulated, and the trust will not be a grantor trust because the beneficiary would be adverse within the scope of section 674(a).²⁹⁴

A grantor-retained power to appoint accumulated income also is not a wise choice for grantor trust status, however, if it is desired that the trust property not be included in the grantor's gross estate, section 2036 would apply, causing an estate inclusion for the grantor's gross estate, regardless of who held the power to accumulate income.²⁹⁵ Nevertheless, a special power of appointment held by the grantor's spouse to appoint accumulated income would create a grantor trust because of the spousal-unity rule and would not result in an estate inclusion problem for the grantor or the spouse.²⁹⁶ The portion rule limits the grantor trust status under section 674(b)(3) to the income portion of the trust, however.²⁹⁷ If grantor trust status is sought for the entire trust, another grantor trust provision would need to be applicable for the principal portion.

A testamentary power to appoint the remainder interest in a trust held by the grantor or the grantor's spouse will cause the principal portion of a trust to be a grantor trust.²⁹⁸ The grantor retaining such a power will result in an estate inclusion for the grantor under section 2036(a)(2) and section 2038.²⁹⁹ This result is acceptable for some trusts—such as grantor-retained annuity trusts and grantor-retained unitrusts—as they will be included anyway, in whole or in part, in the grantor's gross estate

293. Section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

294. See Treas. Reg. § 25.2511-1(g)(2) (a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a "reasonably fixed or ascertainable standard"; a possible implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift would result). No cases or rulings have interpreted that regulation in this context; however, commentators have advised planners of the potential issue. See, e.g., Jerold I. Horn, *Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts*, 20 ANN. HECKERLING INST. ON EST. PLAN. ¶¶ 500, 503.2 (1986).

295. See I.R.C. § 2036.

296. See I.R.C. § 672(e). But see I.R.C. § 2041(a)(3) (treating a special power of appointment as a general power of appointment for estate tax purposes, in some cases, by the manner in which the special power is exercised). See *infra* text accompanying note 299 regarding a power limited to allocating income among charitable beneficiaries.

297. See Treas. Reg. § 1.671-3(b)(1).

298. See I.R.C. § 674(a); Treas. Reg. § 1.674(b)-1(b)(3).

299. See I.R.C. §§ 2038(a), 2036(a)(2).

by section 2036, if the grantor dies during the annuity or unitrust term³⁰⁰ but is likely not acceptable with many other types of trusts a grantor might create for estate planning purposes. A special testamentary power over the remainder held by the grantor's spouse avoids the estate tax issues,³⁰¹ however, and will create a grantor trust as to principal while both the grantor and the spouse are living. Thus, a testamentary special power held by the grantor's spouse over both accumulated income and trust principal will create a wholly grantor trust.

Section 674(b)(4) permits a power to “sprinkle” income or principal (that is, to distribute, on a discretionary basis, the income or principal) among charities that are described in section 170 without causing grantor trust status.³⁰² Thus, such a power will not cause the trust to be a grantor trust.

Section 674(b)(5) is an exception from grantor trust treatment under section 674(a) as to corpus if a “reasonably definite standard” for distributions of corpus exists,³⁰³ or if separate shares are created for the respective beneficiaries and distributions are charged against the beneficiary's share.³⁰⁴ Therefore, to establish a grantor trust by not complying with section 674(b)(5), no “reasonably definite standard” for principal distributions should be included in the trust and the trustee should have a “spray” or “sprinkle” power—any principal distributions cannot be required to be charged against the beneficiary's proportionate share of corpus. Nevertheless, unless the grantor or the grantor's spouse is a trustee, section 674(c) may prevent it from being a grantor trust.³⁰⁵ The exception under section 674(b)(5) does not apply if anyone has the power to add beneficiaries to the trust, excepting after-born or after-adopted children.³⁰⁶

300. See Treas. Reg. § 20.2036-1(c).

301. See *id.* § 20.2038(a)(3) (sections 2036 and 2038 applicable only to the transferor).

302. See I.R.C. § 674(b)(4).

303. I.R.C. § 674(b)(5)(A). Note that in Code section 674(b)(5)(A), the test is whether there is a “reasonably definite standard” without the requirement that it be “external,” as required by section 674(d). Treasury Regulation section 1.674(d)-1 references the definition of *reasonably definite standard* in Treasury Regulation section 1.674(b)-5(i), which suggests that the terms may mean the same thing.

304. See I.R.C. § 674(b)(5)(B). It seems relatively certain that if there is only one trust beneficiary, the entire trust is that beneficiary's “share” for purposes of section 674(b)(5)(B).

305. See I.R.C. § 674(c). If the grantor is a trustee, estate inclusion will occur under section 2036(a)(2) or section 2038(a)(1).

306. See I.R.C. §§ 674(b)(5) (last sentence); 674(b)(6) (last sentence); 674(b)(7) (last sentence). For a discussion of the power to add beneficiaries, see *infra* section 5:5.2[E].

Section 674(b)(6) provides an exception from grantor trust treatment as to income if *any* of the following apply: (1) income accumulated for a beneficiary ultimately must be payable to that beneficiary, to the beneficiary's estate, or to the beneficiary's appointees, which may only exclude the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate;³⁰⁷ (2) income accumulated for a beneficiary ultimately must be payable on termination of the trust, or in conjunction with a distribution of corpus that includes accumulated income, to the current income beneficiaries in shares that have been irrevocably specified in the trust instrument;³⁰⁸ or (3) income accumulated for a beneficiary must be payable to the beneficiary's appointees or to "one or more designated alternate takers (other than the grantor or grantor's estate)" if the beneficiary dies before a distribution date that could "reasonably have been expected to occur within the beneficiary's lifetime."³⁰⁹

The regulations generally provide that the section 674(b)(6) exception from grantor trust treatment will not apply "if the power is in substance one to shift ordinary income from one beneficiary to another."³¹⁰ Nevertheless, an exception to this general statement applies (meaning that the section 674(b)(6) exception applies to avoid grantor trust treatment) if the grantor or a nonadverse party has the power to shift income from one beneficiary to another by accumulating income with a provision that at a later distribution date, accumulated income will be distributed to the current income beneficiaries in shares that are irrevocably specified.³¹¹ For example, a trust instrument might provide for payment of income in equal shares to two of the grantor's children but permit withholding the distribution from either. When the youngest child reaches age thirty, the remaining trust would be distributed equally between the two. If income is withheld

307. See I.R.C. § 674(b)(6)(A). The "other than" exception seems to mean it could be a power that includes the beneficiary's estate, creditors, or creditors of the beneficiary's estate and still come under the section 674(b)(6) exception, although that would make the power a general power of appointment under section 2041 and thus cause inclusion in the powerholder's gross estate. See I.R.C. § 2041(b)(1).

308. See I.R.C. § 674(b)(6)(B).

309. See I.R.C. § 674(b)(6) (last paragraph). It should be noted that, under the section 674(b)(6)(A) exception to create a grantor trust, the power would have to be exercisable in favor of the grantor or the grantor's estate, raising the question of whether such a power triggers section 677(a). The prohibitions in the second paragraph of section 674(b)(6) on appointment to the grantor or the grantor's estate does not by its terms apply to an appointment to the grantor's spouse or the spouse's estate, but it may so apply on account of the spousal unity rule of section 672(e).

310. Treas. Reg. § 1.674(b)-1(b)(6)(i)(c).

311. See *id.*

from one, this provision has the effect of ultimately shifting one-half of the accumulated income from one child to the other. However, the power to effect this shift would not negate the exception from grantor trust treatment.³¹²

Accordingly, a provision that would prevent the section 674(b)(6) exception from applying includes the following: Permit totally discretionary distributions of current and accumulated income to be “sprayed” among beneficiaries.³¹³ Alternatively, if the grantor wishes to provide for “separate shares” for each beneficiary as to accumulated income, the trust will be a grantor trust if it is to last for the lifetime of the beneficiary and the trust does not require that accumulated income be distributed to the beneficiary’s estate or give the beneficiary a broad testamentary power of appointment.³¹⁴ The exception under section 674(b)(6) does not apply if anyone has the power to add beneficiaries to the trust excepting after-born or after-adopted children.³¹⁵

The section 674(b)(7) exception from grantor trust treatment under section 674(a) is very similar to section 674(b)(6) as it permits the accumulation of income, but only in situations when the beneficiary is under the age of twenty-one or when the beneficiary is disabled.³¹⁶ However, there is no requirement that the accumulated income ultimately be payable to the beneficiary, the beneficiary’s estate, or the beneficiary’s appointees.³¹⁷ Thus, if grantor trust status is desirable, a power to accumulate income should not be limited to periods when the beneficiary is under the age of twenty-one or legally disabled. The exception under section 674(b)(7) does not apply if anyone has the power to add beneficiaries to the trust, excepting after-born or after-adopted children.³¹⁸

Finally, under section 674(b)(8), a broad power to allocate trust receipts between income and principal for fiduciary accounting purposes will not result in grantor trust status.³¹⁹ This exception is consistent with a similar rule for estate tax purposes.³²⁰

312. See *id.* § 1.674(b)-1(b)(6)(ii), ex. 1.

313. See *id.* ex. 2.

314. See *id.* ex. 3.

315. See I.R.C. §§ 674(b)(5) (last sentence); 674(b)(6) (last sentence); 674(b)(7) (last sentence). For a discussion of the power to add beneficiaries, see *infra* section 5:5.2[E].

316. See I.R.C. § 674(b)(7).

317. See Treas. Reg. § 1.674(b)-1(b)(7).

318. See I.R.C. §§ 674(b)(5) (last sentence); 674(b)(6) (last sentence); 674(b)(7) (last sentence). For a discussion of the power to add beneficiaries, see *infra* section 5:5.2[E].

319. See I.R.C. § 674(b)(8).

320. See *Old Colony Trust Co. v. United States*, 423 F.2d 601, 603 (1st Cir. 1970).

[B] Powers of Independent Trustee

The section 674(c) exception to grantor trust status permits the trustee or trustees to have discretion to distribute income or principal without being limited by a standard for invasion if neither the grantor nor the grantor’s spouse is a trustee, and if not more than half of the trustees are related or subordinate parties who are “subservient to the wishes of the grantor.”³²¹ Requiring the consent of a person other than the trustees to exercise a discretionary power over income or principal will negate the exception from grantor trust status.³²² “Person” is not defined for this purpose.³²³ A beneficiary who must consent likely would be treated as an adverse party and should not be a “person” for this purpose, but being adverse negates the general rule of section 674(a) without regard to the section 674(c) exception.³²⁴ Who else’s consent might cause grantor trust status is not set forth in the statute or the regulations. Nevertheless, it likely means that requiring the consent of anyone who is not required to act in a fiduciary capacity and who is not adverse will negate the section 674(c) exception.³²⁵

The exception under section 674(c) can be avoided by making the grantor or the grantor’s spouse a trustee or a co-trustee who holds (or may participate in) the discretionary decision to distribute income and principal.³²⁶ A grantor with this power likely will have the assets included in his or her gross estate under section 2036 or section 2038; however, to create a grantor trust, the grantor’s spouse may hold this power without the estate inclusion issue.³²⁷ Subsection (c) does not require the spouse to

321. I.R.C. § 674(c).

322. Thus, a discretionary trust will be a grantor trust (if not falling under another exception) if someone other than a trustee may participate in the exercise of that discretion. Nonetheless, it might be contended such a person is a “de facto” trustee. *See, e.g.*, Priv. Ltr. Rul. 200731019 (Aug. 3, 2007) (whether a power to substitute property of equivalent value under section 675(4)(C) is held in a fiduciary capacity is a question of fact); *see also infra* notes 417–20 and accompanying text.

323. *See* I.R.C. § 672. However, section 7701(a)(1) defines *person* “to mean and include an individual, a trust, estate, partnership, association, company, or corporation.”

324. Code section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

325. The conclusion that *person* means anyone acting in a nonfiduciary capacity is based on the context of the requirement. The surrounding provisions deal with who may be a trustee and who may not for purposes of the section, and it may be assumed that trustees must act as fiduciaries when exercising discretion. *See infra* note 373 and accompanying text about the use of powers of appointment to create grantor trust status.

326. *See* I.R.C. § 674(c).

327. *See* I.R.C. §§ 2038(a), 2036(a)(2).

be living with the grantor,³²⁸ as is required in section 674(d).³²⁹ Grantor trust status will end, however, when the spouse dies if grantor trust status was a result only of the grantor's spouse being a trustee.³³⁰

Thus, one possible method to cause grantor trust status is to give the grantor's spouse as trustee the discretionary power to distribute income or corpus to beneficiaries, not including the spouse, without including a "reasonably definite external standard."³³¹ The spouse should not have any obligation to support the trust beneficiaries, or the spouse will be adverse and the general rule of section 674(a) will not apply.³³² If the spouse did not make any contributions to the trust, this power should not result in estate inclusion for the spouse, so long as the spouse cannot distribute to himself or herself or in satisfaction of his or her legal obligations.

Alternatively, grantor status is achieved by making more than half the trustees persons who are "related or subordinate parties who are subservient to the wishes of the grantor" and giving the trustee the discretionary power to distribute income or corpus to beneficiaries without including a reasonably definite external standard.³³³ The term "related or subordinate party" is defined in section 672(c), and

328. See *id.* § 674(c) (citing *id.* § 672(e)(2)).

329. Section 674(d) applies for trustees "none of whom is the grantor or spouse living with the grantor." *Id.* § 674(d).

330. Obviously, a deceased spouse cannot be a trustee to cause grantor trust status.

331. I.R.C. § 674(b)(5)(A). If there is a "reasonably definite standard," the section 674(b)(5)(A) exception would apply, and the trust would not be a grantor trust as to corpus. See *supra* notes 303–05 and accompanying text. The trustee must have the power to "spray" distributions among multiple beneficiaries, or else the section 674(b)(6) exception may apply as to trust income. See *supra* notes 313–14 and accompanying text. For a discussion of the "reasonably definite standard" exception under section 674(d), see *infra* notes 345–50. See also, e.g., Priv. Ltr. Rul. 200846001 (Nov. 14, 2008) (example of situation where grantor's spouse as trustee with discretionary power of distribution made grantor trust). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

332. If the spouse has an obligation to support all trust beneficiaries, including remainder beneficiaries, the spouse would not seem to be an adverse party as the spouse is not adverse to anyone; however, if the spouse is obligated to support the trust's beneficiaries, the spouse's power to distribute is likely a general power of appointment within the meaning of estate tax section 2041.

333. I.R.C. § 674(c). Note that whether a party is subservient is a factual determination. See I.R.C. § 672(c)(1), last paragraph. Because of section 672(e), this likely means subservient to the grantor's spouse as well. See I.R.C. § 672(e). With regard to the discretionary "spray" power without a standard, see *supra* note 331.

includes the grantor's spouse³³⁴ (if living with the grantor), "father, mother, issue, brother, sister, [as well as] an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, [and] a subordinate employee of a corporation in which the grantor is an executive."³³⁵

Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor. This presumption is difficult to overcome and would require a finding that the trustee is not acting in "accordance with the grantor's wishes."³³⁶

The requirement that the trustee be "subservient to the wishes of the grantor" to cause grantor trust treatment raises an interesting estate tax question. If the person who holds the power to make distributions without a standard is in fact subservient to the wishes of the grantor, does a potential estate inclusion issue arise under section 2036 and section 2038?³³⁷ *Estate of Goodwyn v. Commissioner*³³⁸ answers the question with a "no," holding that de facto control of a trustee was insufficient to cause inclusion in grantor's estate under section 2036.³³⁹ Nevertheless, whether or not someone is subservient is a question of fact, and whether that determination would in turn cause estate inclusion under section 2036 and section 2038 has some inherent uncertainty. Accordingly, some cautious

334. I.R.C. § 672(c). This provision is in addition to the rule of section 672(e). As discussed *infra* note 354 and accompanying text, the specific inclusion of a reference to section 672(e)(2) likely negates any requirement that the grantor's spouse be living with the grantor.

335. I.R.C. § 672(c). *See* Rev. Rul. 66-160, 1966-1 C.B. 164 (director of a corporation is not an "employee" within the meaning of I.R.C. § 672(c) defining the term "related or subordinate party" merely because the individual is a director); Priv. Ltr. Ruls. 9842007, 9841014 (state limited banking association not related or subordinate party within the meaning of I.R.C. § 672(c) where no trust created by grantors owned more than 10% of the voting stock, none of the trust created by one grantor when aggregated with other trusts created by the same grantor owns 10% or more of the voting power, bylaws prohibit the grantors and beneficiaries from participating in any decisions involving the exercise of discretionary powers, none of the grantors or beneficiaries, acting alone, can control the decisions of bank and each beneficiary constitutes an adverse party vis-à-vis the other beneficiary and other factors). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

336. S. REP. NO. 83-1622, at 365 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719.

337. *See* I.R.C. §§ 2036, 2038.

338. 32 T.C.M. (CCH) 740 (1973); *see also* *United States v. Byrum*, 408 U.S. 125 (1972), *aff'g* 404 F.2d 949 (6th Cir. 1971).

339. *See Goodwyn*, 32 T.C.M. (CCH) at 740.

planners are unwilling to rely on this exception to create or avoid grantor trust status.

Finally, the section 674(c) exception can be avoided by requiring the consent of the grantor's spouse to discretionary distributions if the spouse is not adverse, whether or not the spouse is a trustee.³⁴⁰

The portion rule will apply to limit grantor trust status to trust income if the section 674(c) power is solely over income.³⁴¹ A power over principal may create a wholly grantor trust rather than just a grantor trust as to principal if the power over principal may affect income.³⁴²

Because no standard for distributions need be involved with a trust that fails to satisfy the section 674(c) and section 674(b)(5)(A) exceptions, a grantor who is a trustee and who is relying on section 674 to cause grantor trust treatment likely will have an estate inclusion under section 2036 and section 2038. In addition, care must be taken to prevent creating a tax problem for any other trustee who has any obligation to support any trust beneficiary. Such a power might be construed as a general power of appointment and, therefore, gift or estate taxable under section 2041 or section 2514,³⁴³ and such a person may be deemed adverse so that section 674(a) is inapplicable.

The exception under section 674(c) does not apply if anyone has the power to add beneficiaries to the trust, except in providing for after-born or after-adopted children, as discussed in greater detail *infra*.³⁴⁴

[C] Reasonably Definite External Standard Sprinkle Powers

Section 674(d) provides that the general rule triggering grantor trust treatment as to income, but not principal, under section 674(a) will not apply when trustees—other than the grantor or grantor's spouse, who is living with the grantor—have the power to make or withhold distributions of income if the power is limited by a reasonably definite external standard.³⁴⁵

340. See I.R.C. § 672(e). See *supra* notes 44–47 and accompanying text.

341. See Treas. Reg. § 1.671-3(b)(1).

342. See *id.* § 1.671-3(b)(2).

343. See I.R.C. §§ 2041, 2514.

344. See I.R.C. § 674(c) (next to last sentence). See *infra* section 5:5.2[E] for a discussion of the power to add beneficiaries.

345. See I.R.C. § 674(d). Note that in section 674(b)(5)(A) the test is whether there is a “reasonably definite standard” without the requirement that it be “external,” as required by section 674(d). Treasury Regulation section 1.674(d)-1 references the definition of *reasonably definite standard* in Treasury Regulation section 1.674(b)-5, which suggests that the terms

Section 674(d) refers to a power over disposition of income and should preclude grantor status under section 674(a) as to income but on its face it is not applicable to a power over principal, and the regulations do not make clear that the exception does not apply to a power over principal. Nevertheless, if a dispositive power is subject to a “reasonably definite standard,” the exception in section 674(b)(5)(A) likely will prevent grantor trust status as to principal.

A trust that potentially satisfies the exception in this subsection—that is, a trust that is not a grantor trust—will provide that the trustee has discretion to distribute income among a class of beneficiaries or withhold distributions of income based on a “reasonably definite external standard.” If a grantor is willing to limit who may serve as the trustees, section 674(c) is potentially applicable instead to prevent grantor trust status when no external standard for distributions is required by the terms of the trust instrument.

The standard under section 674(d) is a “reasonably definite external standard.”³⁴⁶ Note that this standard is not necessarily the same as an “ascertainable standard” under section 2041 and section 2514.³⁴⁷ For example, an “emergency” standard appears to be a reasonably definite external standard, but it may not be an ascertainable standard under section 2041 and section 2514.³⁴⁸ Also, the “reasonably definite

may mean the same thing. Treasury Regulation section 1.674(b)-5(i) provides:

It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. . . . [h]owever, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. . . . However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

Id.

346. I.R.C. § 674(d).

347. *See id.* §§ 2041, 2514.

348. *See, e.g., Estate of Jones v. Comm’r*, 56 T.C. 35 (1971) (“in cases of emergency, or in situations affecting her care, maintenance, health, welfare and well-being,” court says that words “comfort” and “well-being” (citing *Miller v. United States*, 387 F.2d 866 (3d Cir. 1968)) and “comfort, welfare, or happiness” (citing *Treas. Reg. § 20.2041-1*) are not ascertainable); I.R.S. Tech. Adv. Mem. 8606002 (Oct. 31, 1985) (provision for distributions for ascertainable standard, coupled with power to distribute for “emergency needs,” does not constitute an ascertainable standard); I.R.S. Tech. Adv. Mem. 8304009 (Oct. 25, 1982) (“any great emergencies which may arise

external standard” may be different from the amorphous standard that courts have found will avoid estate inclusion under section 2036 and section 2038 for powers held by grantors as trustees.³⁴⁹ Thus, a grantor who is a trustee could have an estate inclusion under section 2036 and section 2038 because of the difference. Moreover, it is not clear if a power retained by a grantor limited by a reasonably definite external standard is a complete gift.³⁵⁰ In addition, care must be taken to prevent creating a tax problem for any other trustee who has any obligation to support any trust beneficiary. Such a power might be

in the lives and affairs . . . such as extra needed medical services or hospitalization” not an ascertainable standard); Priv. Ltr. Rul. 7841006 (June 19, 1978) (power to invade corpus for “emergency” without “qualifying language” created general power of appointment for section 2041). However, various other cases and private letter rulings have concluded that “emergency” is an ascertainable standard. *See, e.g.,* *Martin v. United States*, 780 F.2d 1147, 1150 (4th Cir. 1986) (“[i]n the event of the illness of [life tenant], or other emergency,” court said clear that Service argument that language created general power “was a loser,” and if argument was not “frivolous” before, it became so after *Sowell* decision of the Tenth Circuit was issued); *Estate of Sowell v. Comm’r*, 708 F.2d 1564, 1565 (10th Cir. 1983) (“in case of emergency or illness” ascertainable and measurable); *Hunter v. United States*, 597 F. Supp. 1293 (W.D. Pa. 1984) (“should any emergency arise” ascertainable standard within section 2041(b)); Priv. Ltr. Rul. 200028008 (Apr. 10, 2000) (construing reference to “other emergency” following an ascertainable standard as limited to the type of emergency covered by that standard); Priv. Ltr. Rul. 9012053 (Dec. 27, 1989) (“to relieve emergencies affecting” beneficiaries; power to invade for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of *Martin* decision). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

349. *See* I.R.C. § 674(d). *See generally* Stephen R. Akers, *Selection of Trustees: A Detailed Review of Gift, Estate, and Income Tax Effects and Non-Tax Effects*, 38 ANN. HECKERLING INST. ON EST. PLAN., ¶¶ 300, 312.6–312.7 (2004).

350. The regulations clarify that a power to change beneficial interests will not cause a transfer to be incomplete for gift tax purposes if the power is held in a fiduciary capacity and is subject to a “fixed or ascertainable standard.” Treas. Reg. § 25.2511-2(c), (g). If there is a fixed or ascertainable standard, the beneficiaries would have legal rights to force distributions according to the standard, thus divesting the donor of dominion and control over the transferred property. The regulations cited above do not give examples of what constitutes an ascertainable standard, but an analogous regulation (Treas. Reg. § 25.2511-1(g)(2), addressing powers by a trustee who has a beneficial interest in trust property) does provide details, including the requirement that the standard be such that the trustee is “legally accountable” for exercise of the power. The analogous regulation states that a power to distribute for the “education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard.” Treas. Reg. § 25.2511-1(g)(2).

construed as a general power of appointment and thus taxable under section 2514 or section 2041, unless there is an “ascertainable standard” for distributions or the powerholder might be deemed adverse so that the general rule of section 674(a) does not apply.

The portion rule will limit grantor trust status under section 674(d) to the income. However, section 674(b)(5) prevents grantor trust status if there is a similar power over principal.³⁵¹ Thus, the trust will be a grantor trust if the grantor or the grantor’s spouse, if living with the grantor, has a power of distribution over income and principal, even though limited by the requisite standard, as long as the consent of an adverse person is not required. The exception under section 674(d) does not apply if anyone has the power to add beneficiaries to the trust excepting after-born or after-adopted children, as discussed *infra*.³⁵²

[C][1] Grantor Trust Status

One way of avoiding the exception in section 674(d), even if there is a reasonably definite external standard, so that grantor trust status can be achieved as to income, but not as to principal—if none of the other exceptions apply—is by making the grantor or the grantor’s spouse, as long as the spouse lives with the grantor, the trustee or a co-trustee. Because section 672(e) generally treats a spouse the same as a grantor, a question exists whether the specific section 674(d) requirement that the spouse must live with the grantor is a limitation. The section 674(d) “living with the grantor” requirement pre-dates section 672(e), but it may have been trumped by the more expansive rule of section 672(e)(2).³⁵³ The confusion is compounded by the fact that section 674(c) specifically mentions section 672(e), while section 674(d) does not.³⁵⁴ Grantor trust status will end, however, when the spouse dies; grantor trust status may also end if the grantor

Only a few cases have addressed the ascertainable standard exception in connection with whether retained powers to change beneficial interests preclude treating a transfer as a completed gift. *See* *McHugh v. United States*, 142 F. Supp. 927, 929 (Ct. Cl. 1956) (“to provide properly ‘for the essential needs—such as food, clothing, shelter and illness expenses’” constituted ascertainable standard; transfer subject to such standard was a completed gift); *Pyle v. United States*, 766 F.2d 1141, 1143 (7th Cir. 1985) (“necessary for her health, support, comfort and maintenance requirements” constituted ascertainable standard, based on an Illinois Supreme Court case holding that the word “comfort” created an ascertainable standard; transfer subject to such standard was a completed gift), *rev’g* 581 F. Supp. 252 (C.D. Ill. 1984).

351. *See* I.R.C. § 674(b)(5).

352. *See* I.R.C. § 674(b)(7)(B). *See infra* section 5:5.2[D] for a discussion of the power to add beneficiaries.

353. *See* I.R.C. § 672(e)(2).

354. *See* I.R.C. § 674(c), (d).

and the spouse divorce or if the spouse is no longer living with the grantor if the specific rule of section 674(d) overrides section 672(e).

Section 672(e) does not include within its rule a spouse who is legally separated from the grantor at the time the power was created, but the spousal rule of section 674(d) might apply if the spouses still lived together, although legally separated.³⁵⁵ If the grantor's spouse is a beneficiary of the trust, the spouse would be an adverse party; the spouse's power of disposition as trustee then would not cause the general rule of section 674(a) to apply, but the trust will be a grantor trust under section 677 and possibly under section 676.³⁵⁶

[D] Power to Add Beneficiaries—Grantor Trust Status

The general rule of section 674(a) causes grantor trust status if the grantor or a nonadverse party holds a power of disposition, but exceptions are provided in section 674(b), 674(c), and 674(d), as discussed above. A limitation to the section 674(b)(5)–(7), 674(c), and 674(d) exceptions applies (meaning that the general rule of section 674(a) applies, thereby causing grantor trust status) if “any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.”³⁵⁷ Thus, permitting the grantor, the grantor's spouse, or another party to add beneficiaries to a trust otherwise described in sections 674(b)(5)–(7), 674(c), or 674(d) will not prevent grantor trust status if the person or persons that may be added is a potential beneficiary of both income and principal.³⁵⁸

The power to add beneficiaries will likely trigger grantor trust status even if held by a beneficiary who would be adverse to adding additional beneficiaries as long as a nonadverse party holds a power over dispositions to invoke the general rule of section 674(a).³⁵⁹ However, a beneficiary with such a power to add beneficiaries might be deemed to have a taxable general power of appointment under section 2514 if

355. See *id.* §§ 672(e)(1)(A), 674(d).

356. For a discussion of section 676, see *supra* section 5:3 and accompanying text; see *supra* notes 188–200 and accompanying text as to section 677.

357. I.R.C. §§ 674(b)(5) (last sentence); 674(b)(6) (last sentence); 674(b)(7) (last sentence); 674(c) (next-to-last sentence); 674(d) (last sentence).

358. Code sections 674(b)(5)–(7), 674(c), and 674(d) deal essentially with distributions that may be made or withheld. In other words, they do not deal with mandatory distributions. Thus, it seems relatively certain that the person or persons added as beneficiaries need not have mandatory rights to distributions to cause the limitations to these grantor trust rule exceptions to apply.

359. The power to add beneficiaries exception in I.R.C. §§ 674(b)(5)–(7), 674(c), and 674(d) does not require that the person holding the power to add

actually exercised.³⁶⁰ Similarly, a powerholder who is able to add himself or herself as a beneficiary may have section 2514 and section 2041 power of appointment issues, depending on the terms of the trust. However, if a third party, other than the powerholder, has discretion to decide whether to make distributions to any added beneficiary, it is likely that the mere power to add oneself as a potential discretionary beneficiary is not within the scope of sections 2514 or 2041.

The grantor should not hold the power to add beneficiaries because that retained power would cause the transfer to be an incomplete gift, unless that result is being sought.³⁶¹ In addition, this power, if held by the grantor, may cause trust assets to be included in the grantor's estate under section 2036 and section 2038. The grantor's spouse could hold the power and thereby make the trust a grantor trust so long as the spouse is not an adverse party.³⁶² The power of the spouse to add himself or herself would not in and of itself make the spouse adverse, except that such a power might make the spouse adverse as to adding other beneficiaries and might be a taxable power of appointment, depending on the terms of the trust.

The power to add beneficiaries might be granted to the trustee of a trust.³⁶³ However, fiduciary duties possibly limit a trustee's exercise of a power to add beneficiaries. A trustee of a trust has a fiduciary duty to act in the best interests of the trust's beneficiaries,³⁶⁴ and it is difficult to argue that adding more beneficiaries to a trust will benefit the current beneficiaries. As a result, it may be preferable to give the power to a nontrustee to avoid the issue or, at a minimum, to provide that the

beneficiaries be a nonadverse party. A power to add beneficiaries merely keeps those exceptions from applying (presumably even if held by an adverse party), and as long as a nonadverse party holds a power over dispositions, the general rule of section 674(a) would apply.

360. The power to add someone else if the powerholder is a beneficiary or has the obligation to support an existing beneficiary arguably could result in a taxable gift. *See* Treas. Reg. § 25.2511-1(g)(2); *see also* *Regester v. Comm'r*, 83 T.C. 1 (1984) (exercise of limited power of appointment by beneficiary with mandatory income interest resulted in a taxable gift).
361. *See* Treas. Reg. § 25.2511-2(c), (f); *see also* *Estate of Sanford v. Comm'r*, 308 U.S. 39 (1939).
362. A spouse who is adverse negates the application of section 674(a).
363. *See* Priv. Ltr. Ruls. 199936031 (Sept. 10, 1999) (trustee who was a nonadverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date); 9709001 (Feb. 28, 1996); 9010065 (Mar. 9, 1990) (independent trustee holding power to add charities as beneficiaries makes grantor trust). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
364. *See, e.g.*, 1 SCOTT AND ASCHER ON TRUSTS § 2.1.5 (Mark L. Ascher et al. eds., 5th ed. 2006).

power is exercisable by the trustee in a nonfiduciary capacity. But can a trustee ever do anything with respect to a trust in a nonfiduciary capacity? It might be wiser, therefore, to provide that the person who is acting as the trustee, holds the power in his or her or its individual capacity not in the capacity as trustee or any other fiduciary capacity.

The power to add beneficiaries could be so broadly stated as to permit adding any person as a permissible additional beneficiary, other than the powerholder or someone the powerholder is obligated to support. Nevertheless, many grantors may be uncomfortable granting anyone discretion that broad. The permissible classes of additional beneficiaries, however, could be limited in any manner acceptable to the grantor so long as it is clearly a larger group than the beneficiaries or a class of beneficiaries designated in the trust agreement “to receive income or corpus” or who are not after-born or after-adopted children.

The statute and applicable regulations specifically provide that a power to add after-born or after-adopted children does not trigger the exceptions to the section 674(a) exceptions, but do not specify whose children may be added, however.³⁶⁵ One view might be that the power refers only to the grantor’s children. A second, more expansive, view would allow the addition of children of a beneficiary or of any other described persons (for example, after-born children of a sibling, whether or not the sibling is a beneficiary). Because neither the Code nor any regulation clarifies the point, the safer view, if grantor status is not intended, is to assume that only after-born and after-adopted children of the grantor may be added without losing the protection of sections 674(b)(5)–(7) and 674(c)–(d).

If grantor trust status is sought, the power to add beneficiaries should be broader than after-born and after-adopted children or other after-born or after-adopted lineal descendants of the grantor and other trust beneficiaries. For example, the power might permit the addition of members of a specific group, such as nieces and nephews, spouses of children, lineal descendants who have already been born, or more remote relatives. However, it is not clear that a power to “add” persons who are already contingent remote beneficiaries would be treated as a power to add beneficiaries that would trigger grantor trust treatment. “Adding” beneficiaries in that situation arguably just elevates their beneficiary status but literally does not add them as beneficiaries.

Some commentators have questioned whether a trust is a grantor trust if the persons who may be added are not living or in existence at a specific moment in time.³⁶⁶ For example, if the power is to add

365. See Treas. Reg. § 1.674(d)-2(b).

366. See, e.g., Virginia F. Coleman, *The Grantor Trust: Yesterday’s Disaster, Today’s Delight, Tomorrow’s What?*, 30 ANN. HECKERLING INST. ON EST. PLAN. ¶¶ 800, 803.2 n. 31 (1996).

spouses of beneficiaries but none of the beneficiaries is married, is the trust a grantor trust? This situation is avoided by providing that the power includes the ability to add charitable beneficiaries generally or specifically identified charities currently in existence. Some cases and rulings have recognized grantor trust status where there is a power to add charities as beneficiaries.³⁶⁷ For a grantor who is uncomfortable with a broad power to add charities, the list of permissive charities may be short and the power to add charitable beneficiaries might be shared by several persons, so long as none of the powerholders is an adverse party; that is, a beneficiary of the trust or a person who is obligated to support a beneficiary should not have this power.³⁶⁸ Alternatively, the power to add charities might be limited to when there are no other potential beneficiaries that may be added at a specific point in time.

Also, commentators have suggested several provisions that “fine-tune” the power to add beneficiaries.³⁶⁹ These provisions include giving the powerholder the right to remove any beneficiary that is added.³⁷⁰ Also suggested is the right to provide that the person may be added for a limited amount of time, such as for the current year or for a limited number of years.³⁷¹

There is no reason, at least for grantor trust purposes, to let the power to add beneficiaries continue after the grantor dies. However, permitting the addition of beneficiaries after the grantor’s death could add opportunities to “split” the trust income among a broader class of persons.

To “toggle off” grantor trust status, the powerholder should have specific authority to release the power to add beneficiaries. To “toggle on” the grantor trust status, a special trustee or trust protector might be given the power to grant a third person the power to add beneficiaries.

367. See *Madorin v. Comm’r*, 84 T.C. 667 (1985); see also Priv. Ltr. Ruls. 199936031 (Sept. 10, 1999); 9710006 (Mar. 7, 1997); 9709001 (Feb. 28, 1997); 9304017 (Jan. 29, 1993). The reason why the power to add charities to the class of beneficiaries that triggers grantor trust status with respect to a discretionary trust is not prevented by section 674(b)(4) is because the latter rule applies only if the corpus or income is irrevocable and payable for charitable purposes (or an employee stock ownership plan (ESOP)). Presumably, if discretionary payments of corpus or income could be made to persons other than charities, the section 674(b)(4) exception could not apply. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

368. Section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

369. See Stephen R. Akers & Diana S.C. Zeydel, *Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure—Putting Grantor Trusts to Work*, 43 ANN. S. FED. TAX INST., R, R-55-57 (2008).

370. See *id.*

371. See *id.*

In other words, it seems that the power to add to the class of beneficiaries applies only for a year in which such a power may be exercised.³⁷²

A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status though it will not be effective to cause the trust to be a grantor trust if held by an adverse party.³⁷³ Thus, giving a third party (who is not a trustee and who is not a beneficiary or otherwise an adverse party) a presently exercisable power of appointment is a way to cause grantor trust status. Because the person is not a trustee, the exceptions in section 674(c) and (d) should not apply. The testamentary power of appointment exception in section 674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in section 674 would apply, so the general rule of section 674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the trust assets.

[E] Summary of “Viable” Choices for Causing Grantor Trust Status Under Section 674

A grantor trust may be created with one or more of the following powers, which should be used only if they do not create other problems (such as estate inclusion for the grantor or another person):

1. Grant a nonadverse person who is not a trustee a presently exercisable special power of appointment over both principal and income of the trust, whether an external standard exists or not.³⁷⁴
2. Designate a nonadverse person as trustee with discretion over distributions of income and principal and give a different nonadverse person the power to add beneficiaries to the trust who are not after-born or after-adopted children, and—to further reinforce grantor trust status—the power to add beneficiaries who are not after-born or after-adopted children of a named beneficiary. The persons who may be

372. Toggling is discussed in greater detail in section 5:6, *infra*.

373. See Priv. Ltr. Rul. 9643013 (Oct. 25, 1996) (trustee for one trust and grantor's spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor's descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the section 674(c) exception did not apply). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

374. See I.R.C. § 674(a). See also *supra* text accompanying note 373.

added should be living or in existence (such as a named charity), and may include, but should not be limited to, additional persons who may not currently exist, such as a spouse of a person who is not yet married.³⁷⁵

3. Name the grantor's spouse as trustee of a trust so long as the spouse does not have a legal obligation to support any beneficiary and the spouse is not a beneficiary. The terms of the trust must permit discretionary distributions of both income and principal (without a reasonably definite standard) that are charged against the trust as a whole, not against a beneficiary's share.³⁷⁶ The trust instrument should carefully plan who the successor trustees would be in the event the spouse ceases to serve, to ensure that more than half of the trustees would be related or subordinate parties so as to continue grant trust status after the spouse ceases to serve.
4. Name "related or subordinate trustees" who outnumber the trustees who are not. These trustees must be nonadverse, that is, trustees who do not have a legal obligation to support any beneficiary,³⁷⁷ and who are not themselves beneficiaries. The terms of the trust must permit discretionary distributions of both income and principal that are charged against the trust as a whole and not against a beneficiary's share.³⁷⁸ However, it must be certain that it cannot be proved that they are not subservient to the wishes of the grantor or the grantor's spouse.³⁷⁹

In nearly all cases, it is unwise for the grantor to retain any of the suggested powers. In most circumstances, it is safe to give the power to the grantor's spouse, so long as the spouse is not a beneficiary of the trust and does not have a legal obligation to support a trust beneficiary. However, if the grantor's spouse has the power, grantor trust status will terminate when the spouse dies and may terminate sooner in the

375. Section 674(a) and the exceptions in section 674(b)(5)–(7), (c), (d) do not apply. *See supra* section 5:5.2.

376. *See supra* notes 303–05 and accompanying text as to avoiding the section 674(b)(5) exception for powers over principal. As to avoiding the section 674(b)(6) exception for powers over income, *see supra* notes 310–15 and accompanying text. The exception in section 674(c) does not apply.

377. If the trustee has a legal obligation to support all beneficiaries, the trustee may not be adverse. *See supra* note 332.

378. The exceptions in sections 674(b)–(d) do not apply. *See supra* notes 303–52 and accompanying text.

379. Some cautious planners avoid this approach because of possible uncertainty over whether giving the power to someone who is subservient to the wishes of the grantor might risk estate inclusion in the grantor's estate. *See supra* notes 333–39 and accompanying text.

event of divorce. Thus, succession of powerholders should be planned if grantor trust status is to continue under section 674(a).

§ 5:5.3 Administrative Control for Benefit of Grantor

Section 675 provides that the grantor is treated as the owner of any portion of a trust over which the grantor has certain administrative powers or controls. The following are the situations covered:

- (1) Where there is a power in the grantor, nonadverse party, or both, whereby the grantor or anyone else can “purchase, exchange, or otherwise deal with or dispose of” the corpus or income for less than an adequate consideration in money or money’s worth.
- (2) Where there is a power in the grantor, nonadverse party, or both, that enables the grantor to borrow corpus or income without adequate interest or security. But if a trustee (other than the grantor) has a general power to make loans without interest or security to persons other than the grantor, the trustee’s power to make unsecured loans to the grantor on the same terms and conditions will not cause the trust income to be taxable to the grantor. Apart from this broad exception, both this and first power, are “disapproved” even if held by the trustee.³⁸⁰
- (3) Where the grantor³⁸¹ has directly or indirectly borrowed the trust corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. This rule does not apply to a loan with adequate interest and security made by a trustee other than a related or subordinate party, as defined in the statute. Because it is a grantor trust—and therefore under Revenue Ruling 85-13 the interest isn’t treated as paid.³⁸²

380. See Treas. Reg. § 1.675-1(c). In general, H.R. REP. NO. 83-1337, at 4089, and S. REP. NO. 83-1622, at 366, state that, except where otherwise provided, the fact that a power is held in the capacity of trustee is not material.

381. The grantor is generally treated as holding any interest or power of his or her spouse as defined, and for the periods, specified in I.R.C. § 672(e). For any periods during which an individual is treated (under I.R.C. § 672(e)(2)) as the spouse of the grantor, any reference in I.R.C. § 675(3) to the grantor includes a reference to such person so treated as the grantor’s spouse.

382. Cf. I.R.C. § 267; *Mau v. United States*, 355 F. Supp. 909, 912 (D. Haw. 1973) (the borrowing of trust property or trust income by the grantor at any time during the taxable year will result in the taxability of the grantor

- (4) Where any one of the following powers of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of anyone in a fiduciary capacity:
- (a) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control;³⁸³
 - (b) a power to control investment of trust funds either by directing or vetoing proposed investments or reinvestments to the extent that the trust consists of securities of corporations in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control (apparently broad powers over other types of investments being permissible);³⁸⁴ or
 - (c) a power to reacquire trust corpus by substituting other property of equivalent value.

The portion rule applies to section 675; thus, to create a wholly grantor trust (that is, one that is a grantor trust in its entirety) by

on the income of that year). It seems that this provides an opportunity to change “retroactively” the tax effect of a transaction that has already occurred during the year, such as attributing the trust’s income, gains, losses, or credits to the grantor. *See* *Benson v. Comm’r*, 76 T.C. 1040 (1981); *see also* *Bennett v. Comm’r*, 79 T.C. 470 (1982) (grantor trust, in part, as a result of indirect borrowing through partnership of which grantor is partner but not as to loan to corporation); *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984) (indirect borrowing, resulting in grantor trust status, arising on sale to grantor from trust for his inadequately secured note). The Service will not follow *Rothstein*. Rev. Rul. 85-13, 1985-1 C.B. 184. In many, but certainly not all, sections of the Code there are explicit provisions dealing with the effect under those sections of grantor trusts—*e.g.*, I.R.C. § 318(a)(2)(B)(ii), (3)(B)(ii). *See* I.R.C. § 163 for restrictions and limits on the deductibility of interest payments. *See also* I.R.S. Tech. Adv. Mem. 8802004 (I.R.C. § 675(3) (applies when grantor-trustee fails to enforce or pay interest or corpus on note to partnership from grantor that is later transferred to the trust). Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110(k)(3).

383. Compare the inclusion in the gross estate for estate tax purposes of retained voting rights of I.R.C. § 2036(b).

384. S. REP. NO. 83-1622, at 4719 (1954); *see* *United States v. Byrum*, 408 U.S. 125 (1972), *aff’g* 404 F.2d 949 (6th Cir. 1971) (estate tax: veto of transfer permitted, even with power to vote); *Holdeen v. United States*, 297 F.2d 886 (2d Cir. 1962) (for year 1946: investment advice permitted); *Estate of Gilman v. Comm’r*, 65 T.C. 296 (1976), *aff’d*, 547 F.2d 32 (2d Cir. 1977). *But see supra* note 383; I.R.C. § 2036(e).

“violating” section 675, the power must affect both income and principal in their entireties.³⁸⁵

[A] Section 675(1)—Power to Deal with Trust Assets for Less Than Full and Adequate Consideration

Section 675(1) provides that a power in the grantor or the grantor’s spouse³⁸⁶ or any nonadverse party, or both, to deal with the trust assets for less than full and adequate consideration results in grantor trust status.³⁸⁷ Creating a grantor trust in such a manner may be unwise, however, because that power likely will cause estate tax problems for the powerholder.³⁸⁸

[B] Section 675(2)—Specific Power of Grantor to Borrow Trust Assets Without Adequate Security or Adequate Interest—Grantor Trust Status

Section 675(2) provides that a power in the grantor or the grantor’s spouse³⁸⁹ to borrow trust income or corpus without adequate security or without adequate interest being charged will result in grantor trust status.³⁹⁰ Excepted from this provision is a power in the trustee to make similar loans to others (besides the grantor or the grantor’s spouse).³⁹¹ The mere existence of the “general lending power” is sufficient to cause grantor trust status regardless as to whether the power is actually exercised. (Contrast this provision with section 675(3), discussed below,³⁹² which requires an actual borrowing of trust funds by the grantor to cause grantor trust status.) As long as the power extends to borrowing corpus or income from the trust, grantor trust status will result as to the entire trust.³⁹³

While the statute refers to permitting the grantor to borrow, the inclusion of a power of a nonadverse party to enable the grantor or the grantor’s spouse to borrow trust income or corpus without adequate security or without adequate interest being charged may

385. See I.R.C. § 671; *see also* Treas. Reg. § 1.675-1(a) (referring to Treas. Reg. §§ 1.671-2 and 1.671-3).

386. The grantor’s spouse is included as a result of section 672(e).

387. See I.R.C. § 675(1).

388. Such problems likely will arise under sections 2036 and 2038 if the power is held by the grantor, and under section 2041 if held by anyone else.

389. Or the grantor’s spouse as a result of section 672(e).

390. See I.R.C. § 675(2).

391. The grantor’s spouse, as a result of section 672(e).

392. See *infra* section 5:5.3[C].

393. See I.R.C. §§ 675, 671; *see also* Treas. Reg. § 1.675-1(a) (referring to Treas. Reg. §§ 1.671-2 and 1.671-3).

trigger section 675(2) even if the grantor cannot compel the loan.³⁹⁴ As discussed below, a power of a nonadverse party to lend or to force the trustee to lend to the grantor seems preferable to giving the grantor the explicit power to borrow in a manner that invokes this section.

If the grantor or the grantor's spouse has the power to borrow, alone or with the consent of a nonadverse party, or a nonadverse party has the power to lend funds, either without adequate security or without adequate interest, the trust is a grantor trust. Grantor trust status, therefore, may be achieved if the trustee has the express power to lend unsecured to the grantor, even if the loan must provide for adequate interest.³⁹⁵ To help avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate inclusion, the lending power should be limited to the authority to make loans without security and should not include the authority to make loans to the grantor without adequate interest. Furthermore, to assure the adequacy requirement is satisfied, the power should be drafted in a manner that explicitly permits making loans without *any* security to the grantor or without adequate security within the meaning of section 675(2).³⁹⁶ If a trustee makes the decision to lend funds to the grantor without adequate collateral, the trustee may require a higher interest rate to carry out the trustee's fiduciary duty to act in the best interests of the trust.

394. See Treas. Reg. § 1.675-1(b)(2); Priv. Ltr. Rul. 200840025 (Oct. 3, 2008). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

395. See Priv. Ltr. Ruls. 199942017 (Oct. 22, 1999) (grantor who has authority to borrow all or any of the corpus or income "without adequate security" is treated as owner of trust; that is, it is a grantor trust); 9645013 (Nov. 8, 1996); 9525032 (June 23, 1995). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

396. See Priv. Ltr. Ruls. 9645013 (Nov. 8, 1996) (nonadverse party authorized to lend to the grantor without security causes grantor to be treated as owner of trust); 9525032 (June 23, 1995) (grantor's power to borrow without security causes GRAT, described in section 2702(b), to be grantor trust). However, in Priv. Ltr. Rul. 199942017 (Oct. 22, 1999), the Service issued a ruling that a trust would be a grantor trust when the grantor retained the power to borrow all or any portion of the corpus or income of the trust "without adequate security." (Presumably, the result would be the same if the trustee merely had the power to lend without adequate security, as opposed to the grantor having the power to borrow without adequate security.) It is interesting to note that in that ruling the S corporation and the grantor who were seeking the grantor trust ruling represented that their intention was "that this section allows Settlor to exercise this power unconditionally, without the approval of the trustees, or any other party." *Id.* Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

A provision permitting the grantor as trustee to make loans to himself or herself without adequate security would cause grantor trust treatment under section 675(2) but could risk estate inclusion for estate tax purposes if the power gives the grantor the authority to obtain trust assets for less than full and adequate consideration. To minimize this estate inclusion risk, the power to lend to the grantor should be held by the grantor's spouse or a nonadverse party other than the grantor or the grantor's spouse. Revenue Ruling 95-58,³⁹⁷ an estate tax revenue ruling that permits a grantor to remove a trustee without risking estate inclusion under section 2036 or 2038 as long as the replacement trustee is required to be someone who is not a related or subordinate party within the meaning of section 672(c), seems consistent with this conclusion.³⁹⁸

[C] Section 675(3)—Actual Borrowing of the Trust Assets by the Grantor—Grantor Trust Status

Section 675(3) provides that if the grantor borrows the trust corpus or income, and has not entirely repaid the loan, including interest, before the beginning of a tax year, the trust is a grantor trust for that year.³⁹⁹ Grantor trust treatment will not arise if the loan provides for adequate interest and security, and if the loan is made by a trustee other than the grantor, the grantor's spouse, or a trustee who is a related or subordinate party subservient to the grantor.⁴⁰⁰ If the borrower is the grantor's spouse, the same rule would apply as a result of section 672(e), so long as section 672(e) applies.⁴⁰¹

Grantor trust status under section 675(2) and section 675(3) overlap to some degree, as both deal with borrowing by the grantor or the grantor's spouse. However, in some situations section 675(3) will apply when section 675(2) does not. For example, actual borrowing from the trust with adequate security and adequate interest by the grantor or the grantor's spouse causes it to be a grantor trust under section 675(3) if the loan is made by a trustee who is a related or subordinate party within the meaning of section 672(c) and who is subservient to the wishes of the grantor,⁴⁰² regardless of the ability to make similar loans, but such a loan is not described in section 675(2).⁴⁰³ Alternatively, if the trust document is silent about

397. Rev. Rul. 95-58, 1995-2 C.B. 191.

398. *See id.*

399. *See* I.R.C. § 675(3).

400. "Related or subordinate party" is defined in section 672(c). "Subservient" is defined in Treas. Reg. § 1.672(c)-1.

401. *See supra* notes 43-47 and accompanying text.

402. *See* I.R.C. § 675(3).

403. Section 675(2) applies if the grantor or the grantor's spouse can borrow from the trust without adequate security and adequate interest. Similarly, section

loans to the grantor or the grantor's spouse so that section 675(2) is not applicable, section 675(3) will apply if a trustee who is the grantor, the grantor spouse, or a related or subordinate party⁴⁰⁴ makes a loan to the grantor or the grantor's spouse with or without adequate security and with or without adequate interest.⁴⁰⁵ Thus, a loan to the grantor or the grantor's spouse with or without adequate security and with or without adequate interest made by the grantor or the grantor's spouse as the trustee will cause grantor trust status under section 675(3). Less certain would be a loan by a related or subordinate trustee, because the determination of whether a related or subordinate party is subservient to the wishes of the grantor is a question of fact that is less than a certainty.⁴⁰⁶

The section 675(3) statutory language provides that grantor trust status depends upon a loan being outstanding at the beginning of a taxable year and not repaid in full before the end of the year.⁴⁰⁷ Thus, if borrowing occurs during a tax year and the loan is repaid by the end of the year, grantor trust status would not seem to exist for that year. However, the courts and the Service interpret section 675(3) to create grantor trust status if the loan to the grantor is outstanding at any time during the year.⁴⁰⁸ For example, if a loan is outstanding at the end of one tax year and repaid early in the next tax year, the grantor would be treated as owning the trust for all of both years. Thus, it is possible to make a loan to the grantor on December 30 of a year, and the trust will be a grantor trust for that entire year. Hypothetically, this strategy could be used in year-end planning to create a grantor trust retroactively for the year. In response to such a plan, the Service might take the position at some point that this strategy is an abusive one, despite the outstanding case and its own Revenue Ruling that it is obligated to follow.⁴⁰⁹

675(2) applies if the trustee is authorized to make loans to the grantor or the grantor's spouse without adequate security or adequate interest. Actually borrowing is not necessary. This rule is not applicable if loans can be made to others over, unless the grantor or spouse is trustee. *See id.*

404. And who is subservient to the wishes of the grantor. *See id.* § 675(3).

405. Of course, the trustee must evaluate his or her fiduciary duties as trustee to determine if such a loan is prudent, if not authorized by the terms of the trust.

406. *See supra* notes 377–79 and accompanying text discussing the meaning of “related and subordinate trustees.”

407. “The grantor has . . . borrowed . . . and has not completely repaid . . . before the beginning of the taxable year.” I.R.C. § 675(3).

408. *See Mau v. United States*, 355 F. Supp. 909 (D. Haw. 1973); Rev. Rul. 86-82, 1986-1 C.B. 253 (following *Mau*).

409. *But see Rauenhorst v. Comm’r*, 119 T.C. 157 (2002) (holding Commissioner cannot “litigate against officially published rulings without first withdrawing or modifying them”).

Whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus that could have been borrowed if some borrowing occurs is unclear.⁴¹⁰ Thus, unless the grantor borrows all of the trust's assets, no assurance can exist that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

Because grantor trust status under section 675(3) is predicated on actual borrowing, toggling grantor trust status "on" and "off" seems possible.⁴¹¹ If the grantor wanted to achieve grantor trust status in any particular year, the grantor could borrow all of the trust funds for some period of time during the year. If the trustee is not a related or subordinate party, the borrowing should not provide for adequate security.⁴¹² However, if the trustee is a related or subordinate party, subservient to the grantor, the borrowing may provide for adequate interest and security and still result in grantor trust status.⁴¹³ The grantor would need to repay the entire amount of the loan, including interest, by the end of the taxable year so that the grantor could make an independent decision in the following year whether the grantor trust status was desired in that year.

Section 675(3) may be used to convert a nongrantor trust into a grantor trust by having the grantor buy back all of the trust assets for a note, if the note is unsecured but with adequate interest, and grantor trust treatment is effective for that sale.⁴¹⁴

410. *Compare* Bennett v. Comm'r, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; grantor was taxable on portion of current year's income that the principal of the loan at the beginning of the year bears to the total trust income from the trust inception), *with* Benson v. Comm'r, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; grantor should be treated as the owner of the entire trust for taxable years loan unpaid).

411. *See* I.R.C. § 675(3).

412. The loan should provide for adequate interest to avoid issues of whether the trustee might be breaching fiduciary duties and possible estate inclusion issues for the grantor. For a discussion of section 675(1), *see supra* notes 386–88 and accompanying text.

413. A loan made to the grantor with adequate interest and adequate security by a related or subordinate trustee should not be an estate tax problem for the grantor because of the adequate interest and adequate security.

414. *See* Rev. Rul. 85-13, 1985-1 C.B. 184 (no gain is recognized because grantor owns "purported consideration both before and after the transaction"). However, the Second Circuit held that such a purchase of trust assets for a note caused the trust to be a grantor trust as to future transactions, but the purchase transaction itself resulted in gain recognition. *See* Rothstein v. United States, 735 F.2d 704, 710 (2d Cir. 1984).

[D] Section 675(4)—Administrative Powers

The powers under section 675(4) commonly are considered when grantor trust status is sought. Section 675(4) triggers grantor trust status when someone in a nonfiduciary capacity has a power to vote closely held stock or to control trust investments related to closely held stock if the trust's holdings of the closely held stock are "significant from the viewpoint of voting control."⁴¹⁵ In addition, a nonfiduciary power to reacquire trust corpus and replace with property of equivalent value will result in grantor trust status.⁴¹⁶ Excepted from these rules are powers that require the consent of someone who must act in a fiduciary capacity.

All powers under subsection (4) must be exercisable in a nonfiduciary capacity to make a trust a grantor trust for income tax purposes. A power exercisable by a trustee will be presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.⁴¹⁷ Under the regulations, if a power is not exercised by a person as trustee, the "determination of whether the power is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and

415. I.R.C. § 675(4)(A). Voting control significance is not defined in the Code or Regulations for purposes of section 675(4)(A).

416. See I.R.C. § 675(4)(C).

417. See Treas. Reg. § 1.675-1(b)(4); see also *Wheeling Dollar Sav. & Trust Co. v. Yoke*, 204 F.2d 410 (4th Cir. 1953) (income of trusts taxable to grantor; involving other powers also), *cert. denied*, 346 U.S. 898 (1953); cf. *Friedman v. Comm'r*, 7 T.C. 54 (1946) (where the major factor leading to taxability of the grantor was his retention, as trustee, of broad powers of administration). In the case of an oral trust, it is difficult to show that the powers are suitably limited. See *Reizenstein v. Comm'r*, 22 T.C. 843 (1954). As to the standards for creation of an oral trust, see *Del Drago v. Comm'r*, 214 F.2d 478 (2d Cir. 1954). For cases of nontaxability where administrative powers were retained as trustee, see, e.g., *Cushman v. Comm'r*, 153 F.2d 510 (2d Cir. 1946) (some powers held as grantor considered "negligible"); *Fruehauf v. Comm'r*, 12 T.C. 681 (1949); *Welch v. Comm'r*, 8 T.C. 1139 (1947); *Smith v. Comm'r*, 4 T.C. 573 (1945); and *Weisman v. Comm'r*, 3 T.C.M. (CCH) 723 (1944). See also Priv. Ltr. Ruls. 9642039 (Oct. 18, 1996) (section 675(4)(C) applied when power of substitution held by person other than grantor); 9247024 (Nov. 20, 1992) (grantor who is not trustee but retains power to substitute property of trust is taxed on income of so-called charitable lead unitrust; does not discuss that the exercise of such a power may be subject to an excise tax under section 4941 for self-dealing); 89-30-021 (July 28, 1989) (section 675(4)(C) applied when trustee, who was also the beneficiary, given the power by modification of the trust and held in nonfiduciary capacity). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

administration.”⁴¹⁸ In general, the regulations indicate that the presence of administrative powers will be judged not only by the provisions of the trust instrument but also by the actual facts of administration.⁴¹⁹ In private rulings the Service generally has ruled that the application of section 675(4) is a question of fact that may only be resolved in an examination after returns have been filed.⁴²⁰ This position seems questionable when the power is made exercisable only in a nonfiduciary capacity within the meaning of section 675(4).

[E] Section 675(4)(A) and (B)—Powers over Closely Held Stock—Grantor Trust Status

The first two powers under section 675(4)—the power of any person acting in a nonfiduciary capacity to control voting of or investments in

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418. Treas. Reg. § 1.675-1(b)(4); *see also* *Richards v. Comm’r*, 213 F.2d 494 (5th Cir. 1954), *rev’g* 19 T.C. 366 (1952); *Moskin v. Johnson*, 115 F. Supp. 565 (S.D.N.Y. 1953), *aff’d*, 217 F.2d 278 (2d Cir. 1954); *cf.* *Estate of Hamiel v. Comm’r*, 253 F.2d 787 (6th Cir. 1958); *Hemphill v. Comm’r*, 8 T.C. 257, 265 (1947) (irregularities in the administration of a trust, subsequently corrected, did not transform income otherwise taxable to the trust into income taxable to the grantor). *See generally* *Query v. Comm’r*, 13 T.C.M. (CCH) 891 (1954); *Morgan v. Comm’r*, 5 T.C. 1089 (1945). Several private letter rulings indicate the Service’s position is that whether or not the power to substitute property of equivalent value is held in a nonfiduciary capacity is a question of fact even if the trust agreement expressly provides it is held in a nonfiduciary capacity. *See, e.g.*, Priv. Ltr. Ruls. 9335028 (Sept. 3, 1993); 9126015 (June 28, 1991); *cf.* Priv. Ltr. Rul. 9345035 (Nov. 12, 1993); 201349001 (July 11, 2013). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
419. *See* Treas. Reg. § 1.675-1(a); *see also* *Goemans v. Comm’r*, 279 F.2d 12 (7th Cir. 1960) (under prior regulations).
420. *See, e.g.*, Priv. Ltr. Ruls. 200731019 (Aug. 3, 2007); 200715005 (Apr. 13, 2007); 199942017 (Oct. 22, 1999); 9645013 (Nov. 8, 1996); 9525032 (June 23, 1995); 9407014 (Feb. 18, 1994); 9352007 (Dec. 30, 1993); 9352004 (Dec. 30, 1993); 9337011 (Sept. 17, 1993); 9335028 (Sept. 3, 1993); 9253010 (Jan. 1, 1993). Other letter rulings have not applied the facts and circumstances requirement but have held that the substitution power caused the trust to be a grantor trust. *See* Priv. Ltr. Ruls. 9451056 (Dec. 23, 1994); 9352017 (Dec. 30, 1993); 9351005 (Dec. 24, 1993); 9345035 (Nov. 12, 1993). Some rulings have applied a compromise approach, stating the grantor trust determination depends on the facts and circumstances but, assuming exercise of a section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. *See, e.g.*, Priv. Ltr. Ruls. 9810019 (Mar. 6, 1998) (charitable lead trust); 200434012 (Aug. 20, 2004) (power of substitution held by person(s) other than the grantor or the grantor’s spouse causes trust to be a grantor trust under section 675(4)(C), if in fact held in a nonfiduciary capacity). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

closely held stock⁴²¹—may have some utility but are limited to situations in which the trust is funded with closely held stock.⁴²² This limited use of controlling the voting of closely held stock is restricted by the potential estate tax problem under section 2036(b) if the grantor has the power.⁴²³ However, the right to veto a sale of the closely held stock covered in section 675(4)(B) should not cause estate inclusion under section 2036(b) as long as it is held by someone other than the grantor.⁴²⁴ But, of course, grantor trust status presumably would end when the stock is sold, assuming the trust is not a grantor trust for some other reason. Grantor trust status may be achieved safely under this subsection, and the estate tax problem avoided, if a married grantor gives the power to vote closely held stock to his or her spouse in a nonfiduciary capacity, but grantor status would end upon the death of the spouse unless there is a successor powerholder or the trust is a grantor trust for some other reason.

The portion rule will limit grantor trust status under section 675(4)(A)–(B) to the closely held stock and, if the trust owns other assets, it will not be a grantor trust in its entirety, unless it is a grantor trust for some reason other than section 675(4)(A)–(B).⁴²⁵ One circumstance when such grantor trust status under section 675(4)(A) and (B) might be used is where the stock is in an S corporation; a grantor trust is an “eligible” shareholder of an S corporation if the grantor would be eligible.

421. See I.R.C. § 675(4)(A)–(B). Closely held stock for purposes of section 675(4) means “stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.” *Id.* Conceivably, this stock could be a small block of stock if there are relatively few shareholders and if the block could constitute a “swing vote.”

422. See S. REP. NO. 83-1622, at 365 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719. See also *United States v. Byrum*, 408 U.S. 125 (1972), *aff’g* 404 F.2d 949 (6th Cir. 1971) (estate tax not applicable to transferred property, even though power to vote retained); *Holdeen v. United States*, 297 F.2d 886 (2d Cir. 1962) (for year 1946: grantor permitted to give investment advice to trustees); *Estate of Gilman v. Comm’r*, 65 T.C. 296 (1975), *aff’d*, 547 F.2d 32 (2d Cir. 1977).

423. See I.R.C. § 2036(b). Under section 2036(b), shares of stock in a corporation transferred by the decedent during his or her lifetime for less than full and adequate consideration in money or money’s worth are included in the transferor’s estate if the transferor retained the power directly or indirectly to vote the stock and held that power at death or relinquished it within three years of death and the block represents at least 20% of the voting rights of all classes of stock. See *id.*

424. Cf. *Byrum*, 408 U.S. at 137–38.

425. See Treas. Reg. § 1.671-3(d)(2).

Section 675(4)(A)–(B) does not seem to apply to control over a limited liability company (LLC). LLCs did not exist when section 675(4) was enacted in 1954.⁴²⁶ It does not apply to a partnership.

[F] Section 675(4)(C)—Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets by Substituting Assets of Equivalent Value—Grantor Trust Status

Section 675(4)(C) provides that “a power to reacquire the trust corpus by substituting other property of an equivalent value,” held in a nonfiduciary capacity by any person who can exercise it without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment.⁴²⁷ Even though section 675(4)(C) refers to a power to reacquire “trust corpus,” this power causes the grantor to be treated as the owner of trust corpus and income, including ordinary income not allocable to corpus.⁴²⁸

The regulations provide that “the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.”⁴²⁹ Because grantor trust status depends upon the power being held in a “nonfiduciary” capacity, the power of substitution should not be held by the trustee (or else the requirement in the initial sentence of section 675(4) will not be satisfied).⁴³⁰ Similarly, a trustee’s approval or consent should not be required. The regulations provide that if a power is exercisable by a person “as trustee,” a rebuttable presumption exists that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.⁴³¹

The power should not be held by an adverse party if grantor trust status is sought by reason of the power. Even though several other clauses of section 675 require that a power be exercisable by a

426. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992). What may be less clear, however, is whether a LLC or a partnership that elects to be income taxed as an association (corporation) might be deemed a corporation for this purpose.

427. I.R.C. § 675(4)(C).

428. See Treas. Reg. § 1.671-3(b)(3).

429. Treas. Reg. § 1.675-1(b)(4). See *supra* notes 417–20 and accompanying text for a discussion of the nonfiduciary capacity requirement.

430. The initial sentence of section 675(4) provides that the nonfiduciary power must be exercisable without the approval or consent of anyone acting in a fiduciary capacity.

431. See Treas. Reg. § 1.675-1(b)(4).

nonadverse party to cause the trust to be a grantor trust,⁴³² subsection 675(4) merely refers to powers held “by any person.”⁴³³ No requirement exists that the power be held by a nonadverse party. However, the regulations refer to powers of administration held in a nonfiduciary capacity “by any nonadverse party.”⁴³⁴ Despite the clear contradiction of the statute and regulations, the regulation possibly might be upheld under the broad deference standard announced in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*⁴³⁵ Even so, it is difficult to understand how someone’s power to substitute assets for equivalent value could be adverse as to that person, thus creating a disincentive to exercise the power. To be safe, however, in making the trust a grantor trust by means of the substitution power, the power should not be held by a trust beneficiary or anyone else who might be considered an adverse party.

Whether the grantor’s retention of a nonfiduciary power to substitute assets of equivalent value causes an inclusion in the grantor’s estate for estate tax purposes has a relatively long history. A power of the grantor to substitute assets of equivalent value does not cause section 2036 or section 2038 to apply when it is held in a fiduciary capacity. In *State Street Trust Co. v. United States*,⁴³⁶ the court concluded in a “very close”⁴³⁷ case that broad management powers retained by the grantor, including the power to exchange trust property for other property without regard to the values of the properties, among other broad powers, caused the predecessor to section 2036 to apply.⁴³⁸ After the *State Street* decision, the Service argued in *Estate of Jordahl v. Commissioner*⁴³⁹ that a substitution power for equal value held by the grantor-trustee constituted a power to alter, amend, or revoke the instrument. The Tax Court disagreed, reasoning that because any property substituted should be “of equal value” to the property replaced, the grantor was thereby prohibited from depleting the trust corpus.⁴⁴⁰ The court viewed that situation as being no different from a case in which a settlor retains the power to direct

432. See I.R.C. § 675(1), (2).

433. I.R.C. § 675(4).

434. Treas. Reg. § 1.675-1(b)(4).

435. *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984). See Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731 (2002).

436. *State St. Trust Co. v. United States*, 263 F.2d 635 (1st Cir. 1959) (Magruder, C.J., dissenting).

437. *Id.* at 638.

438. See *id.* at 638–40.

439. 65 T.C. 92 (1975), *acq. in result* 1977-2 C.B. 1.

440. *Id.* at 96.

investments.⁴⁴¹ The Service subsequently acquiesced in the *Jordahl* decision.⁴⁴²

Private Letter Ruling 200603040 concerned a trust with a substitution power where “[t]he instrument provides that Grantor’s power to acquire Trust property under this section may only be exercised in a fiduciary capacity.”⁴⁴³ The ruling concluded that the substitution power would not cause estate inclusion under sections 2033, 2036 (a), 2036(b), 2038, or 2039.⁴⁴⁴ The ruling focused on the fact that the instrument said that the substitution power could be exercised only in a fiduciary capacity.⁴⁴⁵ In *Jordahl*, the decedent was a co-trustee,⁴⁴⁶ so one might infer that all powers held by the grantor-trustee in that case were held in a fiduciary capacity. However, the letter ruling interpreted *Jordahl* somewhat differently:

Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.⁴⁴⁷

According to the Service’s analysis in the ruling, the reasoning of the court suggests that any substitution power may be exercisable only in a fiduciary capacity to not cause estate tax inclusion. That interpretation might explain why the Service refuses to rule whether a substitution power is held in a nonfiduciary capacity so as to be a grantor trust trigger under section 675(4), even though the instrument specifically says the power is not held in a fiduciary capacity.

Similarly, in Private Letter Ruling 20060006, the Service held that section 2036 would not apply to a situation in which the substitution power was held by the grantor in a fiduciary capacity.⁴⁴⁸ Without changing the trust under state law so that the trustee would hold the

441. See *id.* at 96–97.

442. 1977-2 C.B. 1.

443. Priv. Ltr. Rul. 200603040 (Jan. 20, 2006). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

444. See *id.*

445. See *id.*

446. See *Estate of Jordahl v. Comm’r*, 65 T.C. 92, 93 (1976), *acq.* in result 1977-2 C.B. 1.

447. Priv. Ltr. Rul. 200603040. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

448. See Priv. Ltr. Rul. 200606006 (Feb. 10, 2006). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

substitution power in a fiduciary capacity, the Service would not give a favorable ruling on section 2036.⁴⁴⁹

Jordahl is often cited for the proposition that a substitution power does not trigger section 2036, but under the facts of *Jordahl*, the grantor held the power in a fiduciary capacity.⁴⁵⁰ The issue is a bit different, however, if the grantor retains a substitution power in a *nonfiduciary* capacity, so as to cause the trust to be a grantor trust under section 675(4)(C).⁴⁵¹ Nevertheless, the *Jordahl* court's reasoning suggests the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of "equal value" indicates that the power was held in trust. . . . We do not believe that decedent could have used his power to shift benefits in [a manner to deprive the remaindermen of benefits or to deprive an income beneficiary of property]. Substitutions resulting in shifted benefits would not be substitutions of property "of equal value."⁴⁵²

The regulations and other authority under estate tax sections 2036 and 2038 say that how the power is held makes no difference.⁴⁵³ If the power exists, holding the power in a fiduciary capacity does not help. So if the substitution power were taxable in *Jordahl*, holding it in a fiduciary capacity would not have helped. Stated differently, if holding a power in a fiduciary capacity does not help to cure a section 2036 or section 2038 problem, then holding a power in a nonfiduciary capacity should not trigger a section 2036 or section 2038 situation when holding it in a fiduciary capacity would not, or vice versa. Therefore, *Jordahl* does seem to provide protection from section 2036 inclusion.

449. In the facts of this ruling, other grantor trust triggers were present; the trust was a grantor trust even without a nonfiduciary substitution power. The substitution power was important to the grantor in the ruling because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests. *See id.* Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

450. *See Jordahl*, 65 T.C. at 97.

451. *See* I.R.C. § 675(4)(c).

452. *Jordahl*, 65 T.C. at 97 (citations omitted).

453. *See* Treas. Reg. §§ 20.2036-1(b)(3) ("[I]t is immaterial . . . in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent."); 20.2038-1(a) ("It is immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent.").

Commentators generally have concurred that the *Jordahl* result should apply even when the substitution power is held in a nonfiduciary capacity.⁴⁵⁴ In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion.⁴⁵⁵

Revenue Ruling 2008-22⁴⁵⁶ provides very helpful guidance on the estate tax issue. It says that a grantor-held nonfiduciary substitution power generally will not trigger estate inclusion under section 2036 or section 2038.⁴⁵⁷ The ruling cites *Jordahl*, but says that section 2038 did not apply because the decedent was bound by fiduciary standards.⁴⁵⁸ Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted.⁴⁵⁹ Indeed, if the trustee concludes the substituted assets have a lower value than the assets being reacquired, “the trustee has a fiduciary duty to prevent the exercise of the power.”⁴⁶⁰ The ruling reasons the trustee “has a fiduciary obligation to ensure that the assets exchanged are of equivalent value,” and the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result

454. See, e.g., U.S. TRUST, PRACTICAL DRAFTING 3753–57 (Richard B. Covey ed., 1994).

455. See Priv. Ltr. Ruls. 200001015 (Jan. 7, 2000); 200001013 (Jan. 7, 2000) (holding if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor’s gross estate under section 2036(a); but without specifically addressing grantor’s nonfiduciary substitution power in the analysis); 199922007 (June 4, 1999) (holding where charitable lead unitrust contained substitution clause, trust assets not includible in estate, but without specifically addressing the effect of nonfiduciary substitution clause on estate inclusion issue); 9642039 (Oct. 18, 1996) (holding substitution clause in charitable lead trust causes trust to be a grantor trust for income tax purposes, but does not cause estate inclusion under sections 2033, 2035–38, or 2041); 9548013 (Dec. 1, 1995) (holding powers of substitution made grantor trust holding S corporation stock but does not trigger inclusion under section 2038(a)); 9413045 (Apr. 1, 1994) (holding no estate inclusion in life insurance trust under sections 2036, 2038, or 2042, with discussion of *Jordahl*): 9227013 (June 3, 1992); 9037011 (Sept. 14, 1990). But see Priv. Ltr. Rul. 9318019 (May 7, 1993) (declining to rule on whether amending GST “grandfathered” trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status, or whether it would create estate tax exposure to the grantor). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

456. Rev. Rul. 2008-22, 2008-1 C.B. 796.

457. See *id.* at 797.

458. See *id.*

459. See *id.*

460. *Id.* at 798.

from the substitution, in view of the trustee's power to reinvest assets and the trustee's duty of impartiality regarding the beneficiaries.⁴⁶¹

In *In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*,^{461.1} the court held, in a fact-driven context, that the grantor's "right to reacquire trust assets is inextricably linked with the requirement that in doing so, he substitutes property of equivalent value."^{461.2} The grantor had asserted that he could swap property with the trust and, after the fact, the trustee could challenge the valuation. The court disagreed finding that a "necessary precondition to that substitution is that equivalent value be established."^{461.3} The trustee power and duty required the trustee "to determine whether the attempted substitution complied with the requirements of the substitution clause."^{461.4}

Drafting approaches differ as to how to assure that the trustees must satisfy themselves that assets of equivalent value are substituted and that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Some commentators

461. *Id.* The precise holding of the ruling states:

A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, *and* further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. [The ruling does not suggest how that might occur but does provide some safe harbors against the possible shifting of benefits in the next sentence.] A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus *and* a duty of impartiality with respect to the trust beneficiaries [observe: state law would generally impose both of these duties unless the trust instrument negates these duties]; *or* (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

Id. (emphasis added).

461.1. *In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*, No. 321589, 2015 WL 4255417 (Mich. Ct. App. July 14, 2015).

461.2. *Id.* at *6.

461.3. *Id.*

461.4. *Id.*

recommend relying on state law and general fiduciary principles; others have suggested drafting those requirements into the trust instrument.⁴⁶²

Opinions also differ as to whether the trust instrument should give the trustee the power to prevent the substitution if the trustee

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462. In an early response to the ruling, Jonathan G. Blattmachr and Michael Graham suggested the following sample provision to be included in a trust instrument:

Without reducing or eliminating the fiduciary duties imposed upon the Trustee acting hereunder under the terms of this instrument or applicable law, the Trustee shall ensure the Substitutor's compliance with the terms of this power by being satisfied that the properties acquired and substituted by the Substitutor are in fact of equivalent value within the meaning of Rev. Rul. 2008-22; further, this power to substitute property shall not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22; without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries at all times while this power of substitution is in effect, within the meaning of Rev. Rul. 2008-22.

Akers & Zeydel, *supra* note 369, at R-52. A somewhat more detailed example form clause is provided by Diana S.C. Zeydel and Jonathan G. Blattmachr:

During the settlor's lifetime, the settlor shall have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of section 675(4) of the Internal Revenue Code), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire the trust estate (other than any direct or indirect interest in stock described in section 2036(b) of the Internal Revenue Code or any policy insuring the life of the settlor) by substituting other property of an equivalent value, determined as of the date of such substitution.

This power to substitute property is not assignable, and any attempted assignment will render this power void. Without reducing or eliminating the fiduciary duties imposed on the trustees under this agreement or applicable law, the settlor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value and the trustees shall have a fiduciary obligation to ensure the settlor's compliance with the terms of this power to substitute property by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22.

This power to substitute property shall not be exercised in a manner that can shift benefits among the trust beneficiaries within the meaning of Revenue Ruling 2008-22. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries,

thinks the value is not equivalent, or if the trustee can sue only after the fact if the substituted assets have a lower value than the assets being reacquired. The rationale for the position that the trustee cannot prevent the exchange if the value is too low is that section 675 refers to a “power of administration . . . exercisable in a nonfiduciary capacity by any person *without the approval or consent of any person in a fiduciary capacity.*”⁴⁶³ On the other hand, Revenue Ruling 2008-22 specifically says that if a trustee believes that the substituted assets have a lower value, “the trustee has a fiduciary duty to *prevent* the exercise of the power.”⁴⁶⁴

One approach is to provide that if the trustee believes the property sought to be substituted is not, in fact, property of equivalent value, the trustee should seek a judicial determination to assure that the equivalent value requirement of the substitution provision is satisfied. Treasury and Service officials expressed their personal views at the American Bar Association Section of Real Property Trust & Estate Law Section 2008 Spring Meeting, stating that the trustee would exercise his, her or its fiduciary duty to question the value issue before the transfer if the trustee believes that the value being substituted was not equivalent, which is different from requiring “approval or consent” of the trustee.⁴⁶⁵

Some commentators are concerned that the substitution power should not be applicable over any life insurance policies on the grantor’s life, despite the holding to the contrary in *Jordahl*.⁴⁶⁶ The issue is whether the power to acquire a life insurance policy by exchanging property of equivalent value is a power that would cause inclusion of the life insurance proceeds under section 2042.

Revenue Ruling 2011-28⁴⁶⁷ provides favorable guidance on the estate tax issue when the grantor holds a power of substitution over

the trustees shall have the power to reinvest the principal of the trust and, except in the case of an Marital Trust, the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect, unless the trustees shall have absolute discretion in making distributions of principal and income among the trust beneficiaries so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this power of substitution potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22.

(On file with authors.)

463. I.R.C. § 675(4) (emphasis added).

464. Rev. Rul. 2008-22, 2008-1 C.B. 796 (emphasis added).

465. See Akers & Zeydel, *supra* note 369, at R-52.

466. See Michael D. Mulligan, *Power to Substitute in Grantor Does Not Cause Inclusion, with a Significant Caveat*, 109 J. TAX’N 32, 33 (July 2008).

467. Rev. Rul. 2011-28, 2011-49 I.R.B. 830.

trust assets that include a life insurance policy. It says that a grantor-held nonfiduciary substitution power generally will not trigger estate inclusion under section 2036 or section 2038.⁴⁶⁸ The ruling cites *Jordahl*, but says that section 2038 did not apply because the decedent was bound by fiduciary standards.⁴⁶⁹ More important, Revenue Ruling 2011-28 cites Revenue Ruling 2008-22 discussed above,⁴⁷⁰ and explicitly expands the conclusion of no estate tax inclusion by reason of the power of substitution with respect to policies insuring the life of the grantor:

A grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.⁴⁷¹

Similar to the issue for life insurance before the issuance of Revenue Ruling 2011-28, some commentators suggest providing that the power of substitution could not be exercised to acquire any voting stock of a "controlled corporation" for purposes of section 2036(b).⁴⁷² A controlled corporation is, generally speaking for section 2036(b) purposes, a corporation in which the decedent held, at any time after a transfer of stock and within three years of the decedent's death, the right to vote stock possessing at least 20% of the combined voting power of all classes of stock, after applying the attribution rules of section 318 and

468. *See id.* at 797.

469. *See id.*

470. Rev. Rul. 2008-22, 2008-1 C.B. 796. See note 456 and accompanying text.

471. Rev. Rul. 2011-28, 2011-49 I.R.B. 830.

472. *See Zaritsky, supra* note 25, ¶ 301.2[B].

including a right to vote held in conjunction with another person.⁴⁷³ The three-year rule under section 2036 triggers estate tax inclusion even if the voting rights are relinquished or ended within three years of the date of death, separate from the general three-year rule under section 2035.⁴⁷⁴

A substitution power might be treated indirectly as the power to control the voting of the stock under section 2036(b). The section 2036(b) issue is whether the power to reacquire stock is a “retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation” within the meaning of section 2036(b).⁴⁷⁵ Extending the concept of an indirect power to vote stock to the power to repurchase stock by paying full value for the stock seems to be an extension of the plain meaning of the section, however. In any event, excepting out partnerships or LLCs from substitution powers should not be necessary, as section 2036(b) only applies to corporations, not partnerships or LLCs, except, perhaps, if the LLC has elected to be income taxed as an corporation.⁴⁷⁶

The Tax Court decided in *Jordahl* that the right to buy an asset for its fair market value is not a retained right or interest for purposes of section 2038 or section 2042, and the Service acquiesced in the result of the case.⁴⁷⁷ If a right to purchase assets constitutes a retained right under section 2038, questions could be raised about the application of section 2038 to a buy-sell agreement that gives a donor of stock a right of first refusal if a donee elects to sell the stock or a right to buy back the stock if a donee predeceases the donor. Also, questions might be raised about the impact under the charitable “split-interest rules” of a contribution of voting stock (or other asset) to a charity that is subject to such buy-sell provisions, exercisable either by the donor or by other persons.⁴⁷⁸

Giving a third party a substitution power may be a desirable alternative because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third

473. See I.R.C. § 2036(b)(2).

474. See I.R.C. §§ 2036(b)(3); 2035(a)(1).

475. I.R.C. § 2036(b)(1). Cf. Priv. Ltr. Rul. 200514002 (Apr. 8, 2005) (involving a trust agreement providing that the grantor’s substitution power did not extend to stock of a controlled corporation). However, the explicit holding of Rev. Rul. 2008-22 is a grantor’s nonfiduciary substitution power by itself will not cause inclusion under section 2036 or 2038 (which obviously includes section 2036(b)), even though the ruling does not address the reasoning of the potential application of section 2036(b) specifically. See Rev. Rul. 2008-22, 2008-1 C.B. 796.

476. See *supra* note 426 and accompanying text.

477. See *Estate of Jordahl v. Comm’r*, 65 T.C. 92 (1975), *acq.* 1977-2 C.B. 1.

478. See I.R.C. § 494(a).

party who holds the substitution power), but should not be treated as giving the donor any power that would risk estate inclusion for estate tax purposes.⁴⁷⁹ Read literally, the statute and regulations would both suggest that the power of substitution can be held by a third party. The statute refers to a power held by “any person.”⁴⁸⁰ The regulations refer to a power held “by any nonadverse party.”⁴⁸¹

A concern with third-party substitution powers is that subsection 675(4)(C) applies if “a power to *reacquire* the trust corpus” is present.⁴⁸² A literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property. Several private letter rulings conclude that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes.⁴⁸³

Additional authority provides some insight into using third-party substitution powers. The Service issued Revenue Procedure 2007-45 to provide sample forms for *inter vivos* charitable lead annuity trusts (CLATs).⁴⁸⁴ One of the sample forms is for a CLAT that is a grantor trust CLAT, which uses a third-party substitution power to cause grantor trust status.⁴⁸⁵ Similarly, Revenue Procedure 2008-45 uses

479. See, e.g., Priv. Ltr. Rul. 199908002 (Feb. 26, 1999) (grantor’s brother held nonfiduciary substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

480. I.R.C. § 675(4) (power “exercisable in a nonfiduciary capacity by *any person*”) (emphasis added).

481. Treas. Reg. § 1.675-1(b)(4) (referring to “existence of powers of administration exercisable in a nonfiduciary capacity by any nonadverse party”).

482. I.R.C. § 675(4) (emphasis added).

483. See Priv. Ltr. Ruls. 199908002 (Feb. 26, 1999); 9810019 (Mar. 6, 1998); 9713017 (Mar. 28, 1997) (if the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under section 4941). In Priv. Ltr. Rul. 9037011 (Sept. 14, 1990), the trust instrument gave one of the trustees a power to “acquire any property then held in Trust . . . by substituting property of equivalent value.” The Service held that power caused grantor trust status. See *id.* These rulings did not address the statutory requirement of a power to “reacquire” trust assets. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

484. See Rev. Proc. 2007-45, 2007-2 C.B. 89.

485. The Revenue Procedure provides the following in a sample form:

Retained Powers and Interests. During the Donor’s life, [*individual other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1)*] shall have the right, exercisable only in a

the same approach for the sample form of *inter vivos* CLUT that is a grantor trust.⁴⁸⁶

The sample forms are annotated and contain warnings about the power of substitution:

The donor to a CLAT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLAT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLAT through the use of a power to substitute trust assets under § 675(4) that is held by a person other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity. The circumstances surrounding the administration of a CLAT will determine whether a § 675(4) substitution power is exercised in a fiduciary or nonfiduciary capacity. This is a question of fact. Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941.⁴⁸⁷

Notwithstanding the warning contained in the annotations, the CLAT Revenue Procedure provides that “a grantor CLAT will qualify for the safe harbor created under this revenue procedure if the trust satisfies all of the requirements set forth in the preceding sentence.”⁴⁸⁸

If there is concern that a nonfiduciary grantor substitution power may cause estate inclusion, despite Revenue Ruling 2008-22,⁴⁸⁹ and Revenue Ruling 2011-28,⁴⁹⁰ a third-party power could be used to avoid estate inclusion issues. Thus, if a taxpayer is concerned about the potential application of section 2036(b) or section 2042 (as discussed above), a third-party substitution power might be used with respect to stock of a controlled corporation. In addition, allowing a third party to hold the substitution power could create additional flexibility to “turn off” or to “toggle on” grantor trust status, as discussed below.⁴⁹¹

nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.

Id. § 7, ¶ 11 (brackets and emphasis in original).

486. See Rev. Proc. 2008-45, 2008-2 C.B. 224.

487. Rev. Proc. 2007-45, § 8.09(1), 2007-2 C.B. 89.

488. *Id.* § 3, 2007-2 C.B. 89.

489. See Rev. Rul. 2008-22, 2008-1 C.B. 796. See also *supra* notes 456–61 and accompanying text.

490. See Revenue Ruling 2011-28, 2011-2 C.B. 830. See also notes 456–61 and accompanying text.

491. See *infra* section 5:6.

If grantor trust status is sought under section 675(4) by having someone other than the grantor hold the substitution power, the grantor's spouse could be given the substitution power. Moreover, any concern that the "reacquire" term suggests the power of substitution generates grantor trust status only if held by the grantor should be alleviated if the grantor's spouse holds the substitution power, because any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules.⁴⁹² For example, a spousal substitution power might be used for voting stock of a controlled corporation as well. However, if toggling grantor trust status on and off is planned, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under section 672(e), making it impossible to turn off grantor trust status while spouses are living.

Section 675(4)(C) is not a certain path to grantor trust status, however. The Service's consistent position is that whether or not the power is held in a nonfiduciary capacity is a question of fact that cannot be resolved without a trial (or a concession by the Service) after the fact.⁴⁹³ As a result, caution suggests that section 675(4)(C) alone should not be relied upon to cause grantor trust status.⁴⁹⁴

Although a section 675(4)(C) power may be a less-than-certain avenue to cause grantor trust status, it provides few, if any, risks and offers significant flexibility. Thus, including such a provision to attempt to achieve grantor trust status probably is advisable.

Any of the section 675(4) powers might be triggered by substituting the grantor's spouse for the grantor. This factor should have the advantage of avoiding estate tax issues unique to interests or powers retained by a grantor. But grantor trust status based solely on the spouse's interest would end with the spouse's death, and that outcome may or may not be a desirable income tax result.

One advantage that a section 675(4)(C) grantor substitution power offers is the flexibility of swapping low basis assets held by a grantor trust with higher basis assets owned by a grantor individually, without

492. See I.R.C. § 672(e).

493. In a thorough analysis, two commentators trace the history of section 675(4)(C) and whether a power of substitution fits within the rule. Their conclusion suggests uncertainty when section 675(4)(C) applies because of the Service's position that it is a question of fact. See Craig L. Janes & Bernadette M. Kelly, *When Using a Power of Substitution—Take Nothing for Granted*, 34 EST. PLAN., Aug. 2007, at 3.

494. See *id.* Other commentators have similarly cautioned against sole reliance on section 675(4)(C). See, e.g., Coleman, *supra* note 366, ¶ 803.1.

income or gain recognition.⁴⁹⁵ The low basis assets returned to the grantor will be given a new basis when the grantor dies.

If the grantor or a third party exercises the substitution power over marketable securities, the question is at what exact value. Should values at the close of the day be used, or should the mean between the high and low on the day of substitution be used (for valuing both the assets acquired from the trust as well as the substitution assets)? Because the “mean between the high and the low” is the general valuation approach for estate and gift tax purposes, this method—which may require a small adjustment on the following day if the exact high and low prices are not known on the day of the substitution—may be preferable.⁴⁹⁶

[G] Summary of Powers to Cause Grantor Trust Status Under Section 675

A grantor trust may be created under section 675 with one or more powers without likely causing the trust to be included in the grantor’s gross estate:

1. Grantor trust status can be achieved under section 675(2) if the trustee has the power to make an unsecured loan to the grantor or the grantor’s spouse with adequate interest. To minimize estate inclusion risks, the power should be held by the grantor’s spouse or a nonadverse party other than the grantor. An even safer choice is for the trustee who holds such a lending power to be someone who is not a “related or subordinate party” to the grantor. Because of section 672(e), a power held to make loans to the grantor’s spouse without adequate collateral would similarly result in grantor trust status so long as the conditions for section 672(e) to apply are met.
2. Under section 675(3), if the grantor or the grantor’s spouse borrows the entire corpus of a trust with adequate interest and adequate security, the grantor will be treated as the owner of the entire income and corpus of the trust if the trustee is the grantor, the grantor’s spouse, or a related and subordinate person who is, in fact, subservient to the grantor. For greater certainty on account of the requirement of “subservience to

495. See Rev. Rul. 85-13, 1985-1 C.B. 184, discussed *supra* note 32 and accompanying text.

496. See, e.g., Priv. Ltr. Rul. 200846001 (Nov. 14, 2008) (approving substitution power that determined value of shares exchanged using “mean between highest and lowest quoted selling prices” on day of exchange). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

the grantor” for grantor trust status without estate tax inclusion issues, the trustee should be the grantor’s spouse. If the trustee is related or subordinate, there is possible uncertainty as to whether the trustee is subservient to the grantor, although in most instances subservience will be presumed.⁴⁹⁷ A loan by a trustee other than the grantor, the grantor’s spouse, or a related and subordinate person can still trigger grantor trust status if the loan requires adequate interest but is unsecured.

3. Under section 675(4)(C), a nonfiduciary power of substitution held by the grantor’s spouse should create a grantor trust. If it is desirable to continue grantor trust status after the spouse dies, a successor powerholder should be named who is not an adverse party. Following the issuance of Revenue Ruling 2008-22,⁴⁹⁸ planners may be comfortable using grantor substitution powers. The trust instrument should specifically state that the substitution power is exercisable in a nonfiduciary capacity, and it may be wise to exclude the grantor from exercising the power over insurance on his life or her life or closely held stock described in section 2036(b); someone else could be granted the power over the insurance and stock.⁴⁹⁹

In all three of these avenues, the powerholder should not be the trustee and should not be an adverse party.

§ 5:5.4 Foreign Trust with U.S. Beneficiary

Section 679 provides that a foreign trust is a grantor trust if the trust was created by a U.S. person and any beneficiary of the trust is a U.S. taxpayer.⁵⁰⁰ As to such a trust, the trust income is attributable to the U.S. person who is the grantor.⁵⁰¹ Grantor trust rules for a U.S. person who directly or indirectly transfers property to a foreign trust are discussed in detail in chapter 6.

[A] Generally

A trust is a foreign trust unless both of the following tests are satisfied: (1) a U.S. court is able to exercise primary supervision over the trust; and (2) one or more U.S. persons have the authority to

497. For example, a child of the grantor will always be the grantor’s child and thus related and subordinate.

498. 2008-1 C.B. 796. *See supra* notes 454–77 and accompanying text.

499. *See id.* If insurance covers the life of the grantor’s spouse, the spouse probably should not have the power of substitution as to the life insurance.

500. *See* I.R.C. § 679.

501. *See id.*

control all substantial trust decisions.⁵⁰² A U.S. person is defined in section 7701(a)(30) as a citizen or resident of the United States, a domestic partnership or corporation, a non-foreign estate, or a non-foreign trust.⁵⁰³

When a foreign person has control over at least one substantial decision, foreign trust status results.⁵⁰⁴ Substantial decisions are defined in the regulations to mean “those decisions . . . that are not ministerial.”⁵⁰⁵ The regulation includes very expansive examples: the power to determine the timing and amount of distributions from income or corpus, and the selection of beneficiaries, as well as other administrative actions such as making income and principal allocations, investment decisions, and compromising claims, are all substantial decisions.⁵⁰⁶ The definition even includes the power to appoint a successor trustee (unless it is restricted so that it cannot change the trust’s residency) and the power to remove, add, or replace a trustee.⁵⁰⁷ Thus, a domestic trust becomes a foreign trust if a non-U.S. person or persons come into control of a substantial decision. With multiple trustees, the non-U.S. person or persons must hold a minority vote to make any substantial decision of the trust for the trust to remain a U.S. trust.⁵⁰⁸

Upon termination of grantor trust status—for example, when the grantor dies or when no foreign person or persons any longer controls any substantial decision, or when there are no longer any U.S. beneficiaries—section 684 will impose a tax on the unrealized appreciation in effect (assuming the trust is not a grantor trust with respect to another under section 671).⁵⁰⁹ However, if that occurs because of the death of the grantor, the step-up in basis under section 1014, if applicable, should avoid having any gain under section 684.⁵¹⁰

502. See I.R.C. § 7701(a)(30)(E), (31)(B). It is interesting to note that this statutory definition is, in effect, a negative definition and, therefore, somewhat difficult to understand. For example, the requirement that a trust is a foreign trust unless one or more U.S. persons have authority to control all substantial decisions of a trust might be more readily understood by defining a foreign trust as a trust in which one or more foreign persons have control over at least one substantial decision. For a detailed discussion of foreign trusts, see section 6:3.1.

503. See I.R.C. § 7701(a)(30).

504. See I.R.C. § 7701(a)(31)(B).

505. Treas. Reg. § 301.7701-7(d)(1)(ii).

506. See *id.* § 301.7701-7(d)(1)(ii)(A)–(J).

507. See *id.* § 301.7701-7(d)(1)(ii)(H), (I).

508. See *id.* § 301.7701-7(d)(1)(iii).

509. See I.R.C. § 684.

510. See I.R.C. § 1014. For example, section 1014(c) denies a stepped up basis for section 691 items of income in respect of a decedent. See *id.* Note,

Section 672(f) provides that the grantor trust rules will not apply if they would cause someone other than a U.S. citizen, resident, or domestic corporation to be treated as the owner of the income.⁵¹¹ Thus, if a foreign person is the grantor of a trust, the grantor trust rules will not apply as to that person.

Broad dispositive powers could be granted in the trust agreement without fear of causing the foreign person to be treated as the owner of the trust under the grantor trust rules. For example, section 679 would not apply if a foreign person creates a trust for a U.S. beneficiary, who might be treated as the owner of the income of the trust under section 678 because the beneficiary is the sole trustee or the beneficiary has a Crummey⁵¹² withdrawal power over all contributions to the trust.⁵¹³

Foreign trusts are subject to additional rules not generally applicable to domestic trusts. U.S. beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the Service on Form 3520.⁵¹⁴ Additional required information is described in Notices 97-34 and 2003-75.⁵¹⁵ A U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made.⁵¹⁶ In addition, the foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust may be liable for a 5% penalty of the value of the trust assets that are treated as owned by that person.⁵¹⁷ If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S. grantor must report the transfer.⁵¹⁸ When a grantor foreign trust converts to nongrantor status, such as when the grantor dies and the trust continues as a foreign trust, the U.S. beneficiaries of the foreign nongrantor trusts are subject to several special rules.

however, that under I.R.C. § 1012, I.R.C. § 1014(a) does not apply with respect to persons who die in 2010. Because I.R.C. § 1014(a) would not apply, it appears that termination of grantor trust status by the U.S. grantor of a foreign trust would mean I.R.C. § 684 would be “triggered.”

511. See I.R.C. § 672(f).

512. See *Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968).

513. The grantor trust rules will apply to any portion of the trust with a foreign grantor where amounts attributable to that portion are distributable only to the grantor and/or the grantor’s spouse during the grantor’s lifetime, or to satisfy either of their legal obligations. See I.R.C. § 672(f)(2)(A); Treas. Reg. § 1.672(f)-3(b)(2).

514. See I.R.C. § 6048(c)(i).

515. See I.R.S. Notice 97-34, 1997-1 C.B. 422, amended by I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

516. See I.R.C. § 6677(a).

517. See I.R.C. § 6677(b).

518. See I.R.C. § 679(a)(5).

The distributable net income (DNI) of a foreign nongrantor trust is determined under section 643(a) in a somewhat different way than for a domestic trust. A primary distinction is that all capital gains are included in DNI for the foreign trust, whether allocated to income or corpus and whether distributed to a trust beneficiary or not.⁵¹⁹ When all DNI of a foreign nongrantor trust is not distributed each year, accumulation distributions determined under rules in section 665(b) in subsequent years are subject to the “throwback” rules.⁵²⁰ In addition, the tax under the throwback rule is increased by an interest charge.⁵²¹ Some loans made by foreign trusts are deemed distributions and indirect distributions may be reclassified as direct distributions to a U.S. person.⁵²² Section 1441 requires withholding at the source on distributions to foreign trusts.⁵²³

A foreign trust is not an eligible S corporation shareholder.⁵²⁴ This rule negates one reason why grantor trust status might be attractive if the grantor is a U.S. individual who is a permissible S corporation shareholder.⁵²⁵

[B] Grantor Trust Under Section 679

A grantor trust may be created under section 679 by making a foreign person the trustee. Alternatively, to create a foreign trust the foreign person may be a co-trustee of a trust so long as the foreign person or persons are a majority of the trustees or some substantial decision is delegated to the foreign trustee. It is not necessary to name the grantor or the grantor’s spouse as a trustee or as a beneficiary to create a grantor trust under section 679. However, the trust must comply with the additional complex rules that are applicable to foreign trusts and be subject to the additional taxes that apply to foreign trusts. Certainly, knowledge of the foreign trust rules and experience with them is critical for the planner who suggests this route to grantor trust status.

519. See I.R.C. § 643(a)(3), (a)(6)(C).

520. See I.R.C. § 665(d)(2). These are known as the “throwback” rules because previously accumulated and undistributed DNI is taxed in effect to the beneficiary who later receives it by throwing it back to the year in which the trust received it. See *id.*

521. See I.R.C. §§ 667(a)(3), 668.

522. For a comprehensive discussion of these issues, see section 6:10.

523. See I.R.C. § 1441. For a comprehensive discussion of these issues, see section 6:12.

524. See I.R.C. § 1361(c)(2) (last sentence).

525. See notes 48–49 and accompanying text *infra* chapter 8.

§ 5:5.5 Taxability of Income to Person Other Than the Grantor—Section 678⁵²⁶

Although the grantor trust rules generally address the taxability of trust income to the grantor, in some situations the *Clifford* trust doctrine has been extended to tax the income of a trust to someone other than the grantor. This happens when the powers granted enable a beneficiary to vest the corpus or income in the beneficiary.⁵²⁷ The seminal case of *Mallinckrodt v. Nunan*,⁵²⁸ held that income of a trust was taxable to a beneficiary because the beneficiary had the right to demand the distribution of the trust's income, although any income not demanded during the year was added to corpus at the end of the year.

The 1954 Code adoption of the grantor trust rules included section 678, which adopted the *Mallinckrodt* line of cases and pre-existing regulations.⁵²⁹ This section provides that a person other than the

526. A portion of this discussion of section 678 appears in Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009), copyright Bessemer Trust Company, N.A., and appears herein with permission.

527. *Hirschmann v. United States*, 309 F.2d 104 (2d Cir. 1962), *aff'g* 202 F. Supp. 722 (S.D.N.Y. 1962); *Jergens v. Comm'r*, 136 F.2d 497 (5th Cir.), *cert. denied*, 320 U.S. 784 (1943); *Bunting v. Comm'r*, 164 F.2d 443 (6th Cir. 1947); *Emery v. Comm'r*, 156 F.2d 728 (1st Cir. 1946); *Grant v. Comm'r*, 11 T.C. 178 (1948); *Conant v. Comm'r*, 7 T.C. 453 (1946); *Stix v. Comm'r*, 4 T.C. 1140 (1945); *Oppenheimer v. Comm'r*, 16 T.C. 515 (1951) (portions of income and corpus); *Mallinckrodt v. Nunan*, 2 T.C. 1128, *aff'd*, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945); *Russell v. Comm'r*, 45 B.T.A. 397 (1941); *Richardson v. Comm'r*, 42 B.T.A. 830 (1940), *aff'd*, 121 F.2d 1 (2d Cir.), *cert. denied*, 314 U.S. 684 (1941). As to the relationship between the ordinary trust sections and a power of a beneficiary to demand income or corpus, see Treas. Reg. §§ 1.641(b)-2, 1.643(c)-1(c). *See also* Treas. Reg. § 1.662(a)-4.

528. *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945), *aff'g* 2 T.C. 1128, *cert. denied*, 324 U.S. 871 (1945).

529. Treas. Reg. 118, § 39.22(a)-22 (1939); Priv. Ltr. Rul. 9026036 ("[L]egislative history of section 678 indicates Congress' interest to implement the principles of *Mallinckrodt v. Nunan*"). *See also* Senate Finance Committee Report for 1954 Code that provides:

A person other than the grantor may be treated as the substantial owner of a trust if he has an unrestricted power to take the trust principal or income, or if he has modified this power (by release or otherwise) but has retained powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable because of such a power. Similar rules are contained in the regulations under existing law (commonly known as the *Mallinckrodt* Regulations).

S. REP. NO. 83-1622, at 87 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

grantor is treated as the owner of any portion of a trust over which the person has the sole power to vest the corpus or the income in the powerholder.⁵³⁰ This rule applies even if the power is not exercised.⁵³¹

A trust beneficiary's right to demand from a trust the greater of \$5,000 or 5% of the trust assets (commonly called a "five or five power") is an example of a section 678 power.⁵³² Similarly, the typical Crummey trust withdrawal power is another common example of a section 678 power.⁵³³

Only the portion of the trust's income, deductions, and credits not subject to section 678 (or other grantor trust rules) are subject to the non-grantor portion of subchapter J. Revenue Ruling 67-241⁵³⁴ illustrates how the portion rule applies in the section 678 context.⁵³⁵ In the ruling, a trust beneficiary had the non-cumulative, annual right to vest in herself the greater of \$5,000 or 5% of the principal of a trust. The trust income was payable to the beneficiary's two children. The Service ruled that section 678 applied to treat the trust beneficiary as the grantor of the portion of the trust corpus that the power covered, and as a result the trust beneficiary's income tax liability was to be computed by taking into account the income, deductions, and credits attributable to that portion.

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530. *E.g.*, *Koffman v. United States*, 300 F.2d 176 (6th Cir. 1962); Rev. Rul. 67-241, 1967-2 C.B. 225 (nongrantor "owner" of portion may be taxed less on actual invasion than if she had been ordinary beneficiary); Richard B. Covey, *The Estate Planning Benefits Available via a "\$5,000 and 5%" Withdrawal Power*, 34 J. TAX'N 98, 99-100 (1971); Roy M. Adams, *The Tax Consequences of Powers of Withdrawal Held Individually or as a Fiduciary: A Pandora's Box of Tax Consequences*, 23 INST. ON EST. PLAN. 1900 (1989); Charles E. Early, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status*, 62 J. TAX'N 198 (1985); Douglas G. Dye, *Several Routes Exist to Avoid IRS' Income Tax Roadblocks to Use of Crummey Trust Provisions*, 10 EST. PLAN. 220 (July 1983). In Rev. Rul. 54-153, 1954-1 C.B. 185, dealing with estate tax, it was held that New York law prevented a trustee-beneficiary from distributing principal to himself. *See also* *Oppenheimer v. Comm'r*, 16 T.C. 515 (1951); Rev. Rul. 81-6, 1981-1 C.B. 385 (minor taxed under I.R.C. § 678 even though no guardian appointed to exercise power).
531. Rev. Rul. 67-241, 1967-2 C.B. 225; *cf.* *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
532. Under I.R.C. §§ 2041(b)(2) and 2514(e), the lapse of a general power of appointment (including a power of withdrawal) constitutes a transfer for estate and gift tax purposes only to the extent that the lapse each calendar year exceeds the greater of \$5,000 or 5% of the value of the property subject to the power.
533. *See* *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
534. Rev. Rul. 67-241, 1967-2 C.B. 225.
535. Treas. Reg. § 1.678(a)-1(b). For a discussion of the portion rule, see section 5:2.2, *supra*.

“Five or five” and similar withdrawal powers raise unanswered questions of whether gain or loss⁵³⁶ might be realized by the trust if the amount demanded is satisfied in-kind with a transfer of property. In some respects the trust is satisfying a specific amount due the beneficiary with an appreciated asset, and that invokes the *Kenan* rule discussed above in section 3:5.6.⁵³⁷ Alternatively, the satisfaction of the amount demanded might be viewed as mere segregation of the portion of the trust the beneficiary owns because of the demand right, and thus the distribution is not a taxable event. Avoiding income realization by applying this second theory may be dependent on either a pro rata distribution of trust assets or the trust instrument or state law permitting non-pro rata distributions.⁵³⁸

The Service has ruled that the distribution of an amount demanded by the beneficiary does not consist of any DNI.⁵³⁹ This view of the DNI rules may suggest that the Service considers the distribution within the scope of the specific gift rule of section 663(a)(1)⁵⁴⁰ or that the Service accepts the ownership theory, but the basis for its position is not enunciated.

In Revenue Ruling 81-6,⁵⁴¹ the Service ruled that section 678 applied to a withdrawal power held by a minor, although the minor could not exercise the power under state law and no guardian had been appointed for the minor. The Service held that the existence of the power, and not the legal ability of the powerholder to exercise the power, was determinative. The power in the ruling appeared to be a “garden-variety” Crummey power of withdrawal.⁵⁴² Other conditions precedent may, however, prevent the application of section 678.⁵⁴³

536. I.R.C. § 267 (disallowing loss recognition on sales and exchanges between certain related taxpayers) would be applicable to any possible recognition of loss.

537. For a discussion of the issue, see Adams, *supra* note 530, at 1900.

538. See note 752, at section 3:5.6, *supra*, and accompanying text for a discussion of triggering gain on non-pro rata distributions. The recognition might depend on whether the non-cash distribution was in satisfaction of the \$5,000 threshold (a fixed sum) or 5% (a fractional share) and state law. *Cf.* Rev. Rul. 69-486, 1969-2 C.B. 159.

539. Rev. Rul. 67-241, 1967-2 C.B. 225.

540. It may also take the application of the Service’s position in Rev. Rul. 85-13, 1985-1 C.B. 184, discussed in note 382, *supra*, and accompanying text, to avoid recognition of gain if appreciated assets are distributed by a grantor trust to the trust’s grantor.

541. Rev. Rul. 81-6, 1981-1 C.B. 385.

542. *See* Crummey v. Comm’r, 397 F.2d 82 (9th Cir. 1968).

543. Another example of a condition precedent is a power that is not exercisable before the powerholder reaches a specified age, such as twenty-five. Other sections of the grantor trust rules specifically provide that conditions precedent are ignored when applying the rules. *See, e.g.*, I.R.C. §§ 674(b),

§ 5:5.6 Section 678(a) and Ascertainable Standards

Section 678(a)(1) provides that “a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself.” The question is to what extent section 678(a)(1) applies if the person’s withdrawal power is subject to limitations such as an ascertainable standard.

Courts have held that section 678 may not apply where the power is subject to a reasonable standard, although neither section 678 nor its regulations address this issue.⁵⁴⁴ Note that the courts do not use the term “ascertainable standards” as is found in the estate and gift tax rules,⁵⁴⁵ but they apparently mean about the same thing. The regulations under section 674 provide guidance on the meaning of the term “reasonably definite standard,” but section 674 uses that term and section 678 does not. Thus, it is questionable whether the section 674 regulations have any applicability to section 678 or provide any insight.⁵⁴⁶

The type of control that a court may exercise over a discretionary act undertaken by a trustee or beneficiary can be critical. There are, in essence, five categories of cases. First, the governing instrument of the trust may give the beneficiary the right to withdraw assets from the

676(b), and 677(a), all of which ignore conditions precedent that exceed the 5% reversionary interest rule of section 673. The failure of section 678 to provide a similar rule might be interpreted to support the conclusion that a condition precedent will prevent the application of section 678.

544. *De Bonchamps v. United States*, 278 F.2d 127 (9th Cir. 1960); *Smither v. United States*, 108 F. Supp. 772 (S.D. Tex. 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953) (support, maintenance, comfort, and enjoyment); *see* *May v. Comm’r*, 8 T.C. 860 (1947) (nontaxable on portion allocable to education of taxpayer’s minor children; the taxpayer, whose husband had a salary income, probably had no support obligation); *C.E. Brehm Trust No. 3 v. Comm’r*, 33 T.C. 734 (minors could terminate only through a guardian, and none had been appointed, thus no “unfettered command”), *rev’d*, 285 F.2d 102 (7th Cir. 1960) (on ground such appointment is a routine matter). *But see* *Rev. Rul. 81-6*, 1981-1 C.B. 385; *Priv. Ltr. Rul. 8211057* (power limited to “welfare” taxable); *cf. Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968) (minor’s annual power to withdraw \$4,000 from trust makes transfers to trust constitute gift of present interest under I.R.C. § 2503, because power to withdraw is equivalent to right to immediate use, possession, or enjoyment, although no guardian was appointed to exercise the power for the minor); *cf. also* I.R.C. § 2652(c) (any income or corpus of a trust that may be used to satisfy a support obligation under state law is ignored for generation-skipping transfer tax purposes if such use is discretionary or is substantially equivalent to Uniform Gifts to Minors Act, even apparently if so used).

545. For discussions of “ascertainable standards,” *see* *Treas. Reg. §§ 20.2041-1(c)(2)*, *25.2514-1(c)(2)*.

546. *Treas. Reg. § 1.674(b)-5*.

trust for certain purposes but make the judgment of the beneficiary conclusive.⁵⁴⁷ Where the instrument takes this form, the court is precluded from exercising any supervisory control regarding withdrawals.⁵⁴⁸ Second, while the instrument may give the trustee extraordinarily broad discretion without imposing any standard to guide the trustee's decision making, it may nonetheless have the effect of giving the court the authority to review any exercise of discretion to make sure that it does not violate any type of mandatory fiduciary duty that may not be waived in the trust instrument, such as the duty to act in good faith. Third, the instrument may impose a standard designed to constrain the trustee's discretion. When a so-called ascertainable standard is used, a court has the authority to hold the trustee accountable for any decision that deviates from the standard. Fourth, the instrument may contain an ascertainable standard relating to the powerholder's health, education, maintenance or support (HEMS). This is a subset of the ascertainable standard category, with the court having the authority to hold the powerholder accountable for any withdrawal that is not consistent with the HEMS standard.⁵⁴⁹ Finally, in the fifth category of cases, a powerholder's discretion may be constrained not by trust law or by the trust instrument, but rather by a fiduciary duty that derives from corporate law.

In the first category of cases, where the powerholder may withdraw trust assets with impunity from judicial review, the powerholder is treated as the absolute owner of the trust's assets for all tax purposes and, thus, the trust is treated as the powerholder's grantor trust under section 678. The powerholder is in effect deemed to own the trust's assets outright, making all of the trust's income directly taxable to the powerholder. Absent this power, the trust would ordinarily be respected as a separate entity for income tax purposes.⁵⁵⁰ This ownership-equivalence concept makes sense. After all, it would elevate form over substance to treat a powerholder with such an unfettered right to withdraw trust assets differently.

In the second category of cases, where the powerholder has unlimited discretion but the court nonetheless has some supervisory authority, the ownership equivalence concept applies only for transfer

547. See, e.g., *In re Woollard*, 295 N.Y. 390 (1946). *In re McCoy*, 274 B.R. 751 (Bankr. N.D. Ill. 2002), *aff'd*, 2002 WL 1611588. *But see* RESTATEMENT (THIRD) OF TRUSTS § 58 (2003) (critiquing *McCoy*).

548. See, e.g., *Woollard*, *supra*; *McCoy*, *supra*.

549. The HEMS standard is relevant only in determining whether a powerholder has a general power of appointment for transfer tax purposes. Of course, the use of such a HEMS limitation converts what would otherwise be a general power of appointment into a non-general power. See, e.g., I.R.C. § 2041(b)(1)(A).

550. See chapter 3 for a discussion of the taxation of trusts.

tax purposes.⁵⁵¹ But, inasmuch as the powerholder would not have unfettered or unrestricted access to the trust's assets, however, section 678 should not apply.

In *Mallinckrodt*, the beneficiary's power to demand a withdrawal of income was not limited by any standard. It would seem that, if a third party other than the grantor (for example, a trust beneficiary) has unfettered control over the trust income or corpus, then section 678(a)(1) would apply to make that portion of the trust (the income portion or the corpus portion) a grantor trust with respect to the third party. If, however, the third party could withdraw only if a condition exists, it seems doubtful that section 678(a) would apply unless and until the condition arises. For example, assume a trust created by will unilaterally permits a child to withdraw all of the property when she attains the age of fifty. She has no other right to withdraw income or corpus prior to that time. It seems nearly certain that section 678(a)(1) will apply only when the child reaches age fifty.

In the estate tax context, a decedent's power to consume, invade, or appropriate property for her own benefit which is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent is not deemed to be a general power of appointment and therefore not subject to inclusion in the powerholder's gross estate for estate tax purposes.⁵⁵² Some practitioners take the position that, even though the withdrawal power is limited to a HEMS standard to avoid inclusion for estate tax purposes, it is nonetheless sufficient to trigger section 678(a)(1) for income tax purposes. This, however, does not appear to be a tenable position. In cases where the withdrawal power is subject to a HEMS standard, section 678(a)(1) cannot apply because the powerholder does not have unfettered access. In other words, if a state court has the authority to review the propriety of a distribution, section 678(a)(1) would appear to be inapplicable. If, on the other hand, the governing instrument eliminates the state court's authority to approve or disapprove the distribution, then section 678(a)(1) would apply.

551. The transfer tax treatment of such a power is consistent with the approach courts have taken in I.R.C. §§ 2036 and 2041 jurisprudence. In *O'Malley v. United States*, 383 U.S. 627 (1966), where the trust grantor served as trustee, the Court held that the trust's assets should be included in the grantor's gross estate under I.R.C. § 2036(a)(2) because of the grantor's retained discretion, as trustee, to determine which beneficiaries should receive income distributions. In reaching this conclusion, the Court did not find that the duty of a trustee to act in good faith constituted a sufficient constraint on the trustee to justify excluding the value of the trust's assets from the grantor's gross estate.

552. I.R.C. § 2041. I.R.C. § 2514(c)(1) provides for the same test for gift tax purposes.

These conclusions are borne out in case law. In *Smither v. United States*,⁵⁵³ a case decided before the enactment of section 678 in 1954,⁵⁵⁴ the court held that a beneficiary would not be treated as the owner of the trust because her withdrawal right was limited to her "support, maintenance, comfort and enjoyment."⁵⁵⁵ In *Smither*, the decedent devised his entire estate to his widow for her own support, maintenance, comfort and enjoyment and for the support, maintenance, education, comfort and the enjoyment of their children.⁵⁵⁶ The decedent's will further provided that the executors had the power to expend such part of the income and to invade the corpus for the support, maintenance, comfort and pleasure of the widow and of the children "as in the discretion of my said executors may appear to be proper or desirable."⁵⁵⁷ The decedent's two brothers and his widow were appointed as executors. Some years later, the two brothers died and the widow remained as the sole executor. The IRS asserted that, in the years in question during which the widow was the sole executor, she had unlimited discretion to expend all or any part of the income for her own purposes and, therefore, should be treated as the owner of the income and be liable for the tax thereon.⁵⁵⁸ The U.S. District Court rejected the Service's argument and held that the widow's withdrawal power was not unfettered but rather restricted by the terms of the will. The widow's power was subject to a "legal obligation," namely her power to withdrawal was limited to what was "necessary for her support, maintenance, comfort and enjoyment, with a similar right in favor of the children."⁵⁵⁹ This standard, the court explained, was "sufficiently clear and definite to be both understandable and enforceable."⁵⁶⁰ Therefore, the widow could withdraw "no more than that the needs of maintaining the family in the station in life to which it had become accustomed should be met,"⁵⁶¹ and the trust, and not the widow, was the proper taxpayer with respect to the trust income. By holding that the widow did not have unfettered control over the trust assets and that her power was subject to a legal obligation, the *Smither* court indicated that it had the authority and indeed exercised that authority to review the propriety of distributions based on the

553. *Smither v. United States*, 108 F. Supp. 772 (S.D. Tex. 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953).

554. I.R.C. § 678 is the statutory adoption of Treasury Regulations that were promulgated under the Internal Revenue Code of 1939.

555. *Smither*, *supra* note 553.

556. *Id.*

557. *Id.* at 772–73.

558. *Id.* at 773.

559. *Id.* at 774.

560. *Id.*

561. *Id.*

HEMS standard as expressed in the decedent's will. It is, therefore, reasonable that section 678(a)(1) should not apply in this case.

The U.S. Courts of Appeal for the Ninth and Third Circuits reached similar decisions in *United States v. De Bonchamps*⁵⁶² and *Funk v. Commissioner*,⁵⁶³ respectively. *De Bonchamps* was a consolidation of three cases where the IRS contended that all three life tenants were taxable as the owners of income. In all three cases, the taxpayers' powers to withdraw were subject to their "needs, maintenance and comfort."⁵⁶⁴ The U.S. Court of Appeals for the Ninth Circuit ruled that the powers held by each of the taxpayers were "expressly limited to her needs, maintenance and comfort" and that, therefore, she did not have unlimited power to take the corpus for herself.⁵⁶⁵ As a result, the taxpayers were not taxable on income.

Similarly, in *Funk*, the U.S. Court of Appeals for the Third Circuit focused on the word "needs" to bar income taxation to the beneficiary. In that case, the taxpayer had the power to make distribution to herself subject to her "needs, of which she shall be the sole judge."⁵⁶⁶ The U.S. Tax Court seemed to have ignored the standard imposed in the governing instrument and held that the taxpayer should be taxable on the trust income because she had absolute control over the trust's income under the terms of the trust instrument.⁵⁶⁷ The Court of Appeals reversed the Tax Court and ruled that the taxpayer was not the owner of the trust because her power was limited by the word "needs" in the trust instrument. The Court of Appeals explained that, although the word "needs" cannot be defined precisely, it nevertheless established a "standard effectively distinguishing this case from, and taking it out of the rule, of the *Mallinckrodt* . . . decision."⁵⁶⁸ The Court of Appeals further explained that the word "needs" has been construed by the state court to mean what is reasonably necessary to maintain a beneficiary's station in life and it, therefore, "confined the trustee to limits objectively determinable."⁵⁶⁹

The effect of an ascertainable standard on the applicability of section 678(a) is not beyond debate. There are at least two cases and one private letter ruling⁵⁷⁰ that seem to support a contrary

562. *United States v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960).
 563. *Funk v. Comm'r*, 185 F.2d 127 (3d Cir. 1950), *rev'd*, 14 T.C. 198 (1950).
 564. *De Bonchamps*, 278 F.2d at 128.
 565. *Id.* at 130.
 566. *Funk*, 185 F.2d at 128, *rev'd*, 14 T.C. 198 (1950).
 567. *Id.* For discussion of this point in the Tax Court decision, see 14 T.C. at 213.
 568. *Id.* at 131.
 569. *Id.*
 570. It should be noted that Rev. Rul. 81-6, 1981-1 C.B. 385 is not inconsistent with the notion that section 678 can only apply where there is unrestricted

position. However, upon closer examination of these cases and private letter ruling, they seem to be distinguishable and cannot be said to offer contrary authority. The first of these cases is *Koffman v. United States*⁵⁷¹ where the decedent created a trust for the benefit of his widow to be used by her for her “personal support and maintenance, the reasonableness thereof to be determined by her” (emphasis added).⁵⁷² The U.S. Court of Appeals for the Sixth Circuit ruled the widow should be taxable on the trust income because she had unfettered right to determine the reasonableness of her withdrawals for her support and that her power was not subject to any limitation.⁵⁷³ At first blush, it seems that section 678(a) applies even if the beneficiary’s withdrawal right is limited to her support and maintenance. However, a closer examination of the decision indicates that the key language in *Koffman*, causing the section to be triggered, may not have been the “support and maintenance” standard itself but rather the manner in which the standard was determined to have been met. The words “reasonableness thereof to be determined by her” could be interpreted to have granted the beneficiary the subjective right to determine whether the standard has been met. If the reasonableness of whether the standard has been met is to be determined solely by the beneficiary and cannot be questioned or enforced by another party, then the beneficiary essentially has unfettered control over the trust assets.⁵⁷⁴ This is different from *Smither, De Bonchamps* and *Funk* discussed above, because unlike the governing instruments in those

or unfettered access to the trust’s assets. In the ruling, the Service ruled that a minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in himself, despite the fact that no guardian has been appointed for the minor and the minor does not have the legal capacity to exercise such power. The Service explained that “[f]or purposes of section 678 of the Code it is the existence of a power rather than the capacity to exercise such a power that determines whether a person other than the grantor shall be treated as the owner of any part of a trust.” The ruling relied on *Trust No. 3 v. Comm’r*, 285 F.2d 102 (7th Cir. 1960), where the U.S. Court of Appeals for the Seventh Circuit held that minor beneficiaries with a power to terminate a trust and to take possession of the trust property have a vested present right to use all or any part of the trust property upon demand despite the fact that no guardians have been appointed. The Service acknowledged the Court of Appeals’ reasoning that the appointment of a guardian is a routine step that should have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate the trust.

571. *Koffman v. United States*, 300 F.2d 176 (6th Cir. 1962).

572. *Id.* at 176.

573. *Id.* at 177.

574. *Cf. In re Woollard*, 295 N.Y. 390 (1946) (ruling that a will that provided the decedent’s widow with the right to income and principal of the trust,

cases, the governing instrument in *Koffman* provided that the propriety of the distribution was to be judged solely by the beneficiary, essentially eliminating a state court's authority to review the propriety of the distribution. In *Smither, De Bonchamps* and *Funk*, the courts made clear that the standard in those cases was one that is "objectively determinable"⁵⁷⁵ and "understandable and enforceable"⁵⁷⁶ by the courts. In contrast, the court in *Koffman* could not objectively determine or enforce the standard set forth by the decedent in the governing instrument.

The second case is *Townsend v. Commissioner*,⁵⁷⁷ in which the U.S. Tax Court held that the beneficiary widow should be taxed on the amount of income deemed to be necessary for her support as determined by the state court. The case began as a contested proceeding in the state court involving the accounting of the trustees of a testamentary trust. The decedent's will provided that the income of the testamentary trust was to be payable to the decedent's widow as "she deems necessary for her own support and for the maintenance, education and support of [the decedent's] children."⁵⁷⁸ The state court had previously determined that the widow was entitled to \$30,000 per year from the trust income for her maintenance and support.⁵⁷⁹ The Tax Court relied on this determination and held that the widow was taxable on this \$30,000 of income. The Tax Court's holding that the beneficiary widow should be taxed as the owner of the \$30,000 of the trust income does not appear to be based on the support and maintenance standard in the governing instrument but rather on the state court decree that \$30,000 was the amount the widow was entitled to receive under such standard. Since a state court had determined what amount was payable to the widow subject to the standard, then the widow had unfettered right and control over that amount and should be taxable on that income. In the absence of any state court decree, it is unclear whether the standard would be met and whether the widow would be entitled to any income from the trust. It is also important to note that *Townsend* was decided before the U.S. Supreme Court's decision in *Commissioner v. Estate of Bosch*,⁵⁸⁰ and it is doubtful that

as the widow shall deem necessary for her maintenance, comfort or well being is a power granted to the widow that may not be questioned by anyone).

575. *Funk*, 185 F.2d at 131.

576. *Smither*, 108 F. Supp. at 774.

577. *Townsend v. Comm'r*, 5 T.C. 1380 (1945).

578. *Id.* at 1381.

579. *Id.* at 1384.

580. *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967) (ruling that only the decree of a state's highest court would be binding for federal tax purposes). *Cf.* Rev. Rul. 73-142, 1973-1 C.B. 405 (IRS is bound if the court decree is entered before taxing event).

a subsequent court would follow a lower state court decision in its determination of a federal income tax issue. Lastly, *Townsend* was decided by the Tax Court in 1945, just a few years before *Funk* (where the Tax Court held that a beneficiary withdrawal power subject to a “needs” standard is not taxable to the beneficiary), yet *Funk* did not mention or cite *Townsend*. Therefore, it seems likely that the *Townsend* holding is limited to its facts and stands only for the proposition that, if the beneficiary’s withdrawal right is subject to a standard and a state court has issued a decree (and thus exercised authority to review the propriety of distributions) granting the beneficiary the right to withdraw a certain amount based on that standard, then that amount will be taxable to the beneficiary under section 678(a).

A private letter ruling is another authority potentially contrary to the proposition that an ascertainable standard limits the applicability of section 678(a).⁵⁸¹ In this ruling, the IRS ruled that a beneficiary’s power to invade corpus for her “support, welfare and maintenance” would be taxable under section 678(a). However, “welfare” is not an ascertainable standard⁵⁸² and therefore is not subject to review by a state court. In addition, this private letter ruling serves only as an indicator of what the Service’s position was at the time the ruling was issued. It has no precedential value.⁵⁸³

The authorities seem to suggest that there is indeed no space between section 678(a)(1) and section 2041 (or section 2514). Therefore, where a goal is to avoid estate tax under section 2041 (or taxable gift tax status under section 2514), imposing a HEMS standard on a trust beneficiary’s power of withdrawal will likely block grantor trust treatment under section 678(a)(1) with respect to the holder of the power of withdrawal.⁵⁸⁴ It would seem that consistent treatment should be applied to both the taxpayer during his or her lifetime for income tax purposes and his or her estate after his or her death for estate tax purposes (or to the taxpayer during his or her lifetime for gift

581. Priv. Ltr. Rul. 8211057 (Dec. 16, 1981). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

582. Rev. Rul. 77-60, 1977-1 C.B. 282 (“A power to use property for the comfort, welfare or happiness of the holder of the power is not limited by [an ascertainable] standard”) (emphasis added).

583. Nevertheless, a private letter ruling may be used, in some cases, to meet a standard that may permit a taxpayer to avoid certain penalties. See, e.g., Treas. Reg. § 1.6662-4(d).

584. Indeed, it appears that the only viable way to make a credit shelter trust a grantor trust with respect to the surviving spouse would be to “supercharge” it as discussed in Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trusts*SM, 21 PROB. & PROP., July–Aug. 2007, at 52.

tax purposes), although estate and income tax provisions, unlike gift and estate tax provisions, are not *in pari materia*.⁵⁸⁵

Indeed, a taxpayer probably should be cautious in taking the position that section 678(a) applies, even if his or her withdrawal power is limited by an ascertainable standard, to make the trust a grantor trust with respect to himself or herself for income tax purposes. By taking that position, the taxpayer is essentially representing to the Service that his or her power of withdrawal is an unfettered one and that he or she has absolute control over the trust. If the taxpayer's withdrawal right were for income tax purposes considered not limited by an ascertainable standard, then would not that withdrawal right, not so limited, constitute a general power of appointment? It might be difficult for the taxpayer's estate successfully to take such inconsistent positions.

Tax return preparers and advisors also may be somewhat concerned about taking a position or providing advice that a trust is a grantor trust under section 678 with respect to a beneficiary if the beneficiary has a withdrawal right that is subject to an ascertainable standard. Under amended section 6694, a preparer may not take a position on a return and an advisor may not provide advice that the position may be taken unless there is "substantial authority" for the position or unless there is, in fact, a reasonable basis for the position and the position is specifically disclosed (generally by completing and attaching IRS Form 8275 to the return).⁵⁸⁶

585. *Merrill v. Fahs*, 324 U.S. 308, 311 (1945) ("The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together."); *Farid-Es-Sultaneh v. Comm'r*, 160 F.2d 812, 814 (2d Cir. 1947) ("[I]ncome tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes").

586. As a further alternative: the preparer includes the necessary disclosure form and the taxpayer removes it before filing it. See Mitchell M. Gans, Jonathan G. Blattmachr & Elisabeth Madden, *Notable Changes Seen with 2008 Amendments to § 6694 and Treasury's Final Tax Return Preparer Penalty Regulations*, 2009 TAX MGMT. EST. GIFTS & TR. J. (BNA) 120. In Priv. Ltr. Rul. 201216034 (Jan. 11, 2012), the beneficiary had a power to withdraw any corpus contributed by the grantor to the trust. The beneficiary's right of withdrawal was cumulative but lapsed at a rate of the greater of \$5,000 or 5% of the value of the trust on a specified date of each year. The ruling recites several of the "regular" provisions (such as the power of the grantor to borrow from the trust) and says none applies and concludes the trust would be a trust described under I.R.C. § 678 even as the power to withdraw lapsed if the power to substitute property of equivalent value granted under the instrument were held in a non-fiduciary capacity (a grantor trust provision under I.R.C. § 675). However, if such a power were so held, the trust would presumably be a grantor trust with respect to the grantor (and not the beneficiary) and I.R.C. § 678 could not apply.

§ 5:5.7 Section 678(b) and the Definition of “Income”

Section 678(b) provides that the rules under section 678(a) “shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this Section.” Therefore, on the face of section 678(b), at least with respect to the income of a trust, if the grantor is also treated as the owner of the trust, then the third party who is otherwise treated as the owner of the trust under section 678(a) would not be treated as the owner of the trust for income tax purposes. In other words, the grantor trust rules with respect to the grantor “trump” the grantor trust rules with respect to the third party when determining who should be taxed as the owner of the trust. However, because section 678(b) addresses only “income,” it is unclear, at least on the face of section 678(b), what would happen if both the third party and the grantor are treated as the owners of the trust corpus under the various grantor trust rules.

The answer may be in the definition of “income.”⁵⁸⁷ The word “income” in section 678(b) seems to mean taxable income (as opposed to accounting income) which includes income in a tax sense allocated to trust accounting income and corpus. Treasury Regulation section 1.671-2(b) provides that, for purposes of subpart E of part I of subchapter J of chapter 1 (that is, the grantor trust rules),⁵⁸⁸ the word “income,” unless specifically limited, refers to income determined for tax purposes and not income for trust accounting purposes.

587. Rev. Rul. 81-6, 1981-1 C.B. 385, states, in part, “Section 678(b) provides that Section 678(a) shall not apply if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of subpart E of Part I of subchapter J, other than Section 678” without limiting that statement to a case where the I.R.C. § 678 power is only over “income” as the statute provides. Although that could be claimed to be a concession by the IRS on the issue, such a claim likely would be unsuccessful as the statement is at most just a general description and is not critical to the holding of the ruling.

588. It is interesting to note that Treas. Reg. § 1.671-2(b) specifically provides that the definitions are to apply as “stated in the regulations under subpart E,” leaving open the possibility that the definitions may not apply as stated in the Code. Treas. Reg. § 1.671-2(b) states “[a]ccordingly, when it is stated in the regulations under subpart E that ‘income’ is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes” (emphasis added). However, Treas. Reg. § 1.678(b)-1 essentially repeats the language of I.R.C. § 678(b). Therefore, it is likely that the definitions under Treas. Reg. § 1.671-2(b) are to apply to both I.R.C. § 678(b) and Treas. Reg. § 1.678(b)-1.

The regulation further explains that, if it is intended that income is to refer to income for trust accounting purposes, it would use the phrase “ordinary income.”⁵⁸⁹ This suggests that, for purposes of section 678(b) (which is under subpart E of part I of subchapter J of chapter 1), the word “income” refers to taxable income (as opposed to accounting income) and includes tax income allocated to both accounting income and corpus of the trust. Therefore, if both a third party and a grantor are deemed the owners of income allocated to trust accounting income or corpus, or both, then, under section 678(b), the grantor, and not the third party, would be treated as the owner of that portion of the trust.

Section 643(b) further lends support to this proposition. Section 643(b) provides that, for purposes of subparts B, C and D of part I of subchapter J, the word “income” means the “amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.” The omission of a reference in section 643(b) to subpart E, the grantor trust rules, seems to suggest that, if the word “income” is used in subpart E, it would not have the meaning of accounting income. Indeed, it seems that the definition of income (that is, taxable income) under Treasury Regulation section 1.671-2(b) controls for the provisions under subpart E, including section 678(b).

The Service’s position seems to be consistent with the above proposition. In several private letter rulings, the Service has consistently taken the position that, if a grantor is treated as the owner of a trust under the grantor trust rules, then the grantor will be treated as the owner of the trust despite the fact that a third party is treated as the owner of the trust corpus under section 678.⁵⁹⁰

A series of private letter rulings issued in 2007 by the Service seem to support the proposition that the grantor would be treated as the owner of a trust despite the fact that a third party otherwise would be treated as the owner of the trust corpus under section 678(a).⁵⁹¹

589. Indeed, the Treasury Regulations under subpart E of part I of subchapter J of chapter 1 use the word “ordinary income” on twelve other occasions.

590. Priv. Ltr. Rul. 200732010 (May 1, 2007). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

591. Priv. Ltr. Rul. 200729005 (Mar. 27, 2007) through Priv. Ltr. Rul. 200729016 (Mar. 27, 2007). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

The facts are similar in all of the rulings: the grantor created an irrevocable trust and retained the power in a non-fiduciary capacity to acquire trust property and to substitute other property in its place which would make such trust a grantor trust under section 675(4)(C). The beneficiary of the trust was given a withdrawal power over an amount equal to the additions made to the trust each year not to exceed the applicable annual exclusion amount. The Service ruled that under such circumstances the grantors were treated as the owners of the trust under sections 675 and 678(b). Similar to other private letter rulings, the Service did not provide a detailed analysis of how it reached this conclusion.⁵⁹²

A possible counterargument to the above may lie in the wording of section 678 itself. On two occasions, section 678 specifically refers to “corpus” and “income,” thus implying that there is a distinction between the two.⁵⁹³ Similar distinctions are also contained in other parts of the grantor trust provisions that apply to the trust’s grantor.⁵⁹⁴ If the definition of income under Treasury Regulation section 1.671-2(b) includes income allocated to both accounting income and corpus, then the use of the word “corpus” in two parts of section 678 would seem superfluous. This internal inconsistency in the statutory language is perhaps a legislative oversight as suggested by some commentators.⁵⁹⁵

592. See also Priv. Ltr. Rul. 200603040 (Jan. 20, 2006). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

593. I.R.C. § 678(a)(1) provides that “[a] person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.” (emphasis added). I.R.C. § 678(c) provides that “[s]ubsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of I.R.C. § 661(a) and shall be taxed to the holder of the power under I.R.C. § 662.” (emphasis added).

594. See, e.g., I.R.C. §§ 674(a), 674(b)(4)–(8), 674(c)(2) 674(d).

595. William R. Swindler et al., *Beneficiary Withdrawal Powers in Grantors Trust—A Crumm(e)y Idea?*, 34 EST. PLAN., Oct. 2007, at 30, 33 (“Treasury officials have informally indicated that they view the failure to include ‘corpus’ in I.R.C. § 678(b) as a legislative oversight”). See also Jonathan E. Gopman, *Crummey, the Saga Continues*, 25 BNA TAX MGMT. EST., GIFTS & TR. J. 194 (July 13, 2000) (citing other commentators who have suggested that the failure to include “corpus” in I.R.C. § 678(b) is a drafting oversight).

§ 5:5.8 When Section 678(b) Exception No Longer Applies

[A] Section 678(b) Releases and Lapses

Further, even though a section 678 power has been partially released or otherwise modified so that the person who held it can no longer vest the corpus or the income of the trust in himself or herself, the powerholder continues to be treated as the owner if, after the release or modification, the powerholder has retained such interest in or control over the trust as would subject a grantor of such a trust to treatment as the owner.⁵⁹⁶ For example, this would apply if the powerholder or the powerholder's spouse were discretionary beneficiary of the trust after the power was released or modified.⁵⁹⁷

Despite the lack of guidance from these revenue rulings, the Service has consistently ruled in multiple private letter rulings that a lapsed power is considered "partially released or otherwise modified" for purposes of section 678(a)(2), causing the third party to be treated as the owner of that portion of the trust for income tax purposes even after the lapse of the power.⁵⁹⁸

Although the Service did not elaborate on the reasoning behind its position in the above private letter rulings cited in note 600, the proposition that a lapse should be treated as a partial release or modification under section 678(a)(2) appears to be logical. First, it would seem that, if section 678(a)(2) is only limited to a partial release or modification, then it would have very limited application as the lapse of a power to withdrawal is much more common than a release or modification.⁵⁹⁹ Second, if a lapse is not covered by section 678(a)(2), then similarly situated taxpayers would receive different tax treatments simply because one beneficiary took an action to partially release a power while the other failed to take such action and let the power lapse.⁶⁰⁰ In neither case is the beneficiary's power exercised; the only difference is in the mechanical means by which the beneficiary chooses not to exercise the power.

596. I.R.C. § 678(a)(2). *See also* Rev. Rul. 55-38, 1955-1 C.B. 389, as to the taxability of a beneficiary who has temporarily assigned trust income; *cf.* Rev. Rul. 77-436, 1977-2 C.B. 25 (beneficiary continues to be taxed on income from trust after assignment which is void under state law).

597. I.R.C. §§ 676, 677.

598. Priv. Ltr. Rul. 200104005 (Sept. 11, 2001); Priv. Ltr. Rul. 200147044 (Aug. 22, 2001); Priv. Ltr. Rul. 200022035 (Mar. 3, 2000). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

599. *See* Jonathan G. Blattmachr & Frederick M. Sembler, *Crummey Powers and Income Taxation*, CHASE REV., July 1995, at 4 [hereinafter Blattmachr & Sembler].

600. *Id.*

However, the terms “partially released” and “otherwise modified” do not appear to encompass the term “lapse.” In other words, a complete lapse does not seem to be a partial release or otherwise a modification of the power to withdraw. Moreover, the word “lapse” is expressly missing in the statute and the regulations. One may assume that Congress intentionally omitted the word for a reason. In fact, just a few years before the enactment of section 678, Congress enacted statutes that expressly treat a lapse as a release of a power of appointment for gift and estate tax purposes.⁶⁰¹ Yet, Congress did not include the concept of lapse in section 678(a)(2).⁶⁰²

The legislative history to the Internal Revenue Code of 1954 did not address the issue of “lapse.” The legislative history of section 678 is brief and only provides a very general description of the Section. It does not discuss section 678(a)(2) specifically or the concept of a lapse.⁶⁰³ Nonetheless, it is important to note that it does appear to contemplate broad application of the release/modification concept.⁶⁰⁴

Another possible argument as to why a withdrawal power that has lapsed is not considered “partially released or otherwise modified” under section 678(a)(2) is that a lapse could be characterized as a complete release of a power and section 678(a)(2) only refers to a partial release of a power. Commentators have suggested that, perhaps, a lapse would be categorized under the “otherwise modified” language.⁶⁰⁵ Although a “lapse” implies that no action is taken by the powerholder and “modify,” in contrast, implies an action of some kind, the “otherwise modified” language could be viewed as a catch-all,

601. For gift tax purposes, I.R.C. § 2514(e) provides that “[t]he lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.” Similarly for estate tax purposes, I.R.C. § 2041(b)(2) provides “[t]he lapse of power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.”

602. See generally Blattmachr & Sembler, *supra* note 599, at 8.

603. See H.R. REP. NO. 83-1337, at 4357 (1954); S. REP. NO. 83-1622, at 5013 (1954). See also SENATE FINANCE COMMITTEE REPORT TO ACCOMPANY H.R. 8300, Part 7 of 10 (Comm. Print 1954); HOUSE WAYS AND MEANS COMMITTEE REPORT TO ACCOMPANY H.R. 8300, Part 6 of 10 (1954).

604. See *id.* (indicating that “a person other than the grantor may be treated as the substantial owner . . . if he has modified the power (by release or otherwise)”).

605. Blattmachr & Sembler, *supra* note 599, at 6. See also David Westfall, *Lapsed Powers of Withdrawal and the Income Tax*, 39 TAX L. REV. 63, 69 (1983-1984); William Natbony, *The Crummey Trust and “Five and Five” Powers After ERTA*, 50 TAXES 497, 501 (1982).

intended to apply to any change to a power that would otherwise subject the third party to section 678(a).⁶⁰⁶

If a lapse is a complete release and is, therefore, outside the application of section 678(a)(2), then similarly situated taxpayers would be treated differently depending on the manner in which a given taxpayer allows her withdrawal power to become no longer exercisable. A taxpayer who relinquishes or permits to lapse her withdrawal power on a yearly basis would be treated differently from a taxpayer who relinquishes or permits to lapse her entire withdrawal power, including the power to withdraw in future years. Substantively, the end result is the same but due to the difference in the way the relinquishment or lapse occurs, one taxpayer would not be treated as the owner of the trust for income tax purposes while the other one would.

Perhaps, a possible explanation is that a lapse is a partial release of the power if one considers the power as a whole over the entire term of the trust.⁶⁰⁷ On at least one occasion, the Service has made a distinction between a complete release and a partial release. In a 1979 private letter ruling, the grantor created a trust in which the beneficiary has a lifetime power to withdraw principal from the trust.⁶⁰⁸ The Service ruled that, if the beneficiary “completely released the power to vest corpus” in himself “(as opposed to a partial release or modification),” the beneficiary will not be the owner of the trust under section 678(a)(2).⁶⁰⁹ This ruling seems to suggest that, if a third party relinquishes her withdrawal power for all future years, then section 678(a)(2) would not apply, but, if the third party simply allows the power to lapse with respect to the property for one year, then section 678(a)(2) would continue to apply. This ruling may lend support to the argument that an annual lapse is a partial release within the meaning of section 678(a)(2). On the other hand, a complete lapse (as opposed to an annual one) is more difficult to view, as indicated above, as a partial release (or modification).

In addition, a review of the language used by the Service in all the private letter rulings cited in this section indicate that the Service has consistently held that a third party who has allowed a withdrawal power to lapse each year or after a number of days (as opposed to a complete lapse of the power to withdraw in future years) has either “released” or

606. The original regulation, under the 1939 Code, states “or if he has modified this power (by release or otherwise),” which again may suggest some action on the part of the beneficiary.

607. Blattmachr & Sembler, *supra* note 599.

608. Priv. Ltr. Rul. 7943153 (July 30, 1979). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

609. *Id.*

“partially released” the power.⁶¹⁰ With the exception of this private letter ruling, it does not appear that the Service, at least in recent years, has made a distinction between a third party who has “released” or “partially released” a withdrawal power in the context of a lapse.

In any case, it is uncertain that a trust will remain a section 678 trust after a beneficiary’s withdrawal power lapses. As a consequence, it may not be wise to rely on its continuing section 678 status where loss of that status could cause adverse effects.⁶¹¹

The application of section 678 after a power is released or lapses creates complex reporting issues when the power is over some portion but less than all of the trust. For example, the typical “five or five” power creates a pseudo-grantor trust for only 5% of the trust when the value of the trust exceeds \$100,000 (so that 5% is larger than \$5,000). Real complexity arises when the “five or five” power is non-cumulative, but is available annually. The Service takes the position that section 678 applies to an ever-increasing portion of the trust income. Private Letter Ruling 200022035 sets the IRS position:

After each succeeding year in which [the powerholder] fails to exercise the five or five power, [the powerholder] will be treated as the owner of an increasing portion of the corpus of Trust 2. The annual increase of the portion of the corpus of Trust 2 of which [the powerholder] is treated as the owner is the product of the amount which [the powerholder] could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which [the powerholder] is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made.⁶¹²

This means the powerholder will be deemed the grantor for an ever-increasing percentage of the trust, but the percentage will never reach

610. Priv. Ltr. Rul. 200104005 (Jan. 26, 2001) (a lapse of a power to withdraw after the calendar year is considered “partially released”); Priv. Ltr. Rul. 200011054 (Mar. 17, 2000) (a lapse of a power to withdraw after thirty days is considered “released”); Priv. Ltr. Rul. 9504024 (Jan. 27, 1995) (a lapse of a power to withdraw after sixty days is considered “released”). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

611. For example, the powerholder sells an appreciated asset to a section 678 trust for a note. No gain is recognized. *See* Rev. Rul. 85-13, *supra*, note 540. However, if section 678 status ends before the note is paid and the powerholder dies, gain might occur. *See* Jonathan Blattmachr, M. Gans & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death*, 97 J. TAX’N 149 (Sept. 2002).

612. Priv. Ltr. Rul. 200022035. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

100%, not even in twenty years, unless the value of the trust is less than \$100,000, so that \$5,000 is the upper limit of the withdrawal power.⁶¹³ Thus, in most instances, some of the trust income will be still subject to regular reporting rules.

In another private letter ruling, the unilateral power to withdraw lapsed but the beneficiary continued for life to have a power to withdraw for health, education, maintenance and support.⁶¹⁴ The Service appears to expressly rule that there was a partial release (because only the unilateral power to withdraw lapsed but the one to withdraw pursuant to the standard remained). It may be noted that the power to withdraw under the standard was not a general power of appointment so that, once the unilateral power lapsed, no portion of the trust would be included in the gross estate of the beneficiary for estate tax purposes.

[B] Section 678(b)—678 Grantor Trust Status After “True” Grantor Trust Status Ends

As discussed above, section 678(b) provides that, when the grantor is treated as the owner of a trust, then the third party who is otherwise treated as the owner of the trust under section 678(a) will not be treated as the owner of the trust. However, what happens when the grantor is no longer treated as the owner of the trust? Grantor trust status with respect to the grantor ends when the grantor dies or when a condition under which the grantor was deemed to be the owner of the trust no longer applies. In such case, will section 678(a) operate to cause the third party to be treated as the owner of the trust?

Neither the Code nor the Regulations addresses this issue. However, the Service adopted the above view in private letter rulings.⁶¹⁵ It may be of interest to note that the Service’s private letter position changed in Private Letter Ruling 9321050 (Feb. 25, 1993).⁶¹⁶ In this ruling, the Service reversed its prior position the holding relating to the ownership for federal income tax purpose of the trust

613. If the value of the trust were a constant \$75,000, for example, a \$5,000 right of withdrawal would create a 100% section 678 grantor trust in fifteen years under the apparent IRS position.

614. Priv. Ltr. Rul. 200949012 (Aug. 17, 2009). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. The ruling is discussed in Diana S. C. Zeydel & Jonathan G. Blattmachr, LISI Estate Planning Newsletter #1559 (Dec. 10, 2009), www.leimbergservices.com.

615. Priv. Ltr. Rul. 9026036 (Mar. 28, 1990).

616. It is also interesting to note that in the interim, the Service refused to rule on the income tax consequences of a similar trust upon the death of the grantor. Priv. Ltr. Rul. 9141027 (July 11, 1991). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

upon the wife's death. The Service did not provide any explanation of its reversal or any analysis of its new position. The Service simply ruled that, after the wife's death, the husband will not be treated as the owner of the trust for income tax purposes. The Service did not clarify who, if anyone, would be the owner of the trust for income tax purposes. Presumably, because the wife is deceased and the husband is not the owner of the trust, the trust is no longer a grantor trust.

The Service's reversal of its position would suggest that, if grantor trust status with respect to the grantor is "turned off," then section 678(a) is no longer operative. In other words, if the third party has partially released or otherwise modified a power that would have made the trust a grantor trust with respect to the third party under section 678(a)(2), the third party would not be deemed the owner of the trust during and after the time that the trust was a grantor trust with respect to the grantor. Although the ruling did not address the situation of a third party being treated as the owner under section 678(a)(1), it arguably suggests that, even in such a case, the trust would not be a grantor trust with respect to the third party after the grantor trust status with respect to the grantor has been "turned off."

The income tax treatment under section 678 is unclear for the situation where the trust ceases to be a grantor trust with respect to the grantor. Without further guidance from the Service, it is difficult to understand the Service's reason in revising its position in the later private letter ruling. Taxpayers who find themselves in this situation may be well advised to seek a private letter ruling to clarify this issue.

§ 5:5.9 Section 678(c)—Support Exception

Another exception, contained in section 678(c), makes the entire section inapplicable to a power that enables a person as trustee "merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied."⁶¹⁷ This parallels the similar provisions for income taxable to grantors under section 677. However, a possible implication of the above quotation is that a person is income taxable where he or she has a power to and does apply income to a dependent's support (with, perhaps, a further implication of taxability

617. The Senate Finance Committee Report for the 1954 Code adoption provides:

The bill, however, makes a specific exception to the effect that a power to apply the income for support of dependents is not to result in the trust income being taxable to such other person unless the income is actually applied for the support of dependents.

S. REP. NO. 83-1622, at 4719.

where he or she must so apply it; for example, a trust for support of the grantor's minor grandchildren with the beneficiaries' mother or father as trustee).⁶¹⁸ This might be a tightening of prior law.⁶¹⁹ The 1954 Committee Reports describe the provision as a "liberalizing provision,"⁶²⁰ on the theory that under prior law the holder of the power would have been taxed even if the power had not been exercised. The regulations take the position that the holder of such a power is taxable except to the extent that the powerholder falls exactly within the exception.⁶²¹ On the other hand, probably because of the controversy aroused by section 678(c), the regulations state that section 678(c) has no application to the taxability of income not subject to a power specified in the section, and that the taxability of such income is governed by other provisions.⁶²²

The section 678(c) exception does not apply if the power is not held in a fiduciary capacity, that is, the powerholder is not trustee.⁶²³ Moreover, if the support payment is made from other than current income, that is from principal or accumulated income, sections 661(a)(2) and 662 are applicable instead.⁶²⁴

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618. For a contrary view, see Milton H. Stern, *A Tax Trap for the Family Trustee*, 33 TAXES 594 (1955). There may be a minimal requirement that the beneficiaries' father have some connection, at least being the trustee, before he will be taxed. See generally Harry A. Flannery, *The "Sprinkler Trust" and Its Inherent Federal Income Tax Problems: Fulfilling of Legal Support Obligations*, 54 TAXES 438 (1976); Sydney C. Winton, *Taxation of Nongrants Under Trusts for Support of Their Dependents*, 33 TAXES 804 (1955).
619. See *Stern v. Comm'r*, 137 F.2d 43 (2d Cir. 1943); *Welch v. Comm'r*, 8 T.C. 1139 (1947) (point not raised); *Joseph v. Comm'r*, 5 T.C. 1049 (1945). But cf. *Allen v. Nunnally*, 180 F.2d 318 (5th Cir. 1950).
620. H.R. REP. NO. 83-1337, at A212 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4089; S. REP. NO. 83-1622, at 5013; cf. Treas. Reg. § 20.2041-1(c) (donee holds general power of appointment if exercisable (whether or not exercised for post-1942 powers) in discharge of donee's legal obligations).
621. Treas. Reg. §§ 1.678(a)-1(b), 1.678(c)-1(b); see also Treas. Reg. § 1.662(a)-4. The Code exception is silent about a power of the specified kind if it is to apply to corpus rather than income. The regulations follow the language of the Code, except that there is one broader sentence in Treas. Reg. § 1.678(a)-1(b).
622. Treas. Reg. § 1.678(c)-1(c). This does not fully remove the implication, particularly in view of the cross-reference to Treas. Reg. § 1.662(a)-4. See also Rev. Rul. 59-357, 59-2 C.B. 212 (discussing Uniform Gifts to Minors Act, and indicating that income is taxable to any person to the extent used towards a support obligation of such person). For a general discussion of income taxation of Uniform Gift to Minors Act accounts, see section 3:7.1.
623. Treas. Reg. § 1.678(c)-1(b). Cf. I.R.C. § 674(c) (exception for powers to sprinkle income held by independent trustees).
624. I.R.C. § 678(c), last sentence.

Apart from this support situation, taxation of a person under section 678 seems avoidable because of the section's requirement that the power be exercisable *solely* by the person who is to be taxed, so a jointly-held power is outside the reach of section 678.⁶²⁵ This apparently is true even if the other co-powerholder is subordinate to the powerholder's wishes or the joint powerholders are related to each other.

§ 5:5.10 Section 678 and Spouses

Section 678 does not seem to apply even if the power is held by one spouse to make payments to the other spouse.⁶²⁶ This result does not appear to be altered by the 1986 enactment of section 672(e).⁶²⁷ Section 672(e) attributes to a grantor powers or interests that are held by the grantor's spouse, but a person taxed under section 678 is not a grantor. Section 678 provides: "A person other than the grantor shall be treated as the owner. . . ." If funds are actually paid to the spouse, section 678(b) might apply.⁶²⁸ Moreover, section 672(e) attributes powers and interests held by the grantor's spouse to the grantor for grantor trust purposes; it does not attribute the grantor's powers to the spouse. Thus, a trust would not be described in section 678 with respect to the spouse; rather, to the extent the grantor could transfer the trust property to his or her spouse, it might be a grantor trust with respect to the grantor under sections 674, 676, and 677. Similarly, to the extent the grantor's spouse could direct the trust property to the grantor, it would be a grantor trust with respect to the grantor, under at least those same sections.

§ 5:6 Switching or Toggling Grantor Trust Status On and Off

§ 5:6.1 Generally

Although grantor trust status generally may be advantageous, sometimes it may be desirable not to be a grantor trust. In other situations, being able to switch back and forth between grantor and nongrantor trust status may be desirable. For example, a grantor may

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625. See Treas. Reg. § 1.678(a)-1(b); Rev. Rul. 67-268, 1967-2 C.B. 226 (beneficiary was cotrustee with husband, who as managing trustee had power to distribute income to her: not taxable to either); *cf.* *Spies v. United States*, 84 F. Supp. 769 (N.D. Iowa 1949), *aff'd*, 180 F.2d 336 (8th Cir. 1950) (before the effective date of the *Mallinckrodt* regulations). T.D. 5488, 1946-1 C.B. 19, 23; *Cochran v. United States*, 62 F. Supp. 872 (Ct. Cl. 1945).
626. Rev. Rul. 67-268, 1967-2 C.B. 226.
627. See *supra* section 5:2.4.
628. See *Mesker v. United States*, 261 F. Supp. 817 (E.D. Mo. 1966).

be concerned with being liable for what potentially could be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to “turn off” the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a grantor trust initially. Similarly, it may be desirable to switch status if the grantor moves from a low or no income tax state (for example, Wyoming) to a high or higher income tax state (for example, California) where the trust would not be subject to state income taxes because of its “domicile.”⁶²⁹ Moreover, it may be appropriate to switch grantor trust status “on” when the grantor has a capital gain or loss and it is expected that the trust will have the “reverse” gain or loss. Thus, planning flexibility, for whatever reason, is increased if grantor trust status may be toggled on or off.⁶³⁰

§ 5:6.2 Turning Off Grantor Trust Status

Sometimes, turning off grantor trust status is as easy as releasing the power or beneficial interest that caused grantor trust status.⁶³¹ In other circumstances, it is accomplished by changing trustees to those who may have the grantor-trust sensitive power without causing grantor trust status.⁶³² Some grantor trust triggers seem to allow toggling by their very nature, such as actual borrowing of trust assets by the grantor under section 675(3).⁶³³ However, in a few circumstances, converting the trust to nongrantor status may not be possible.⁶³⁴ The ability to convert will depend on why the trust is a grantor trust.

Maximum flexibility of grantor trust planning involves restoring grantor trust status to a nongrantor trust that once was a grantor trust or making a trust a grantor trust that has never been one. However, several traps must be avoided. For example, when the grantor or the grantor’s spouse has the authority to relinquish the power that causes

629. It should be noted that different statutes use different criteria to impose their income taxes on trusts that are not grantor trusts. Compare N.Y. TAX LAW § 605, with CAL. REV. & TAX. CODE §§ 17742(a) *et seq.*

630. For an excellent discussion of these issues, see Videotape: Ellen L. van Hoften, Planning With Intentionally Defective Grantor Trusts (A.L.I.-A.B.A. Video Law Review Mar. 26, 1997). See also Howard M. Zaritsky, *Toggling Made Easy—Modifying a Trust to Create a Grantor Trust*, 36 EST. PLAN. 48 (2009).

631. For example, a section 675(4)(C) power. See *supra* section 5:5.3[F].

632. For example, a section 674(c) power. See *supra* section 5:5.2[B].

633. See I.R.C. § 675(3). Whether grantor trust status exists for a particular year depends on whether the grantor has actually borrowed trust assets during the year. See *supra* section 5:5.3[C].

634. For example, a section 673 power. See *supra* section 5:3.

grantor trust status, only a third party should be given the authority to reinstitute that power; that is, to toggle back “on” the grantor trust status.⁶³⁵ If the grantor or the grantor’s spouse has the right to relinquish a power that causes grantor trust status but has the right to reacquire that same power, the relinquishment likely would not be given effect. The regulations provide specifically that if the grantor has a power sufficiently broad to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under section 675, the grantor will be treated as the owner of the portion from the trust’s inception.⁶³⁶

Many of the grantor trust powers must be exercisable without the consent of any adverse party to result in grantor trust status.⁶³⁷ However, the power to eliminate or reinstate a grantor trust power could be held by either an adverse party or a nonadverse party. Having the status of an adverse or a nonadverse party is important for the person who holds the power that may make a trust a grantor trust, but that distinction has no relevance for a person who has the authority to eliminate or reinstate that power. Thus, a beneficiary might be given the power to toggle on or off grantor trust status.

Either the trustee or the grantor could be given the authority to relinquish the trustee’s power to make loans to the grantor without requiring adequate security.⁶³⁸ To toggle on grantor trust status, someone other than the grantor could be given the power to reinstate the power to loan without adequate security.⁶³⁹ If desirable, one person, who is not the grantor, or related or subordinate to the grantor—to put the grantor in the best position to argue that the power to lend without adequate security does not cause estate inclusion—could be given the power to both terminate the lending power in one taxable year and reinstate the lending power in a subsequent taxable year. However, to

635. The grantor’s retention of the right to toggle grantor trust status arguably might, in some cases, constitute a section 2036(a)(2) estate inclusion power or the gift to the trust might conceivably be an incomplete gift. It might be argued that if one person has the power but has released it, and another may reinstate the power, that in fact the power still exists because of the combined power of the two, and thus grantor trust status has not been toggled off. Under this view, terminating grantor trust status may be impossible. While this argument seems farfetched, for drafters who have such concerns, the trust instrument might specifically provide that the power to reinstate may not be exercised in the same year that the power is released. Then, on January 1st of each year, the initial powerholder may reaffirm the release of the power for the upcoming year, unless toggling back on may be desirable.

636. See Treas. Reg. § 1.675-1(a).

637. See *supra* section 5:5.2.

638. See *supra* section 5:5.3[B].

639. See the caveat given, *supra* note 635.

provide additional checks and balances, different persons could be given the authority to terminate and reinstate the power to lend without adequate security.

A person who is given the authority to add one or more persons (other than later-born or later-adopted) as beneficiaries could also be given the authority to relinquish the right to add beneficiaries and thereby turn off grantor trust status when the authority to add to the class was what alone caused grantor trust status. If a potential toggle is desired, another party should be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries.) Even if different persons are used, some commentators are concerned that the Service may view the two persons together as still holding the power.⁶⁴⁰ To ameliorate that concern, the instrument might provide that if the power to add beneficiaries is relinquished in any particular year, it could only be reinstated in a subsequent taxable year. In that case, if the power is ever relinquished, the trust would seem to be a nongrantor trust for the balance of that year.

When grantor trust status is achieved under section 674(c) using related or subordinate trustees⁶⁴¹ with the authority to make discretionary distributions not covered by a reasonably external standard, a third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause no more than one-half of the trustees to be related or subordinate parties if grantor trust status is not desired, or reversed to cause more than half of the co-trustees to be related or subordinate parties if grantor trust status is desired. The grantor should not hold the power to remove and replace successor trustees, unless the successor must be someone who is not a related or subordinate party in order to meet the "safe harbor" provided in estate tax Revenue Ruling 95-58.⁶⁴²

640. See, e.g., Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, in A.L.I.-A.B.A. COURSE OF STUDY: PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1556 (2007) ("The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a 'protector'), that probably only means that the trustee and the protector together still have the power."), quoted in Akers & Zeydel, *supra* note 369, at R-60.

641. The trustees must be subservient to the wishes of the grantor for their positions to cause grantor trust status. That is a factual issue that cannot be determined with complete certainty. If their position does cause grantor trust status, eliminating them as trustees, or reducing the number of them so that no more than half of them are trustees, will foreclose grantor trust status for that reason.

642. Rev. Rul. 95-58, 1995-2 C.B. 191.

Using this mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee rather than a power to add additional trustees. A second potential problem exists if the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, as in some circumstances it could be difficult to determine at the time that the trust agreement was prepared whether or not the next successor would be a related or subordinate party.

A grantor's spouse could have the power that results in grantor trust status power directly and could be authorized to relinquish the grantor trust power.⁶⁴³ This method might be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor's spouse. However, beware of section 672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes.⁶⁴⁴ Thus, if the grantor's spouse is given the power to relinquish *and* to reacquire the grantor trust power, the grantor might be treated as holding the power to reacquire the grantor trust power, and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

The powers used to result in grantor trust status may be very "significant" powers. For example, the power to add beneficiaries might permit the trustee to alter who might receive the income or principal distributed by a grantor trust. Giving different persons the authority to exercise those powers, to relinquish them, or to reinstate them, may provide useful checks and balances against the ability to misuse those powers. A private letter ruling⁶⁴⁵ illustrates the technique: An unrelated trustee could add a qualified charity (which would cause grantor trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer's spouse.⁶⁴⁶ Other parties—a majority of the taxpayer's

643. For example, the exception contained in section 674(c) to the general grantor trust rule of section 674(a) does not apply if the grantor's spouse is the trustee.

644. See I.R.C. § 672(e).

645. See Priv. Ltr. Rul. 9010065 (Mar. 9, 1990). The trust instrument in this letter ruling contains an intricate checks and balances system. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

646. If the spouse were not living, the approval of the taxpayer's sibling was required. See *id.* Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

adult descendants—were given the power to cut off grantor trust status by terminating the trustee’s authority to designate additional beneficiaries.⁶⁴⁷

The release of a grantor trust power should indicate specifically whether or not it is binding on successor trustees or successor persons holding the power. Maximum flexibility could be retained by not having the release binding on all successors, so that a third party could reinstate the power. In that case, the trust document, perhaps, should provide that the reinstatement power could only be exercised in the year after taxable year of the reinstatement, to help clarify that the trust is not a grantor trust in the year in which the relevant power is relinquished.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries or result in liability for the person holding the power for exercising or not exercising it.

Sometimes an irrevocable trust may be modified by either a court or by decanting.⁶⁴⁸ Thus, it may be possible to change the terms of a grantor trust to remove the grantor trust power.

I.R.S. Notice 2007-73⁶⁴⁹ identifies two rather complicated series of transactions involving toggling of grantor trusts. In each, a grantor trust would be formed that creates a unitrust interest and a non-contingent remainder interest for the grantor.⁶⁵⁰ The non-contingent remainder interest causes grantor trust status.⁶⁵¹ The goal of the scenarios is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain.⁶⁵² The Notice states “transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest” that require disclosure.⁶⁵³ The complicated transactions described in the two scenarios do not appear to be “garden variety” grantor trusts (even though grantor trust status has been toggled). The

647. *See id.* Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

648. *See* William R. Burford & Patricia H. Char, *Renegotiating the Irrevocable Trust: Amending, Decanting, and Judicially Modifying*, A.L.I.-A.B.A. EST. PLAN. COURSE MAT. J., Dec. 2008, at 37.

649. I.R.S. Notice 2007-73, 2007-36 I.R.B. 545.

650. *See id.*

651. *See id.*

652. *See id.*

653. *Id.*

Notice states explicitly that merely terminating grantor trust status does not invoke the Notice: “The transactions in this notice, as described above, do not include the situation where a trust’s grantor trust status is terminated, unless there is also a subsequent toggling back to the trust’s original status for income tax purposes.”⁶⁵⁴

At first blush, the quoted language seems to suggest that toggling grantor trust status off and then back on might be a “transaction of interest.” However, the quote more likely means that if the described underlying *transaction* is toggled off, but not back on, it is not a “transaction of interest.” If the Service means otherwise, the Notice is not delivering the message.

Despite the apparent technical ability to toggle grantor status off and back on, some planners are reluctant to exercise the “toggle back on” step for fear that the process appears artificial and might seem abusive of the grantor trust system. While the Notice does not indicate that toggling back on grantor trust status is necessarily a “transaction of interest,” the Notice does provide some level of support for those who are reluctant to exercise the “toggle back on” step.

§ 5:6.3 Turning On Grantor Trust Status

When a lifetime trust is not originally a grantor trust, it may be possible to convert it to a grantor trust. One way might involve changing the trustees. For example, if the trust allows distributions without a reasonably definite external standard, changing trustees so that more than half of the trustees are related or subordinate parties will result in grantor trust status under sections 674(a) and 674(c) if those trustees are, in fact, subservient to the wishes of the grantor or if the grantor’s spouse is the trustee.⁶⁵⁵ A domestic trust may be converted into a section 679 foreign trust by adding a foreign trustee or co-trustee or replacing the trustee with a foreign trustee.⁶⁵⁶ Actual borrowing of assets from the trust by the grantor without giving adequate security, but adequate interest, will make a trust a grantor trust under section 675(3) if loans are permitted under the terms of the trust agreement and the loan is not repaid before the beginning of the tax year.⁶⁵⁷ In addition, grantor trust status might be achieved by

654. *Id.* See generally JONATHAN G. BLATTMACHR & MITCHELL M. GANS, CIRCULAR 230 DESKBOOK § 3:2.1[A][6] (PLI 2009) (discussing “transactions of interest”).

655. See *supra* section 5:5.2[B].

656. See *supra* notes 502–24 and accompanying text.

657. See *supra* section 5:5.3[C].

paying the assets of the nongrantor trust over to a grantor trust pursuant to a “decanting” power or statute.⁶⁵⁸

An irrevocable trust may be modified by either a court or by decanting.⁶⁵⁹ Thus, it may be possible to change the terms of a nongrantor trust to add an appropriate grantor trust power.

When a nongrantor trust is converted into a grantor trust, the trust usually does not become a grantor trust for the entire year, but only for a fraction of the year. However, for some triggers, such as borrowing from the trust during the tax year, the trust will become a grantor trust for the entire year.⁶⁶⁰

§ 5:6.4 Tax Consequences of Toggling On and Off Grantor Trust Status

A change in the grantor trust status of a trust may cause unexpected income tax consequences. Issues involve pass-through entities, estimated payments, suspended losses and deductions, basis, and carryovers.⁶⁶¹ In Chief Counsel Advice 200923024, the Service concluded that “[t]he conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes . . . that requires recognition of gain to the owner.”⁶⁶² For a more detailed discussion, see section 5:7, below.

658. See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2009); ALASKA STAT. § 13.36.157 (2009).

659. See Burford & Char, *supra* note 648. See also Diana S.C. Zeydel & Jonathan G. Blattmachr, *Tax Effects of Decanting—Obtaining and Preserving the Benefits*, 111 J. TAX’N 288 (Nov. 2009). The IRS ruled that the modification of a trust “in accordance with State law” by the execution of a modification by the grantor and all beneficiaries of the trust to add a nonfiduciary substitution power would convert a non-grantor trust into a grantor trust in any year in which the power was determined to be a nonfiduciary power. Priv. Ltr. Ruls. 200848006 (Nov. 27, 2008), 200848015 (Nov. 28, 2008), 200848016 (Nov. 28, 2008), 200848017 (Nov. 28, 2008). In those rulings, the IRS expressed no opinion on the gift tax effects of the modification or of an exercise of the substitution power. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

660. See *supra* notes 407–10 and accompanying text.

661. For an excellent review of potential income tax effects of toggling grantor trust status, see Laura H. Peebles, *Mysteries of the Blinking Trust*, TR. & EST., Sept. 2008, at 16. For an extensive discussion of the issues concerning terminating grantor status, see section 5:8.

662. Chief Couns. Adv. 200923024 (June 5, 2009).

§ 5:7 The Termination of Grantor Trust Status—Tax Consequences⁶⁶³

It is the position of the Service that the existence of a wholly grantor trust is ignored for income tax purposes.⁶⁶⁴ Such a trust does not appear to be ignored for estate, gift, and generation-skipping transfer tax purposes.⁶⁶⁵ In fact, it seems that the use of a grantor trust may help to achieve certain estate planning results.⁶⁶⁶ Grantor trusts are used affirmatively to enhance three common estate planning strategies:

- (1) to permit the income earned by the trust to grow free of income tax, because the tax burden is imposed upon the grantor, and the payment of the income tax is not a gift;⁶⁶⁷
- (2) to permit assets to be sold by the grantor to the trust for their fair market value without the imposition of gift tax⁶⁶⁸ or income tax even if the assets sold are appreciated; and
- (3) to permit the purchase or exchange by the grantor shortly before death, without the imposition of income tax, of low-basis assets in exchange for higher-basis assets, such as cash, so the low-basis assets will be included in the grantor's gross estate at death and have a basis, once the grantor dies, equal to their estate tax values.⁶⁶⁹

663. This section is derived, in part, from Jonathan G. Blattmachr et al., *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (2002).

664. Rev. Rul. 85-13, 1985-1 C.B. 184. *But see* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). In Rev. Rul. 85-13, the Service announced it would not follow *Rothstein*. Taxpayers are permitted to rely on Revenue Rulings. *Rauenhorst v. Comm'r*, 119 T.C. 157 (2004); *Dover Corp. v. Comm'r*, 122 T.C. 324 (2004). *See also* Rev. Rul. 2007-13, 2007-1 C.B. 684.

665. Rev. Rul. 2004-64, 2004-2 C.B. 7.

666. *See, e.g.*, Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3 (1996); Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?*, 32 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶¶ 1500–11 (1998); Stephen J. Oshins et al., *Sale to a Defective Trust: A Life Insurance Technique*, TR. & EST. MAG., Apr. 1998, at 35; Jerome M. Hesch & Elliot Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶¶ 1600–02 (2000); Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000).

667. Rev. Rul. 2004-64, 2004-2 C.B. 7.

668. An individual makes a gift only to the extent the taxpayer receives back consideration in money or money's worth that is less than the value of what the taxpayer transferred. I.R.C. § 2512(b).

669. I.R.C. § 1014(a).

Even if the grantor receives a note in exchange for the transfer of trust assets to the trust, he or she incurs neither income nor gift tax liability at the time of the sale: for gift tax purposes, because the individual taxpayer receives full consideration, the transaction is viewed as a sale and, therefore, is not subject to gift tax;⁶⁷⁰ for income tax purposes, on the other hand, because the grantor of the trust is deemed to own all of the assets in the trust,⁶⁷¹ no sale is deemed to occur and, therefore, no part of the gain inherent in the asset becomes taxable by reason of the sale from the grantor to the trust.⁶⁷²

§ 5:7.1 Termination of Grantor Trust Status During the Grantor's Lifetime

[A] Third-Party Indebtedness

If, during the individual taxpayer's lifetime, a trust ceases to be a grantor trust, the income tax consequences appear to be certain: the grantor is deemed for federal income tax purposes to have transferred the assets in the trust at that time. For example, if there is indebtedness on the assets held by the trust, the grantor will be deemed to have sold them. If liabilities owed to a third party secured by the assets are in excess of the basis of the assets and the grantor does not remain liable for such debt, the grantor will realize gain.⁶⁷³ By a parity of logic, the trust takes as its basis in the assets the amount of such indebtedness.⁶⁷⁴

[B] Grantor Indebtedness

Although some commentators⁶⁷⁵ have concluded that gain similarly will be recognized where liabilities secured by the assets are in

670. See I.R.C. § 2512.

671. Rev. Rul. 85-13, 1985-1 C.B. 184.

672. See *id.* Also, because the grantor is deemed to continue owning all of the assets in the trust, the provisions in the note calling for payment of interest (inserted to avoid imputed-interest taxable gifts) do not result in income or deduction to the grantor or to the trustee.

673. See Treas. Reg. § 1.1001-2, ex. 5; see also Rev. Rul. 77-402, 1977-2 C.B. 222 (containing the same analysis that is now embodied in that example). See also Chief Couns. Adv. 200923024 (conversion of nongrantor trust to grantor trust not a taxable event at least where debt on trust's assets did not exceed income tax basis). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

674. The trustee's basis is equal to cost, as it would be in the case of any purchase under section 1012. See Treas. Reg. § 1.1015-4(a).

675. See, e.g., Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95

excess of the basis of the assets and the grantor does not remain liable for such debt, even where the indebtedness is owed not to a third party but to the grantor, no authority so holds and the conclusion may not be correct. Under the official position of the Service, there never is any debt for federal income tax purposes during the period that the trust is a grantor trust.⁶⁷⁶ Thus, although the property is treated as though it was transferred from the grantor to the trust at the time grantor trust status ends, the property was not treated at that time as being subject to indebtedness. As a result, authority that holds that the grantor is treated as though the grantor transferred a debt-laden asset when the debt that was recognized as being in existence, for federal income tax purposes, before grantor trust status terminated is inapposite. Nevertheless, where the debt owed on the property is recourse to the trust (at least once grantor trust status terminates during the grantor's lifetime), it seems the grantor is treated as though he or she sold the property to the trust in exchange for the amount of the debt (although timing of recognition of income by the grantor may not be immediate). The result may well be the same where the debt is non-resource to the trust (that is, the assets are treated as transferred to the non-grantor trust subject to the indebtedness), but there is no authority that discusses the issue; it may be that income is recognized only as the debt is paid off, as section 453 installment reporting is automatic unless elected out of or the asset sold does not qualify for an installment sale.

§ 5:7.2 Termination of Grantor Trust Status by Reason of the Grantor's Death

Where, however, the trust ceases to be a grantor trust as a result of the grantor's death, well-developed tax principles seem to support with reasonable certainty that neither the grantor nor his or her estate should be viewed as having made a sale of the assets in the trust. In addition, it appears relatively certain that no income in respect of a decedent⁶⁷⁷ is created by reason of the grantor's death for the assets of the trust. Under current law, there does not seem to be a clear answer to what the basis of the assets held in a grantor trust after the death of the grantor is in all cases.

J. TAX'N 49 (2001). This section is derived from Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002).

676. See Rev. Rul. 85-13, 1985-1 C.B. 184.

677. I.R.C. § 691 sets up the basic framework for income in respect of a decedent (IRD).

[A] Basic Rule of No Gain at Death

Although no section of the Code explicitly addresses the question, the traditional, well-ingrained view is that gain is not recognized by the transferor in connection with a testamentary or lifetime gift.⁶⁷⁸ Indeed, some argue that a contrary approach would raise constitutional questions,⁶⁷⁹ thereby obliging the courts to avoid any construction that would tax gain at death in the absence of an unambiguous direction from Congress.⁶⁸⁰ Not only does the Code fail to contain such a direction, it implicitly reflects the no-gain approach. In section 1001(b) of the Code, the term “amount realized” is defined “as including cash and the fair market value of other property received upon a sale or disposition of an asset.” Therefore, in the case of a lifetime gift, which ordinarily does not involve the receipt of any consideration, gain is not recognized.⁶⁸¹ The no-gain implication in section 1001 is consistent with the rule in section 1015 that the donee of a lifetime gift takes, as a general matter, the donor’s basis, again implying that the donor does not recognize any gain.⁶⁸²

Similarly, in the case of a bequest, there being no consideration, neither the decedent nor the estate is required to recognize gain.⁶⁸³ In its landmark decision in *Crane v. Commissioner*,⁶⁸⁴ the Supreme Court’s treatment of the legatee strongly suggests that testamentary gifts do not trigger gain. In *Crane*, the legatee inherited an asset that was encumbered by a liability exactly equal to its fair market value. Given that equality, the Court could have treated the transfer as a sale and given the legatee a cost basis for the purchase under the predecessor of current section 1012 of the Code. Instead, the Court treated it as a devise and, therefore, determined the legatee’s basis under the predecessor of section 1014, which provides, as a general rule, for the basis of each asset included in a decedent’s gross estate to

678. See *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); see also *Int’l Freighting Corp. v. Comm’r*, 135 F.2d 310 (2d Cir. 1943). Of course, if liabilities exceed basis, gain is recognized when *inter vivos* gifts are made. See *Diedrich v. Comm’r*, 457 U.S. 191 (1982).

679. See, e.g., JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS* 18 (11th ed. 2000). But see Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 5 ILL. L. REV. 779, 791 (1941); see also Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 52 (1999).

680. See *INS v. St. Cyr*, 533 U.S. 289, 300 (2001) (statutory interpretation that would raise constitutional questions should be avoided where alternative interpretation is “fairly possible”).

681. See *Int’l Freighting Corp. v. Comm’r*, 135 F.2d 310 (2d Cir. 1943); cf. *Diedrich v. Comm’r*, 457 U.S. 191 (1982).

682. See *Taft v. Bowers*, 278 U.S. 470 (1929).

683. Cf. *Crane v. Comm’r*, 331 U.S. 1 (1947).

684. *Id.*

be equal to its estate tax value. In refusing to treat the legatee as a purchaser, it tacitly rejected the view that the decedent or the estate had made a sale.

Ironically, many years later, the Supreme Court relied on a different aspect of its analysis in *Crane* to establish an exception to the no-gain rule. In *Diedrich v. Commissioner*,⁶⁸⁵ the Court held that, in the case of a lifetime gift under which the donee of the gift agreed to pay the gift tax, *Crane* requires that the donor be treated as having made a sale in part and as having recognized a gain when the liability encumbering the gifted asset exceeds the donor's basis. The exception recognized by the Court in *Diedrich* has never been applied in the case of a testamentary gift. Indeed, while the regulations under section 1001 do not affirmatively state that the exception to the no-gain rule is limited to lifetime transfers, it would be difficult to read them as contemplating otherwise. Neither the text nor any of the examples of the section 1001 regulations suggest that gain is triggered on a testamentary transfer of an asset encumbered by a liability in excess of the decedent's basis.⁶⁸⁶

Limiting the exception to lifetime transfers is not only consistent with *Crane's* logic but also appears to make sense as a matter of policy. The *Crane* decision can be read as having established two propositions. First, the Court held that the testamentary transfer of an asset that is fully encumbered by liability is to be treated as a bequest or devise, not a purchase. Also, as suggested, that implies that neither the decedent nor the decedent's estate should be viewed as having made a sale. Second, the Court held that when a taxpayer transfers an asset encumbered by a liability, the amount of the liability is to be included in the taxpayer's amount realized in computing gain or loss. These two holdings are somewhat in tension with each other. Under the latter holding, one might conclude that a testamentary transfer of an encumbered asset should result in gain. But, under the former holding, a decedent should not be viewed as having made a sale or taxable disposition at death. The treasury regulations under section 1001⁶⁸⁷ implicitly resolve this tension by creating the exception to the no-gain rule only for lifetime

685. *Diedrich v. Comm'r*, 457 U.S. 191 (1982); *see also* *Ebben v. United States*, 783 F.2d 906 (9th Cir. 1986).

686. *See* Treas. Reg. § 1.1001-2 (indicating that a disposition by "gift" triggers the exception and containing several examples that all involve transfers during life). Self-cancelling installment notes (SCINs) present unique issues for estates of decedents. The typical SCIN provides that no payments are due the decedent-seller or the seller's estate after the decedent's death. In *Estate of Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part* 98 T.C. 341 (1992), the U.S. Court of Appeals for the Eighth Circuit held that cancelling the installment sale obligation triggered income under section 453B(f).

687. *Id.*

transfers. The treasury regulations contain no indication that the exception should be applied in the case of a testamentary transfer.

In terms of policy, the exception to the no-gain rule for lifetime transfers is critical to prevent potential abuse by taxpayers, whereas there is no necessity for such an exception regarding testamentary transfers. In the absence of the exception, a taxpayer could borrow against an asset an amount equal to its value and then “gift” it subject to the liability without recognizing the gain—in effect converting the asset to cash on a tax-free basis. The potential for such abuse makes an exception to the no-gain rule necessary for lifetime transfers. In recognizing the need for the exception for such transfers in *Diedrich*, the Supreme Court—although ostensibly basing its decision on *Crane*—obviously perceived the policy-based need for the exception. In the case of a testamentary transfer, in contrast, the potential for abuse is much more limited because taxpayers seeking to enjoy the benefit of the no-gain rule must first die to come within its scope. And while, as a matter of policy, it might be contended that a similar exception to the no-gain rule should apply in the testamentary context as well, the justification for extending the exception is certainly not as compelling as the justification for the exception in the lifetime context.⁶⁸⁸

In legislation enacted in 2001,⁶⁸⁹ Congress explicitly rejected an exception to the no-gain rule in the testamentary context. In explaining section 1022 of the Code, the new carryover-basis-at-death regime that is operative during the year 2010 (when the estate tax is not operative), the Conference Committee explained: “The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent’s basis in the property.”⁶⁹⁰

688. Cf. I.R.C. § 1022(g)(1), (2) (gain must be recognized under the carryover basis rules effective in 2010 in some cases where a debt-laden asset is bequeathed to a tax-exempt entity).

689. Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, 115 Stat. 38 (2001).

690. See H.R. REP. NO. 107-84 at 113 (2001), *reprinted in* 2001 U.S.C.C.A.N. 46,311. Nevertheless, the Committee’s “clarification” was not made part of the statute. Moreover, while such a clarification may be determinative regarding future cases, the courts will often refuse to give weight to an opinion offered by a later Congress as to the intent of an earlier one. See, e.g., *United States v. Price*, 361 U.S. 304, 312–13 (1960). In other words, had Congress embodied the clarification in the statute and explicitly made it effective retroactively, it would unquestionably control the disposition of any pending or future litigation. Nevertheless, the report is consistent with, and therefore confirms the validity of, the widely accepted rule that death does not trigger gain, even where liabilities are in excess of basis.

Given that framework, the issue may become whether the transfer should be treated as lifetime (and, therefore, subject to the exception) or testamentary (and, therefore, not subject to the exception). Initially, it might appear that the transaction seems more in the nature of a lifetime transfer. After all, the transfer is made by the taxpayer during life into a lifetime trust. On closer scrutiny, however, it would seem more appropriate to treat it as a testamentary transfer. The reason is that when a taxpayer engages in transactions with a grantor trust there are no income tax consequences.⁶⁹¹ That is, transactions between the grantor and a grantor trust are completely disregarded for federal income tax purposes until the trust ceases to be a grantor trust.⁶⁹² Consequently, it would seem that, if the trust is to be disregarded for income tax purposes until the grantor's death, the transfer should be viewed as occurring at the time of the grantor's death and, therefore, treated as testamentary in nature. The regulations under section 1001 contain an example where the taxpayer transfers an asset encumbered by a liability to a grantor trust and then, in a subsequent transaction, renounces the power that causes it to be a grantor trust.⁶⁹³ The example concludes that a sale is deemed to occur (that is, gain must be recognized to the extent that the encumbering liability exceeds the grantor's basis in the asset) at the time the power is renounced, not when the transfer to the grantor trust occurred.⁶⁹⁴ That is simply an application of the exception to the no-gain rule for lifetime transfers.⁶⁹⁵ In the circumstances of the example, it would be inappropriate to treat the transfer as a testamentary one given that, during the grantor's life, the asset ceases to be owned by the grantor and the donee becomes obligated to discharge the encumbering liability. If

691. See Rev. Rul. 85-13, 1985-1 C.B. 184.

692. See *id.*

693. See Treas. Reg. § 1.1001-2, ex. 5.

694. See *id.*

695. For a case reaching the same conclusion even before the promulgation of the regulations, see *Madorin v. Comm'r*, 84 T.C. 667 (1985); see also Rev. Rul. 77-402, 1977-2 C.B. 222. Chief Couns. Adv. 200923024 (conversion of nongrantor trust to grantor trust not a taxable event at least where debt on trust's assets did not exceed income tax basis). The Chief Counsel Advice notes that:

[T]he rule set forth in these authorities [Treas. Reg. § 1.1001-2(c), Ex. 5, *Madorin v. Comm'r*, 84 T.C. 667 (1985), Rev. Rul. 77-402, 1977-2 C.B. 222] is narrow, insofar as it affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.

Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

the exception were not applicable on those facts, taxpayers would be able to convert their appreciated assets into cash on a tax-free basis through the simple expedient of making the transfer in three steps: by encumbering the appreciated asset; then contributing it to a grantor trust; and then relinquishing the power that caused it to be a grantor trust.

Treating an incomplete lifetime transfer as if it were a testamentary one is somewhat analogous to the approach taken for wealth transfer tax purposes. Where a power is retained by the grantor at the creation of a lifetime trust that renders the gift incomplete for gift tax purposes, the subsequent termination of the power completes the transaction and triggers a taxable gift at that time.⁶⁹⁶ However, if the power terminates because of the grantor's death, it is treated as a testamentary transfer: the gift tax does not apply; instead, the trust corpus is included in the grantor's gross estate.⁶⁹⁷ In *DiMarco v. Commissioner*,⁶⁹⁸ the government argued that an incomplete gift became complete for federal gift tax purposes and, therefore, subject to the gift tax at the time of the donor's death. The court rejected that argument, holding that the gift tax regulations require that an incomplete lifetime transfer be treated as a testamentary transfer (that is, become subject to estate tax, not the gift tax) where the power making the gift incomplete terminates at the grantor's death. Assuming the same analysis is applied in the income tax setting, a transfer of assets to a grantor trust subject to indebtedness owed to the grantor should be treated as a testamentary transfer that does not trigger gain unless the power or right causing grantor trust status is released before death.⁶⁹⁹

Section 684 of the Code, provides that, as a general rule, a transfer to a foreign trust requires the transferor to recognize all gain inherent in the transferred asset at the time of transfer. The section was clearly designed to apply to lifetime gifts in trust, even in the absence of an encumbering liability.⁷⁰⁰ Thus, the section contemplates at least a partial qualification of the no-gain rule. Echoing the notion in the domestic (non-foreign) trust setting that transactions or sales between the grantor and a grantor trust are to be disregarded, section 684(b)

696. See Treas. Reg. § 25.2511-2(b).

697. See Treas. Reg. § 25.2511-2(f).

698. *DiMarco v. Comm'r*, 87 T.C. 653 *acq.* 1990-2 C.B. 1.

699. It may be appropriate to note that the regulation at issue in *DiMarco* (Treas. Reg. § 25.2511-2) does state that transfers deemed to occur at death are not subject to the gift tax. Although there is no comparable provision in the regulations under section 1001 explicitly stating that termination of grantor trust status at death should not be subject to the income tax, the section 1001 regulations do, as previously indicated, implicitly take this position.

700. See H. REP. NO. 105-220, (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129.

provides that the section does not apply and that gain, therefore, is not recognized where the transfer is made to a grantor trust.

The Treasury Department has issued regulations that seem to reveal its views about the no-gain rule in the context of a grantor trust that retains its character as such until the grantor's death. In setting forth the scope of that provision, the regulations address the same questions that arise in the case of a sale to a domestic (U.S.) grantor trust: (1) whether a sale is deemed to occur if the grantor trust status ends during the grantor's lifetime; and (2) whether the cessation of grantor-trust status by reason of the grantor's death triggers gain under the section. As to the first issue, the regulations provide, as do the regulations under section 1001, that gain must be recognized when grantor trust status ends.⁷⁰¹ Unlike the regulations under section 1001, however, which provide that the sale is deemed to occur at the moment grantor trust status ceases, the section 684 regulations create the fiction that a sale is deemed to occur immediately before the cessation of such status.⁷⁰² As to the second issue, extending the fiction, the regulations provide that the grantor is deemed to make the sale immediately before death.⁷⁰³

As indicated in the preamble to the final regulations to Code section 684, one commentator questioned the authority for abandoning the no-gain-at-death rule.⁷⁰⁴ Implicitly recognizing the foundational nature of this rule, the Treasury Department justified its departure from the rule by making an argument specific to section 678 of the Code (which provides that a beneficiary of a trust who is not its grantor may be treated as the owner of the trust for income tax purposes in certain situations). The preamble maintains that the language of the section, particularly when considered against the backdrop of language in sections 679 and 6048(a)(3)(A)(ii) (which provides special and essentially adverse rules for foreign trusts and transfers to foreign trusts), reveals that Congress intended to tax testamentary transfers under section 684.⁷⁰⁵ Even so, it seems that the regulations make only a modest departure from the rule,

701. See Treas. Reg. § 1.684-2(e).

702. See *id.*

703. See Treas. Reg. § 1.684-2(e)(2), ex. 2. It may be noted that this is not only inconsistent with the rule under the I.R.C. § 1001 Treasury Regulations, but may well be inconsistent with I.R.C. § 684 itself. For, under subsection (b), no gain is to be recognized as long as the trust remains a grantor trust. And since immediately before the grantor's death the trust is still a grantor trust, it would appear that the fiction cannot be applied in the case of death without violating subsection (b).

704. See T.D. 8956, 2001-32 C.B. 112.

705. See *id.*

providing that gain need not be recognized if section 1014 of the Code will determine the basis of the assets in the hands of the trustee.⁷⁰⁶

As a consequence, as reflected in the preamble to the section 684 regulations, the Treasury Department acknowledges the foundational nature of the no-gain-at-death rule and the need for a clear indication of Congress's intent before any departure from the rule is warranted. With no such indication from Congress in the context of a sale to a domestic grantor trust, the Treasury Department's apparent logic inexorably leads to the conclusion that the cessation of grantor trust status by reason of the grantor's death does not trigger gain.

In *Estate of Frane v. Commissioner*,⁷⁰⁷ the Tax Court held that the cancellation of an installment note at the death of the obligee constituted a disposition of the note that triggered gain on the seller's final return under section 453B(f). Although this decision might be viewed as deviating from the no-gain-at-death rule, it should be emphasized that the decedent had elected installment reporting during his life. Under the cited section, a taxpayer electing this method of reporting gain implicitly agrees, in exchange for the privilege of deferring gain, that any cancellation of the note will result in the eventual recognition of the remaining untaxed gain.⁷⁰⁸ In contrast, in the case of an installment sale to a grantor trust, no taxable sale or disposition is made by the grantor during life and, of course, no installment-method election is or could be made. Nor has Congress enacted a provision analogous to section 453B(f) that would make death a taxable event as a general matter or that would force the grantor of a grantor trust to recognize gain at death. If the section is relevant at all, it is in its implication that the Code should be understood as embracing the no-gain-at-death rule as generally controlling in the absence of a specific section to the contrary, such as section 453B(f) or 684. Of course, the Eighth Circuit reversed the Tax Court and held that the balance of the installment note was reportable by the decedent's estate.⁷⁰⁹

In sum, given:

- the constitutional questions that taxing gain at death might raise and the rule that statutes should be construed so as to avoid such questions;

706. See Treas. Reg. § 1.684-3(c). Note that even where the assets in the trust are encumbered by a liability in excess of their basis, no gain is recognized under the I.R.C. § 684 Treasury Regulations if I.R.C. § 1014 determines the basis of the assets in the hands of the trustee after the death of the grantor.

707. *Estate of Frane v. Comm'r*, 98 T.C. 341 (1992), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

708. See *id.* at 351.

709. See section 2:3.1 and accompanying text for a discussion of IRD and *Frane*.

- the fundamental nature of the no-gain-at-death rule; Congress's rejection of a liability-in-excess-of-basis exception to the rule;
- the Supreme Court's implicit recognition of the rule in *Crane*; the Treasury Department's implicit recognition of the rule in the section 1001 treasury regulations and in the drafting of the section 684 treasury regulations;
- the lack of any clear indication from Congress that departure from the rule is appropriate, outside of section 684, where grantor-trust status terminates by reason of the grantor's death; and
- the notion that the assets in a grantor trust are deemed to be owned by the grantor as long as grantor-trust status has not terminated,

it seems nearly certain that there is no viable ground to lead to taxing gain at the death of a grantor with respect to which the trust is indebted at the grantor death.

[B] Income in Respect of a Decedent

As previously stated, section 1014 provides, as a general rule, that the income tax basis of an asset included in a decedent's estate for federal estate tax purposes is equal to its estate tax value. An exception is created for "income in respect of a decedent" (IRD), described in treasury regulations under section 691.⁷¹⁰ IRD is taxable income to which the decedent was entitled at death (such as accrued interest or the unrecognized gain from a sale being reported under the installment method of reporting) and which is not properly reportable for a period before the decedent's death.

Whether or not IRD is triggered at the death of the grantor where there is indebtedness on property owned by a grantor trust is an issue that seems to be closely related to whether the grantor's death caused gain to be realized at that time. The reason is that, under section 691, any gain attributable to the collection of an installment note constituting IRD would be taxable to the estate (or the beneficiary who receives collection on the note).⁷¹¹

Inherent gain will represent IRD where the grantor (or the grantor trust) has made a sale before the grantor's death, which is being recognized under the installment sale rules of section 453. However, the rule applies where indebtedness is owed to the grantor (or the grantor trust). That rule does not, by its terms at least, apply where the trust owes indebtedness, regardless of how the indebtedness arose.

710. Treas. Reg. § 1.691(a)-1. For a detailed discussion of IRD, see chapter 2.

711. See, e.g., *Rollert v. Comm'r*, 80 T.C. 619 (1983) (indicating the estate's distribution of the right to receive IRD makes the recipient taxable at the time of ultimate collection of the IRD item).

As explained above, no income is recognized by the taxpayer or his or her estate by reason of dying and owning property subject to indebtedness, even if the liability exceeds the taxpayer's income tax basis at death.⁷¹² Similarly, where a grantor trust is indebted on property it owns, there should be no gain recognition. Of course, property that a taxpayer owns at death will be included in his or her gross estate for federal estate tax purpose.⁷¹³ Property held by a grantor trust may not be. Nevertheless, it does not seem that the result should be any different. As a general rule, IRD means taxable income to which the decedent was entitled at death (but is not properly included in a pre-death income tax return of the decedent).⁷¹⁴ The payment by the grantor trust (treated for federal income tax purposes as paid by the grantor) cannot result in income to the grantor even if the payment is made during the grantor's lifetime. Therefore, there should be no IRD generated by reason of indebtedness owed by the trust to someone other than the grantor.

As mentioned above, there could be indebtedness owed by the trust to the grantor. But that indebtedness should not represent IRD.

The regulations under section 691 provide that where the decedent enters into an agreement providing for a sale that is to occur at the time of death, the sale proceeds do not constitute IRD.⁷¹⁵ Indeed, relying on these regulations, the Tax Court has stated that a sale does not result in IRD where "the sale is only effective upon the decedent's death."⁷¹⁶ Because a sale by the grantor to a grantor trust is ignored for income tax purposes, the earliest moment at which a sale should be viewed as having occurred is immediately after the grantor's death. And because sales occurring at the moment of death are not within the scope of the IRD concept, there is no basis for subjecting such an installment sale to the IRD rules under section 691.

[C] Trustee's Basis

An additional issue for grantor trusts is: what is the income tax basis of the assets in the grantor trust immediately following the death

712. Crane v. Comm'r, 331 U.S. 1 (1947).

713. I.R.C. § 2033.

714. Treas. Reg. § 1.691(a)-1.

715. See Treas. Reg. § 1.691(a)-2(b), ex. 4 (indicating that gain on the sale of stock under a buy-sell agreement is not IRD because the sale is not consummated until the decedent's death).

716. See Estate of Peterson v. Comm'r, 74 T.C. 630, 641 (1980), *aff'd*, 667 F.2d 675 (8th Cir. 1981). Although the court in *Peterson* does indicate that its definition of IRD is not "ironclad," 74 T.C. at 639 n.9, its discussion of the rule that a sale that is consummated at death does not create IRD suggests that the rule is not a flexible one. Indeed, the court reads the Treasury Regulation as creating a per se limitation on the IRD concept. 74 T.C. at 641.

of the grantor that terminates grantor trust status? There does not seem to be adequately developed law to provide a certain answer.

To attempt to provide an answer, it may be appropriate to characterize the trustee's acquisition. If the trustee is viewed as acquiring the assets by bequest or devise, section 1014 will determine basis, in which case it will equal the fair market value of the assets in the trust on the date of the decedent's death.⁷¹⁷ If, in contrast, the trustee is viewed as acquiring the assets by purchase, the trustee's basis will equal cost under section 1012. Or if the acquisition is viewed as either a lifetime gift or a transaction that is in part a purchase and in part a gift, section 1015 will govern.⁷¹⁸

Initially, it might seem that section 1014 is inapplicable if the terms of the grantor trust preclude it from being included in the grantor's gross estate for federal estate tax purposes. Indeed, section 1014 is commonly understood as applying only where the asset is included in the decedent's gross estate. A careful reading of the section, however, suggests more complexity. Although subsection (b)(9) of section 1014 does explicitly depend on estate-tax inclusion, subsection (b)(1) does not. It simply requires that the asset be acquired by bequest, devise or inheritance (or by the decedent's estate from the decedent). Also, the regulation interpreting subsection (b)(1) appears to contemplate that it will only apply in the case of property passing under the decedent's will or under the laws of intestacy.⁷¹⁹ However, neither the regulation nor the statutory language affirmatively precludes transfers made under a lifetime trust from qualifying as a bequest or devise.

In a colloquial sense, only an individual and not a lifetime trust effects a bequest or devise. Nevertheless, assets held by a grantor trust are deemed to be owned by the grantor for federal income tax purposes. Therefore, for federal income tax purposes, it seems that assets held in such a trust may be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death. Ignoring the lifetime character of the transaction under state law in favor of its tax-determined status is not without precedent. The grantor trust example, discussed above, in the section 1001 treasury regulations adopts the tax fiction that the grantor owns a partnership interest that, in fact, is owned for all non-income tax purposes by the trust. And, based on this fiction, the example subjects the grantor to the

717. If the executor elects to use alternate valuation under I.R.C. § 2032 for federal estate tax purposes, value will be determined on the alternate valuation date. Note that for individuals dying in 2010, no asset that passes from the decedent receives a "step-up" in basis pursuant to I.R.C. § 1014(a). See I.R.C. § 1014(f).

718. See Treas. Reg. § 1.1015-4 (providing the basis rule for a part sale/part gift).

719. See Treas. Reg. § 1.1014-2(a)(1).

provisions in Subchapter K of the Code⁷²⁰ that apply only to taxpayers who actually own a partnership interest. Also, in *DiMarco*, the Tax Court treated the grantor of a lifetime trust as having made a testamentary transfer for tax purposes, even though it clearly would have been viewed as lifetime in character for all other purposes.

The most likely reply to this argument would be based on subsections (b)(2) and (b)(3) of section 1014. They make the section applicable in the case of certain lifetime trusts. In addition, because both of the lifetime trusts described in these subsections would constitute grantor trusts, one might infer in these subsections a negative implication that the assets in a grantor trust cannot be viewed as having been transferred by bequest or devise simply because they are deemed to be owned until death by the grantor (for if that were the case, there would have been no need to include these subsections in section 1014 given subsection (b)(1)). This was presumably the view that the Treasury Department took of the section when it drafted the regulations under section 684. These regulations provide that, where a grantor trust ceases to be such upon the grantor's death, a sale is deemed to occur immediately before death unless section 1014 determines the trustee's basis in the assets. Thus, the Treasury Regulations under section 684 reflect the impression that section 1014 does not contemplate that it will apply in every case in which the assets are held in a grantor trust at the time of the grantor's death.

The weakness in that reply is that its premise, the negative implication, is not particularly compelling. None of the various subsections in section 1014 was enacted after the Service issued Revenue Ruling 85-13. Thus, at the time of enactment, it was not at all clear that grantor trusts should be disregarded for all income tax purposes. Indeed, in Revenue Ruling 85-13, in adopting the approach that all transactions between the grantor and a grantor trust should be disregarded for all income tax purposes, the Service expressly rejected the Second Circuit's then-recent decision in *Rothstein v. United States*.⁷²¹ In short, given that history, it would be difficult to infer that, in drafting subsection (b)(1) of section 1014, Congress contemplated that it would not apply to assets in a trust that remained a grantor trust until the grantor's death.

As a matter of policy, the argument that subsection (b)(1) of section 1014 applies to all grantor trusts that terminate at the time of the grantor's death is attractive. Were the rule otherwise, taxpayers would easily be able to circumvent it provided they had access to competent counsel and did not die precipitously. In other words, as the rationale

720. Subchapter K of the Code provides the fundamental income tax rules for partnerships and their partners.

721. *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

of Revenue Ruling 85-13 suggests, a taxpayer deemed to own the assets of a grantor trust having a basis less than value, if properly advised and assuming death were not completely unexpected, could purchase the assets for cash from the trustee without triggering a gain and thereby make the basis of the assets equal to their value under section 1014. Because it seems to make no sense—and, arguably, would be inequitable—to create an advantage for taxpayers who have more competent counsel or who have an advance indication of the time of their death, it is preferable to read subsection (b)(1) as applicable to all trusts that remain grantor trusts until the grantor's death. That is not to say that the law should continue to permit the estate tax freeze that sales to such trusts presently provide while, at the same time, allowing the trustee's basis to be determined under section 1014. It is, rather, to say that it would be inappropriate to deny section 1014 treatment where the taxpayer dies without having made the repurchase while permitting such treatment where the taxpayer has the foresight to accomplish the repurchase before death.

Finally, it might be contended, at least where the indebtedness is owed by the grantor trust to the grantor at death, that the presence of an encumbering liability makes it inappropriate to apply section 1014. In other words, if the trustee has given a note to the grantor as consideration for acquiring the assets, it makes more sense to view the transaction as a purchase than as a bequest or devise.⁷²² This strand of analysis was rejected, however, in *Crane*, where the Supreme Court applied the predecessor of section 1014 even though the asset acquired by the legatee was encumbered by a liability equal to its value. Consequently, the fact that the trustee undertakes the liability in connection with the acquisition (or, more precisely, the grantor's estate) does not inexorably render section 1014 inapplicable. To be sure, a reply might be made that *Crane* involved a devise and the transaction under inquiry has more of a lifetime flavor. Nevertheless, as indicated, the trust must be ignored for income tax purposes until the grantor's death, so it may be more appropriate to view the trustee's acquisition as a bequest or devise and to apply, therefore, *Crane's* analysis.

In the alternative, the trustee's acquisition could possibly be viewed as a purchase. Under this view, given the requirement that the transaction be ignored during the grantor's life, the trustee would be treated as having acquired the assets in exchange for the note at the moment of the grantor's death. The trustee's basis would, as a result, be equal to cost under section 1012, which would be the

722. Cf. *Farid-Es-Sultaneh v. Comm'r*, 160 F.2d 812, 815 (2d Cir. 1947) (indicating that the presence of consideration suggested that the transaction should be viewed as a purchase, rather than a lifetime gift, for purposes of determining basis).

amount of the note (assuming the post-death interest rate on the note is sufficient or the note is immediately payable).⁷²³ This, of course, would have the asymmetrical effect of treating the trustee as having made a purchase while treating neither the decedent nor the estate as having made a sale. But, pointed out above, there is no basis under current law for treating the decedent or the estate as having made a sale where grantor-trust status terminates by reason of the grantor's death.

It seems that the final alternative is to view the trustee as having acquired the assets by lifetime gift. That, of course, implicates section 1015, which provides the basis rule for assets acquired by gift. There are three different rules under section 1015 that might conceivably be employed to determine the trustee's basis.⁷²⁴

First, if the acquisition is viewed as a "pure gift" (that is, as if the assets were acquired without any consideration), then section 1015(a) would determine basis.⁷²⁵ Under this subsection, for purposes of computing gain on any subsequent sale (as well as for purposes of computing depreciation),⁷²⁶ the trustee's basis in the assets would be equal to the grantor's basis. For purposes of computing loss on any subsequent sale, however, the trustee's basis would be equal to the lesser of (a) the donor's basis or (b) the fair market value of the asset on the date of the gift.⁷²⁷ The requirement that fair market value be used as the donee's basis for purposes of computing loss, where less than the donor's basis, is designed to prevent the shifting of losses that accrue during the donor's ownership to the donee.

In the case of a loss, one would have to determine the date of the gift because of the requirement that the fair market value on the date of the gift be ascertained. Under the regulations, the donee is treated as acquiring the asset when the donor relinquishes dominion over it. Does this suggest that the date of the gift, for this purpose, is the date of the sale to the grantor trust? But this violates the rule that transactions between the grantor and a grantor trust be ignored for income tax purposes—and, of course, section 1015 is an income tax provision.⁷²⁸ Second, it might be argued that, because of the liability

723. See Treas. Reg. § 1.1274-5(d).

724. Whichever approach is followed, there should, in addition, be an adjustment for gift tax paid under I.R.C. § 1015(d).

725. See *Malone v. United States*, 326 F. Supp. 106, 113–14 (N.D. Miss. 1971), *aff'd*, 455 F.2d 502 (5th Cir. 1972) (indicating that section 1015(a) only applies in the case of a "pure gift" and that, where a trustee acquires an asset that is encumbered by a liability, it is not a pure gift and, therefore, I.R.C. § 1015(b) governs).

726. See Treas. Reg. § 1.167(g)-1.

727. I.R.C. § 1015; Treas. Reg. § 1.1015-1(c).

728. See *Newman v. Comm'r*, 4 T.C. 226 (1944) (discussing the government's argument that a distribution from a grantor trust to the grantor's child

undertaken by the trustee, section 1015(b) should determine the basis. This subsection applies to a transfer in trust other than by gift, bequest or devise. In other words, it contemplates that it will apply where (a) the transfer is in trust, not outright, and (b) there is at least some consideration present.⁷²⁹

When it applies, the trustee's basis is equal to the sum of the donor's basis and the amount of gain recognized by the donor on the transfer (or the donor's basis reduced by any recognized loss). The congressional purpose in creating this differentiation in these two subsections was to prevent the shifting of losses for transactions falling under the former subsection while permitting it for transactions falling under the latter subsection. Apparently, Congress was of the view that abusive loss-shifting strategies that could be deployed in the context of an outright gift were not as problematic where the transfer is made in trust for a consideration. In contrast, in terms of determining basis for purposes of computing gain or depreciation, Congress intended the two subsections to be parallel: basis, for purposes of computing gain or depreciation, would be the same under either subsection.

To illustrate why Congress may have decided it was unnecessary to include a loss-shifting provision in subsection (b) of section 1015, assume a taxpayer owns an asset with a basis of \$200,000 and a value of \$100,000. If the taxpayer were to sell the asset to a trust for its value of \$100,000, the basis of the asset in the hands of the trustee would be \$100,000 under subsection (b)—the trustee's basis, under the subsection, would be equal to the taxpayer's basis of \$200,000 less the taxpayer's recognized loss of \$100,000. Applied in this fashion,

should be viewed as effecting a gift to the child on the date of the distribution, thus, making the fair market value on that date determinative for purposes of computing loss).

729. As indicated in note 725, *supra*, in *Malone*, the court concluded that, because the trustee acquired the asset by undertaking to pay an encumbering liability, it was not, in the language of the court, a "pure gift." As a result, the court held, subsection (b) of I.R.C. § 1015 controlled the determination of the trustee's basis—the court indicating that all transfers in trust fall under subsection (b) unless they constitute a "pure gift" (*i.e.*, no consideration). It could, however, be maintained that the court's analysis was flawed, as the court indicated that, were it not to apply subsection (b), it would create an unsatisfactory result as a matter of policy in that the trustee's basis would not be increased by the amount of gain recognized by the grantor on the transfer. In making this assumption, however, the court failed to appreciate (or even cite) Treas. Reg. § 1.1015-4, under which the trustee's basis would reflect the gain recognized by the grantor. In other words, contrary to the court's assumption, the correct result in terms of policy could have been reached without invoking subsection (b).

subsection (b) does not permit the trustee to deduct a loss on any subsequent sale that accrued economically during the taxpayer's ownership of the asset. Therefore, if so applied, subsection (b) does not permit loss-shifting to occur, making unnecessary the kind of rule designed to prevent it in the context of subsection (a) of section 1015 transactions. It is, however, possible that subsection (b) might, contrary to Congress' expectations, permit loss-shifting. If, in this example, the taxpayer had first created the trust (even if the taxpayer made no contribution of funds) and the loss on the sale to the trust was consequently disallowed because it was a sale between a trust grantor and the fiduciary,⁷³⁰ the trustee's basis would be \$200,000. Thus, the loss that accrued economically during the taxpayer's ownership of the asset is shifted to the trust on a subsequent sale.

Third, the part-sale-part-gift provision contained in the regulations might apply.⁷³¹ Under this provision, the trustee's basis would be equal to the greater of (a) the grantor's basis or (b) the amount paid by the trustee.⁷³² While this provision is commonly understood as producing a basis in the recipient's hands equal to the sum of the donor's basis and the amount of gain recognized by the donor on the transaction, it might, surprisingly, produce a different result if applied in the context of a sale to a grantor trust. To illustrate, assume that the grantor has an asset with a basis of \$1 million and a value of \$2 million. If the asset is sold to a grantor trust for \$2 million, the part-sale-part-gift provision produces a basis in the hands of the trustee of \$2 million (because the consideration paid, \$2 million, is greater than the grantor's basis, \$1 million). The provision obviously assumes that, to the extent that the recipient has furnished consideration, consideration enters into the grantor's amount realized and is therefore subjected to income tax. But the assumption does not hold if, as earlier suggested, neither the decedent nor the decedent's estate recognizes any gain on the sale. The predicate for invoking this provision is that the transaction be in part a gift and in part a sale. Seeking to limit the trustee's basis to the grantor's basis, the Service would presumably argue in response to any taxpayer argument based on this provision that it does not apply where the sale is for a consideration equal to the asset's value. In terms of planning, therefore, it might be appropriate to consider making the sale for a consideration that is somewhat less than full value.

730. I.R.C. § 267(b)(4) (denying loss deduction on sale between grantor and fiduciary); Treas. Reg. § 1.671-2(e) (implying that a person who creates a trust but who does not fund it should nevertheless be viewed as a grantor).

731. See Treas. Reg. § 1.1015-4.

732. See *id.*

In sum, it appears that a more compelling argument can be made to have the basis of assets held in a grantor trust at the grantor's death determined under section 1014 than under either section 1012 or 1015.

In Chief Counsel Advice 200937028, the Service stated:

Quoting from section 1.1014-1(a) of the Regulations: 'The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally, . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]'

Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9).⁷³³

Nevertheless, in Private Letter Ruling 201245006, the Service ruled that assets of a foreign grantor trust received a stepped-up basis under section 1014(a) even though the assets of the trust will not be included in the taxpayer's gross estate.⁷³⁴ The ruling concludes that:

Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. *See* Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.

In Revenue Procedure 2015-37,^{734.1} the Service announced that effective with respect to private letter ruling requests received after

733. Chief Couns. Adv. 200937028. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

734. Priv. Ltr. Rul. 201245006. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

734.1. Rev. Proc. 2015-37, 2015-16 I.R.B. 1196.

June 15, 2015, it would no longer rule on the basis adjustments under section 1014 for assets held in a grantor trust when deemed owner of the trust dies, if the assets are not included in the gross estate of the owner. This change is an amendment to Revenue Procedure 2015-3,^{734.2} which lists issues on which the Service will not issue a private letter ruling.

Note that a trustee may choose to report the trust's income, deductions and credits on Form 1041 (the U.S. Fiduciary Income Tax Return) regardless of whether the trust is a "grantor trust" in its entirety with respect to one or more persons, and this option should be considered at each stage of the analysis.

§ 5:8 Incomplete Non-Grantor Type Trusts: No Gift Not a Grantor Trust⁷³⁵

§ 5:8.1 Introduction

The initial reaction and, in some quarters, the continuing reaction of many practitioners is that it is not possible to have lifetime transfers made to a trust be incomplete for federal gift tax purposes and have the trust not be a grantor trust for federal income tax purposes. However, the Internal Revenue Service has issued several private letter rulings that reach that result. The apparent purpose of using such a structure is to attempt to avoid state and local income taxes on taxable income generated on the assets transferred in such an arrangement.⁷³⁶

§ 5:8.2 A Brief History of Gift and Grantor Trust Rules

As a general rule, an individual taxpayer, subject to state (or local) income tax may create a non-grantor trust that avoids state (or local) income taxation. For example, an income tax resident of New York City and State, both of which impose income taxes, may transfer property during his or her lifetime to a trust that is not a grantor trust so that the income avoids New York state and local taxes.⁷³⁷ The basis upon which a state may seek to impose its income tax on income of a non-grantor trust varies significantly from jurisdiction

734.2. Rev. Proc. 2015-3, 2015-1 I.R.B. 129.

735. Portions of this section appeared in Jonathan G. Blattmachr & William D. Lipkind, *Fundamentals of Ding Type Trusts: No Gift Not a Grantor Trust*, 26 PROB. PRAC. REP., no. 4, at 1 (Apr. 2014) (copyright Jonathan G. Blattmachr & William D. Lipkind), and appears herein with permission.

736. Some states have passed legislation that would attempt to foil such a result. *See, e.g.*, N.Y. TAX LAW § 612(40), (41) (2014), enacted in 2014 Sess. Law News of N.Y. Ch. 59 (S. 6359-D) (Mar. 31, 2014).

737. As many states do, New York defines a "resident trust" as one created by a New Yorker and imposes its income tax on such resident trusts. *See*

to jurisdiction,⁷³⁸ but there seems to be constitutional limitations on the ability of a state to impose its income tax merely on the ground that the trust was created by an income tax resident of the state.⁷³⁹

Although creating a non-grantor trust can avoid state and local income taxes, there are at least two reasons why that has not been widely done. First, it has been perceived that neither the individual taxpayer who creates the trust nor his or her spouse may be a trust beneficiary because, as widely believed, if either is a trust beneficiary, the trust will be a grantor trust, meaning the income will be attributed back to the individual taxpayer and, thereby, be subject to the state and local income taxes that would be imposed upon the taxpayer if he or she had directly earned the income. That is because almost all state and local jurisdictions impose income taxes based essentially, but subject to exceptions and special rules, on the taxpayer's federal income. Thus, income attributed to the grantor under the grantor trust rules would continue to be taxed under the same state and local taxes as would all other income reportable by the grantor. Although by excluding the grantor and the grantor's spouse as beneficiaries a non-grantor trust may readily be created, many taxpayers do not want to lose access to the property transferred to a trust as well as the income the property thereafter produces.

The second "limitation" is that it is generally perceived that any transfer of property to a non-grantor trust will be a completed gift for federal gift tax purposes resulting in the use of the taxpayer's lifetime gift tax exemption⁷⁴⁰ and, to the extent the gift exceeds the available exemption, resulting in the payment of gift tax.⁷⁴¹ Many

N.Y. TAX LAW § 605(b)(3) (2009). However, no tax is imposed if the trust has no New York trustee, no New York source income, or no assets situated in New York.

738. Under California law, for example, the state income tax is imposed if there is a California trustee or a California beneficiary. *See* CAL. REV. & TAX. CODE § 17742 (1983). The tax residence of the grantor of the trust is not a factor in determining whether California will seek to impose its income tax.

739. *See, e.g.,* McNeil v. Pennsylvania, 67 A.3d 185 (Pa. Commw. Ct. 2013); Linn v. Dep't of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013). *But cf.* Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999).

740. *See* I.R.C. § 2505(b).

741. "The [Internal Revenue] Code states that if a donor 'transfers property by gift,' such donor will be liable for a gift tax. However, not all transfers of property are considered 'gifts' or, more appropriately, 'completed gifts.' This is important because only completed gifts are taxable gifts." THE ELDER LAW PORTFOLIO SERIES § 4-4 (Harry S. Margolis ed., Aspen Publ'ns 2007). Of course, a taxpayer could make a gift of property to charity and avoid gift tax under gift tax charitable deduction of section 2522 but that is usually not a reason to make a transfer to charity. A taxpayer also could

taxpayers wish to preserve their exemptions, especially if they anticipate receiving all or a portion of the gifted property back. Moreover, as a general rule, taxpayers want to avoid paying gift tax.

§ 5:8.3 Initial Private Letter Rulings

Beginning in the early 2000s, the Service began issuing private letter rulings holding that the transfer of assets to a specifically designed trust would not be a completed gift and the trust would not be a grantor trust even though all the property might be returned to the grantor.⁷⁴² Although under section 6110(k)(3), these private rulings could not be cited or used as precedent, there were so many and so consistent that several practitioners created such arrangements for clients without private letter rulings.⁷⁴³ ING trusts began being called “DING trusts” for “Delaware Incomplete Non-Grantor” trusts, although most of the private letter rulings were issued for trusts governed by Alaska law.

The structure of the trusts in these rulings was essentially the same. The trusts were irrevocable and the trustee had no authority to make distributions to any beneficiary during the grantor’s lifetime but only at the direction of a group of individuals, who were beneficiaries in addition to the grantor, and called the “Distribution Committee”⁷⁴⁴ either by their unanimous direction or by the direction of the grantor and a member of the Distribution Committee. The grantor also retained a testamentary special (non-general) power of appointment and, in default of its effectual exercise, the trust remainder would pass to the grantor’s descendants or, if not, to alternate

transfer property to his or her spouse and avoid gift tax under the gift tax marital deduction of section 2523 if the spouse is a U.S. citizen but the income generated on the gifted property will be taxed to the spouse. If the transfer is to a marital deduction trust, at least the so-called ordinary income tax portion of the trust’s income will be taxed back to the grantor under section 677, although the “principal income” portion (*e.g.*, capital gain) might not be if that portion of the income is not available for distribution to the taxpayer or the spouse.

742. *See, e.g.*, Priv. Ltr. Ruls. 200731019 (Aug. 3, 2007); 200715005 (Apr. 13, 2007); 200647001 (Nov. 24, 2006); 200612002 (Mar. 24, 2006); 200502014 (Jan. 14, 2005); 200247013 (Nov. 22, 2002). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

743. I.R.C. § 6110(k)(3).

744. In some of the trusts, this committee was called the “Power of Appointment Committee.” *See, e.g.*, Priv. Ltr. Rul. 200612002 (Mar. 24, 2006). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

remainder beneficiaries (for example, charitable organizations). Under this structure, the Service consistently held that the transfer to the trust was not a completed gift and the trust was not a grantor trust.

Eventually, taxpayers began asking for another ruling: that the taxpayers who held the power, in a non-fiduciary capacity, to require the trustee to make distributions (and who comprise the Distribution Committee) would not be treated as making a gift for federal gift tax purposes by directing the trustee to make distributions to a beneficiary other than themselves because the members of the Committee did not hold general powers of appointment described in section 2514.⁷⁴⁵

Many critical aspects of these trusts do not appear from the rulings themselves but can only be derived from the requests for the rulings and the experience of the practitioners who have acquired them.⁷⁴⁶ These additional aspects are discussed below.

§ 5:8.4 I.R.S. Release 2007-127

On July 9, 2007, the Service issued Release 2007-127 (the “Release”) in which the Chief Counsel requested comments on whether the private letter rulings holding that no member of the Distribution Committee held general powers of appointment was consistent with Revenue Ruling 76-503⁷⁴⁷ and Revenue Ruling 77-158.⁷⁴⁸ Many professional organizations submitted comments with the great number concluding that no member of a Distribution Committee held a general power of appointment.⁷⁴⁹

To date, the Service has not issued any guidance on its position with respect to the issue raised in the Release. But beginning in 2013, the Service began issuing private letter rulings addressing all three issues

745. See, e.g., Priv. Ltr. Rul. 200502014 (Jan. 14, 2005). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

746. Co-author Jonathan Blattmachr received most of the pre-Release private letter rulings. Co-author William Lipkind received the first post-Release private letter rulings and several of the others that have been issued since then.

747. 1976-2 C.B. 275.

748. 1977-1 C.B. 285.

749. See, e.g., Letter from Michael I. Frankel, Chair, Estate & Gift Taxation Committee, to the Internal Revenue Serv. (Oct. 3, 2007), www.nycbar.org/pdf/report/IR-2007-127.pdf; Letter from Kathleen M. Martin, Section Chair, ABA Section of Real Property, Trust and Estate Law, to the Internal Revenue Serv. (Sept. 26, 2007), www.americanbar.org/content/dam/aba/publications/rpte_ereport/2007/october/comments_on_private_letter_rulings.authcheckdam.pdf.

involving a somewhat different structure that appears to obviate the issue addressed in the Release.⁷⁵⁰

§ 5:8.5 Grantor Trust Issues

A trust may be a grantor trust for one of several reasons, including: (1) when it is a foreign trust with an American beneficiary as described in section 679; (2) where certain administrative powers described in section 675 are present; or (3) when certain borrowing of trust property has occurred within the meaning of section 675(3).⁷⁵¹ As a general rule, careful drafting of the trust document and administration of the trust may avoid these grantor trust rules.

However, other circumstances when grantor trust status is sought to be avoided may be more difficult to find such as when the grantor or the grantor's spouse holds certain powers over or has interests in the trust. For example, if the grantor (or the grantor's spouse) holds a reversionary interest in the trust described in section 673, it will be a grantor trust. Similarly, if the grantor (or the grantor's spouse) holds certain powers to control the beneficial enjoyment of trust property as described in section 674, it will be a grantor trust. Moreover, if income or corpus must or may be distributed to or for the grantor (or the grantor's spouse) as described in section 676 or 677, it will be a grantor trust. Thus, for the trust not to be a grantor trust (one of the results sought in the private letter rulings), these provisions must be avoided.

To begin, it is appropriate to note that many of the powers or interests that would make a trust a grantor trust do not apply if these powers or interests are exercisable or enjoyable only with the consent of an "adverse party." Section 672(a) defines "adverse party" as any person having a substantial beneficial interest in the trust which would be

750. The first was Priv. Ltr. Rul. 201310002 (Mar. 8, 2013). *See also* Priv. Ltr. Ruls. 201410001–2014100010 (Mar. 7, 2014); Priv. Ltr. Ruls. 201310003–201310006 (Mar. 8, 2013), Priv. Ltr. Ruls. 201430003–201430007 (July 25, 2014); Priv. Ltr. Ruls. 201510001–201510008 (Mar. 6, 2015). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

751. In each trust that is the subject of one of the private letter rulings, provisions essentially prohibit the trust from being a foreign trust and, to avoid section 677(a)(3), prohibit using income of the trust to pay premiums on a policy insuring the life of the grantor or the grantor's spouse. Because no beneficiary may unilaterally withdraw all income or corpus from a trust, no trust could be a grantor trust with respect to a beneficiary under section 678. *See generally* Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 35 (Fall 2009).

adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. Whether an interest is substantial and whether it is adverse are, in general, questions of fact.⁷⁵²

The Service apparently has concluded that, because the members of the Distribution Committee have absolute discretion to direct distributions from income and principal among themselves, each of the members of the Distribution Committee has a substantial interest in both the income and principal of the trust that would be adversely affected by any decision to accumulate income in the trust rather than distribute the income currently among the members.⁷⁵³ Because the question of whether an interest is substantial and adverse is one of fact, it is not possible to conclude with certainty that the conclusion of the Service is correct, but it does not seem to be unreasonable. In any case, this determination by the Service seems critical to the conclusion that the trusts involved in the rulings were not grantor trusts, as discussed below.

[A] Section 673⁷⁵⁴

A trust is a grantor trust if the grantor (or the grantor's spouse) has a reversionary interest in the corpus or income of the trust that, at the trust's inception, has a value of more than 5% of the value of the corpus or income. It does not seem that the grantor (or the grantor's spouse) has any reversionary interest in the type of trust that has been the subject of the private letter rulings, such as when (1) the trust agreement never provides for a distribution by its trustee to the grantor; (2) the grantor's testamentary power of appointment cannot be exercised in favor of the grantor, the grantor's creditors or estate, or the creditors of the grantor's estate; and (3) to the extent the power of appointment is not effectually exercised, the trust property passes to other default takers, which do not include the grantor or the grantor's estate.

Perhaps, more critically, a reversion under section 673 apparently can arise only in situations involving a traditional reversion under property law. Under the traditional definition, a reversion arises when a person having a vested estate transfers a lesser vested estate to another. There seems to be no authority holding or commentary

752. See section 5:4.2[A], *supra*.

753. Although the current beneficiaries in each of the post-Release private letter rulings were also the default remainder beneficiaries of the trust, the grantor could appoint the remainder to others pursuant to the testamentary power of appointment.

754. For a more thorough discussion of section 673, see sections 5:3 and 5:5.1, *supra*.

suggesting that a trustee's discretionary power to distribute principal or income to the transferor, with the consent of an adverse party, constitutes a reversionary interest under section 673.

The Service itself has acknowledged that "a reversionary interest is the interest a transferor has when less than his entire interest in property is transferred to a trust and which will become possessory at some future date."⁷⁵⁵

Similarly, in General Counsel Memorandum 36410,⁷⁵⁶ when comparing a possibility of reverter under section 676(a) with a reversion, the Service defined a reversion as "the residue left in the grantor on determination of a particular estate" and stated that "the reversionary interest arises only when the transferor transfers an estate of lesser quantum than he owns." As mentioned above, the trusts that are the subject of the ruling provide for alternative remainder beneficiaries so no portion of the trust may ever revert to the grantor or the grantor's estate.

Thus, the Service seems correct in concluding in the ruling that section 673 does not apply to cause these trusts to be grantor trusts.

[B] Section 674⁷⁵⁷

Section 674(a) provides that a trust will be a grantor trust if the beneficial enjoyment of its corpus or the income is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. The real scope of section 674 is determined by the many exceptions it contains. Some powers of disposition may be held by anyone (including the grantor or the grantor's spouse) without causing the trust to be a grantor trust. Others may be held only by persons other than the grantor (or the grantor's spouse) and certain others without causing the trust to be a grantor trust. Still other powers may be held by anyone other than the grantor (or the grantor's spouse) without triggering grantor trust status.

In the private letter ruling trusts, the only powers retained by the grantor were: (i) a power to appoint principal exercisable by will; (ii) a power to appoint income (accumulated with the consent of the Distribution Committee, the members of which are adverse parties) exercisable by will; and (iii) a non-fiduciary power to distribute principal limited by a reasonably definite standard.

755. I.R.S. Tech. Adv. Mem. 8127004 (Feb. 25, 1981). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

756. Gen. Couns. Mem. 36410 (Sept. 11, 1975).

757. For a thorough discussion of section 674, see section 5:5.2, *supra*.

[C] Power to Appoint Corpus and Accumulated Income by Will

Under section 674(b)(3), a trust is not a grantor trust merely because someone (including the grantor) holds a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust when the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. Under the trusts involved in the rulings, the grantor has a testamentary power of appointment not just over the original corpus of the trust but accumulated income as well.

However, accumulation of income may occur under the trust only, generally, with the consent of at least one member of the Distribution Committee (as the grantor may direct the distribution of trust property only with the consent of at least one member of the committee, each of whom the Service concluded is an adverse party). Thus, accumulation of income may occur only with the consent of an adverse party. Therefore, the section 674(b)(3) exception to the general rule of section 674(a) applies and, as a result, the testamentary power does not trigger grantor trust status.

[D] Power to Distribute Principal Pursuant to a Standard

Under section 674(b)(5), a trust is not a grantor trust merely because someone (including the grantor) holds a power to distribute corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard set forth in the trust instrument.⁷⁵⁸ Such a standard is broader than the familiar ascertainable standard relating to health, education, maintenance, and support (HEMS) commonly used to avoid the power holder from being treated as holding a general power of appointment under sections 2514 and 2041 for gift and estate tax purposes.⁷⁵⁹ In any case, a HEMS standard falls within the reasonably definite standard under section 674(b)(3).⁷⁶⁰ Thus, the retention of the power by the grantor

758. Note that a power does not fall within the powers described in section 674(b)(5) if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

759. See I.R.C. §§ 2514(c)(1), 2041(b)(1)(A).

760. Treas. Reg. § 1.674(b)-1(b)(5)(i).

to appoint the principal of the trust among the beneficiaries (other than the grantor) does not cause a trust to be a grantor trust.

Some powers trigger grantor trust status only if held in a non-fiduciary capacity.⁷⁶¹ However, it seems that the “exception” contained in section 674(b)(5) applies whether the power to distribute is held in a fiduciary or non-fiduciary capacity. The reason the section 674(b)(5) power in the post-Release private letter rulings is held in a non-fiduciary capacity relates to the incomplete gift aspect of the rulings, as discussed below.

[E] Sections 676 and 677⁷⁶²

Section 676 provides that a trust is a grantor trust when it provides for the possible return to the grantor of the corpus of a trust but only if it does not require the consent of an adverse party. Section 677 triggers grantor trust status in a situation where the income of a trust may be distributed to or used for the benefit of the grantor or accumulated for the grantor (or the grantor’s spouse) but only if it does not require the consent of an adverse party.

Under the terms of the trusts that are the subject of the private letter rulings, all of the income and corpus may be returned to the grantor but only with the consent of at least one member of the Distribution Committee. (In the later rulings, it requires the consent of a majority of the members of the committee with that of the grantor.) As discussed above, the Service has concluded that each member of the Distribution Committee is an adverse party. Thus, the grantor’s power to direct the distribution of income and principal to himself or herself does not cause either section 676 or 677 to apply because that may occur only with the consent of one or more adverse parties.

[F] Importance of State Law

It seems that all of the pre-Release private letter rulings deal with trusts formed under the laws of Alaska or Delaware.⁷⁶³ Although not discussed in the rulings, the laws of those states were used because, even though the assets in the trust could be distributed to the grantor, the governing law did not permit creditors to attach the trust assets.⁷⁶⁴ If the grantor’s creditors could attach trust property in satisfaction of

761. See, e.g., I.R.C. § 675(4)(C).

762. For more thorough discussions of sections 676 and 677, see sections 5:3 and 5:5.4, *supra*.

763. These trusts are commonly referred to as “AKINGs” or “DINGs” respectively.

764. See, e.g., ALASKA STAT. § 34.40.110 (2013).

the grantor's debts, the trust would be a grantor trust.⁷⁶⁵ The post-Release private letter rulings have all dealt with trusts formed under Nevada law.⁷⁶⁶ Like Alaska and Delaware, Nevada law, as well as several other states, permits individuals to create trusts that are not subject to the claims of the creditors of the grantor.⁷⁶⁷

However, Nevada law was chosen over the laws of other states (for example, Alaska or Delaware) for the post-Release private letter ruling requests for rulings because in the ruling process after the Release the Service insisted that the grantor hold a power described in section 674(b)(5), which is the power to distribute corpus to the

765. See Rev. Rul. 54-516, 1954-2 C.B. 54. It is at least arguable that a ING type trust is not subject to claims of creditors. Although the law in most states essentially provides that a trust a person creates or settles for himself or herself (a so-called "Self-Settled Trust") is permanently subject to the claims of the settlor's creditors, *see, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 7-3.1 (2005); RESTATEMENT (THIRD) OF TRUSTS § 60 (2003), it seems somewhat uncertain what constitutes a self-settled trust. For example, under N.Y. EST. POWERS & TRUSTS LAW § 7-3.1, a self-settled trust is void with respect to creditors of the settlor. In *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941) with what some view as America's greatest three judge panel (Judge Learned Hand, Judge Augustus Hand and Judge Chase) held that the trust was not subject to the claims to creditors of the settlor because the trustee could distribute income and corpus to persons other than the settlor. Later New York state case law suggests that *Herzog* was incorrectly decided. *See, e.g.*, *Vanderbilt Credit Corp. v. Chase Manhattan Bank*, 100 A.D.2d 544 (1984).

766. These trusts are commonly referred to as "NINGs."

767. Some states provide this protection only in limited circumstances. For example, in Arizona and Florida, the assets in an *inter vivos* QTIP trust are not deemed contributions by the surviving settlor even if the settlor has some interest in the trust after the death of the settlor's spouse. *See ACTEC Comparison of the Domestic Asset Protection Trust Statutes* (David G. Shaftel ed., 2012), <http://www.actec.org/public/Documents/Studies/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes-Updated-through-April-2014.pdf>; *see also, e.g.*, S.C. CODE ANN. § 62-7-505(b)(2) (2014). It is at least arguable that a NING-type trust may be created under the law of any state because a self-settled trust (that is, a trust the assets of which may be attached by the creditors of the settlor) includes only one from which the trustee must or may distribute assets to the settlor. As explained earlier, the trustee of the trusts that were the subject of the private letter rulings did not hold the power to distribute trust property to the grantor. However, the grantor could distribute trust property to himself or herself, which would make it subject to the claims of his or her creditors under the law of virtually all states. But some states continue to protect the trust's assets when the grantor's power of revocation is held only with the consent of an adverse party. *See, e.g.*, ALASKA STAT. § 34.40.110(b)(2) (2013). Thus, the conclusion is that the trust should be formed under the law of a state that protects the trust assets from claims of the creditors of the grantor.

beneficiaries pursuant to a reasonably definite standard set forth in the instrument. At the time the original post-Release request for ruling was filed with the Service, only Nevada law expressly permitted a grantor to hold a lifetime special power of appointment without exposing the trust assets to claims of creditors of the grantor. Alaska, Delaware, and other states permitted the grantor to hold a testamentary special power of appointment without such exposure but not a lifetime power, although the laws of some states (for example, Alaska and Delaware) have since been amended to permit lifetime powers as well.⁷⁶⁸

§ 5:8.6 Gift Tax Issues

A taxpayer makes a gift for federal gift tax purposes to the extent the value of what the taxpayer transfers exceeds the value of what the taxpayer receives in exchange.⁷⁶⁹ A gift is complete (and, therefore, potentially subject to gift tax) to the extent the taxpayer has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another.⁷⁷⁰ For example, a gift is incomplete if and to the extent that a reserved power gives the taxpayer the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.⁷⁷¹

The implication is that if the taxpayer retains a power to distribute property pursuant to a fixed or ascertainable standard (such as a HEMS standard) held in a non-fiduciary capacity, the power renders the gift incomplete. So the section 675(b)(5) power to distribute corpus, which does not trigger grantor trust status whether retained in a fiduciary or non-fiduciary capacity, was retained in the trusts that are the subject of the post-Release private letter rulings in a non-fiduciary capacity so this power prevented the entire gift with respect to both corpus and accumulated income from being complete.

There is a second power retained by the grantor in all the trusts that are the subject of the private letter rulings and that renders at least part of the transfers to the trust as incomplete for federal gift tax purposes: the testamentary special power of appointment. Although this power could not be exercised in favor of the grantor,

768. See, e.g., ALASKA STAT. § 34.40.110(b)(2) (2013), as amended.

769. I.R.C. § 2512(b).

770. Treas. Reg. § 25.2511-2(b) (1954) (first sentence). See generally Diana S.C. Zeydel, *When Is a Gift to a Trust Complete: Did CCA 201208026 Get It Right?*, 117 J. TAX'N 142 (Sept. 2012).

771. Treas. Reg. § 25.2511-2(c) (1954) (second sentence).

the grantor's creditors or estate, or creditors of the grantor's estate, such a power may render a gift incomplete. As mentioned above, a gift is incomplete if and to the extent that a reserved power gives the taxpayer the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves (unless the power is a fiduciary power limited by a fixed or ascertainable standard). This regulation seems to reflect the Supreme Court's decision in *Estate of Sanford v. Commissioner*.⁷⁷² In that case, the taxpayer created a trust for the benefit of named beneficiaries, reserving the power to revoke the trust in whole or in part and to designate new beneficiaries other than himself. Six years later, the taxpayer relinquished his power to revoke the trust. However, the taxpayer continued to retain his rights to change the beneficiaries. The taxpayer thereafter relinquished his right to change the beneficiaries. The Court held that a donor's gift is not complete, for purposes of the gift tax, until the donor relinquishes the power to determine those who would ultimately receive the property.

Accordingly, the retention of the special power of appointment exercisable by will (falling under the section 674(b)(3) grantor trust exception) together with lifetime power (falling under the section 674(b)(5) grantor trust exception), held in a non-fiduciary capacity, to distribute corpus pursuant to the HEMS standard renders the gifts to the trusts incomplete. Nonetheless, these powers will cause the trust to be included in the grantor's gross estate under sections 2036(a)(2) and 2038. However, avoiding estate tax is not the goal of these trusts which, as mentioned, seems to be to provide a way in which state and local income taxes may be avoided.

Under Treasury Regulations section 25.2511-2(e), a taxpayer is considered as having a power that would render any gift incomplete even if it is exercisable by the taxpayer in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The Distribution Committee members are not takers in default for purposes of Treasury Regulations section 25.2514-3(b)(2). They are merely co-holders of the power to distribute to the beneficiaries including the grantor. The Distribution Committee ceases to exist upon the death of grantor. Under Treasury Regulations section 25.2514-3(b)(2), a co-holder of a power is only considered as having an adverse interest when he or she may hold the power after the death of the current possessor of the power and the co-holder may then exercise it in favor of himself or herself, his or her estate or creditors, or the creditors of his or her estate. The Service concurred in Revenue Ruling 79-63:

772. *Estate of Sanford v. Comm'r*, 308 U.S. 39 (1939).

In this case, *A* is a taker in default not of the lifetime power in which *A* has a power of consent but rather of the testamentary power exercisable solely by the decedent. In such a situation *A* would not have necessarily been in a better economic position after the decedent's death by refusing to exercise the power in favor of the decedent during the decedent's lifetime. Thus, the fact that *A* might survive the decedent and receive an interest in the property, if the decedent failed to exercise the testamentary power in favor of persons other than *A*, does not elevate *A*'s interest as a consenting party of the lifetime power to a substantial adverse interest.⁷⁷³

In the situations involved in the private letter rulings, the Distribution Committee ceased to exist upon grantor's death. Accordingly, the Distribution Committee members do not have interests adverse to the grantor under Treasury Regulations section 25.2514-3(b)(2) and for purposes of Treasury Regulations section 25.2511-2(e). Therefore, the grantor is considered as possessing the power to distribute income and principal to any beneficiary himself or herself because he or she retained the power to distribute the trust property (with the consent of a majority of the members of the Distribution Committee). The retention of these powers causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes. The grantor also retained the power described in section 674(b)(5) over the principal of trust.⁷⁷⁴

§ 5:8.7 General Power of Appointment Issue

In most of the pre-Release private letter rulings, the Service held that no member of the Distribution Committees held general powers of appointment, but in the Release the Chief Counsel asked for comments of whether those holdings were consistent with Revenue Ruling 76-503⁷⁷⁵ and Revenue Ruling 77-158.⁷⁷⁶

The apparent concern of the Service was whether the powers held by members of the Distribution Committee to distribute corpus to themselves (as well as to the grantor and, perhaps, other beneficiaries) constituted a general power deemed held by each such member.

773. 1979-1 C.B. 302.

774. The grantor retains dominion and control over the income and principal of the trust unless and until the Distribution Committee members exercise their power, which, if the grantor does not consent, must be exercised unanimously, to make distributions. This power held by the Distribution Committee does not appear to cause the transfer of property to be complete for Federal gift tax purposes. *See* Estate of Goelet v. Comm'r, 51 T.C. 352 (1968); Goldstein v. Comm'r, 37 T.C. 897 (1962).

775. 1976-2 C.B. 275.

776. 1977-1 C.B. 285.

Sections 2514(c)(3)(B) and 2041(b)(1)(C)(ii) essentially provide that an individual is not treated as holding a general power of appointment that is exercisable in his or her own favor if it is only exercisable with the consent of someone with a substantial interest that is adverse to such exercise. Revenue Rulings 76-503 and 77-158 (which amplified the 1976 ruling) appear to hold that persons who hold a "joint" power to distribute property to themselves are not adverse to the exercise of the power by the others when surviving powerholders must continue to share the power with someone who succeeds to the joint power when one of the original powerholders dies.⁷⁷⁷

Almost all of the professional organizations that submitted comments concluded that no member of the Distribution Committees held a general power of appointment. However, the Service has not issued any official or unofficial statement as to that matter. Nonetheless, the trusts that are the subject of the post-Release private letter rulings avoid the issue by providing that, at all times, the power of the Distribution Committee to direct distributions (other than with the consent of the grantor) must be exercised unanimously and, although initially there were more than two Distribution Committee members, the trust agreements require that, at all times, there must be at least two individuals (other than the grantor) who are members of the Distribution Committee. Accordingly, the Service has ruled in these post-Release private letter rulings that the members do not hold a general power of appointment. If trust property is distributed back to the grantor, neither the Distribution Committee members nor the grantor will be deemed to have made a gift, but, to the extent any property is distributed to anyone else (even by direction of the Distribution Committee and without the participation by the grantor), the grantor, but not the members of the Distribution Committee, will be deemed to have made a completed gift.

§ 5:8.8 Practice Pointers

Requesting a ruling is a time consuming and expensive undertaking. Some practitioners and clients may feel that the reasoning expressed in the post-Release private letter rulings is sufficiently accurate and the rulings so consistent that it is not imprudent to adopt such an arrangement without a ruling. However, no one but the

777. A taxpayer is not treated as a general power holder if it is exercisable only with the consent of the person who granted the power. I.R.C. §§ 2514(c)(3)(A), 2041(b)(1)(C)(I). As mentioned, one of the powers a member of the Distribution Committee holds is to exercise the power with the consent of the grantor. Thus, that power held by members of the Distribution Committee is not a general power of appointment for gift or estate tax purposes.

taxpayer who obtained a private letter ruling may rely upon it.⁷⁷⁸ Even though practitioners may view the risk of the Service taking a contrary position as minimal, other than on a prospective basis, it may be wise to consider that it could happen. As indicated above, some practitioners seem to be of the view that it is not possible to create a trust so that gifts to it are incomplete for federal gift tax purposes and for the trust not to be a grantor trust.

As a general rule, a trust instrument must be construed to carry out the grantor's intent, and it appears tax courts will follow that intent in determining the tax effects of the trust.⁷⁷⁹ Accordingly, it seems appropriate to have the trust recite that the grantor intends that no gift made to the trust be complete for federal gift tax purposes and for the trust not to be a grantor trust, and to direct that the trust instrument be construed to achieve those intentions but, if it is not possible to achieve both, that it be construed so no transfer to the trust is a completed gift. If the trust is found to be a grantor trust, the grantor is in the same position as if the transfer had not been made. But if the gift is complete, the result, especially if considerable value has been transferred to the trust, could be viewed as quite adverse.

778. I.R.C. § 6110(k)(3).

779. See, e.g., *In re Lepore*, 492 N.Y.S.2d 689 (Sur. Ct. 1985). But see *Estate of Reid v. Comm'r*, T.C. Memo. 1982-532.

Chapter 6

Foreign Trusts

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§ 6:1 Overview

Foreign trusts were once perceived as vehicles for income tax avoidance. As a result, Congress enacted a series of provisions to deal with the tax avoidance opportunities and the special issues concerning foreign trusts and, in some cases, foreign estates. First, many foreign trusts with foreign grantors are not classified as “grantor trusts” so that the usual income taxation of trusts rules apply. Second, some foreign trusts are classified as grantor trusts so that a “U.S. grantor” is taxed on the trust’s income. Third, in general, transfers by U.S. grantors to non-grantor foreign trusts are treated as sales or exchanges. Fourth, for foreign trusts that are not grantor

trusts, the throwback rules apply and interest is charged on delay taxes. Fifth, transfers to and from foreign trusts have additional reporting requirements with significant penalties for failure to comply and the withholding-at-the-source rules apply. Sixth, capital gains are included in distributable net income of all foreign trusts.¹

§ 6:2 History of Legislation

The possibility that foreign trusts could avoid taxes by accumulating income were regarded as so great that in 1962 the throwback rules² applicable to accumulation distributions by domestic trusts were expanded to apply to foreign trusts created by U.S. persons for distributions to U.S. beneficiaries.³

Subsequently, in 1976, Congress decided that the tax avoidance possibilities of foreign trusts created by U.S. persons were still so substantial that additional restrictions should be imposed on foreign trusts.⁴ Three new restrictions on foreign trusts that were not applicable to domestic trusts were enacted. First, if a U.S. person transferred part or all of the corpus of any foreign trust and a beneficiary of the trust was an American, the trust was subject to new grantor trust provisions.⁵ These rules generally taxed the income of the trust to the U.S. grantor. Second, the excise tax on transfers to foreign entities, including foreign trusts, was expanded in scope and the rate was increased.⁶ Third, if the income of a foreign trust was not taxed to the grantor, the taxation of any distribution to a U.S. beneficiary was altered: the taxation of capital gains income was revised⁷ and a nondeductible interest charge on the income tax due on accumulation distributions was added.⁸

The Revenue Reconciliation Act of 1990,⁹ added Code section 672(f), which made a U.S. beneficiary of a trust the owner for

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1. I.R.C. § 643(a)(6)(C); see the discussion *supra* section 3:3.2[C].
 2. See *supra* section 3:6 for a general discussion of the throwback rules of sections 665–68.
 3. Revenue Act of 1962, Pub. L. No. 87-834, § 7, 76 Stat. 960, 985–87.
 4. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1013(a), 90 Stat. 1520, 1614. See *infra* text accompanying notes 5–14.
 5. I.R.C. § 679.
 6. See I.R.C. § 1491 (repealed in 1997 by Pub. L. No. 105-34, 111 Stat. 978). This provision did not apply to a transfer to a grantor trust under I.R.C. §§ 673–79 until it ceased being a grantor trust. Rev. Rul. 87-61, 1987-2 C.B. 219, *revoking* Rev. Rul. 69-450, 1969-2 C.B. 168. Cf. I.R.C. § 1057 (repealed in 1997 by Pub. L. No. 105-34, 111 Stat. 980) (taxpayer could elect to recognize gain in lieu of having I.R.C. § 1491 apply).
 7. I.R.C. § 643(a)(6)(C).
 8. I.R.C. §§ 667, 668; Tax Reform Act of 1976 §§ 1013(c), 1014(b).
 9. Pub. L. No. 101-508, § 11343, 104 Stat. 1338.

income tax purposes of any trust created by a foreign grantor to the extent the beneficiary had previously made gifts to the foreign grantor. The effect of this provision was to tax the beneficiary on the trust's income regardless of the how the trust income might otherwise be taxed.

The Small Business Job Protection Act of 1996¹⁰ added to the expanded treatment of foreign trusts under U.S. tax law and eliminated grantor trust status for many trusts with foreign grantors—whether a domestic (U.S.) trust or a foreign trust.¹¹ The Act revised the interest charge on taxes related to accumulation distributions from foreign trusts and changed the method for determining the periods for which the accumulation distributions related.¹² As a general matter, these changes increased the interest charge on these types of distributions.

The 1996 Act made additional changes. Certain loans of cash or marketable securities to a U.S. grantor or a U.S. beneficiary (and to certain related parties) from a foreign trust are treated as distributions.¹³ A foreign trust that makes such a loan cannot be treated as a “simple” trust described in section 651.¹⁴ Distributions from a foreign trust to a U.S. person through a nominee are treated as if paid directly to the U.S. person.

The 1996 Act also provided, as a general rule, that the grantor trust rules apply only to the extent they result in income being taken into account by a U.S. citizen, resident, or corporation. The Treasury Department was authorized to re-characterize transfers from a partnership or foreign corporation that the recipient treats as a gift or bequest. Reporting requirements on transfers from foreign sources were enhanced. The rules relating to the taxation of a foreign trust created by a U.S. person were revised. The Act added new definitions of foreign and domestic trusts. Moreover, the excise tax on transfers of appreciated property to foreign trusts was expanded by the 1996 Act.

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10. Small Business Job Protection Act of 1996 (the "1996 Act"), Pub. L. No. 104-188, § 1901, 110 Stat. 1755, 1903-04, *as modified by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1027, 111 Stat. 788, 925-926.
 11. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1903, 110 Stat. 1755, 1909-10 (codified as amended I.R.C. § 679).
 12. *Id.*, § 1901, 110 Stat. 1755, 1904-07.
 13. *Id.*, § 1906, 110 Stat. 1755, 1915.
 14. A simple trust cannot be treated as making an accumulation distribution and, therefore, no distribution from a simple trust may be taxed under the throwback rules. I.R.C. § 651(a).

§ 6:3 Definitions—Foreign Trusts, Foreign Estates

§ 6:3.1 Foreign Trusts

A foreign trust¹⁵ is any trust that does not meet the Code definition of a U.S. (domestic) trust.¹⁶ Thus, the definition of a foreign trust turns on what qualifies as a domestic trust. Essentially, a trust is a U.S. trust if:

- (i) a court within the United States is able to exercise primary supervision over the administration of the trust,¹⁷ and
- (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.¹⁸

A trust that is not domestic (U.S.) is considered foreign.¹⁹

The legislative history indicates that “primary supervision” will generally be the same as the governing law specified in the trust instrument.²⁰ The “court test” is satisfied under a safe harbor contained in the final regulations, which applies if (1) the governing instrument does not direct that the trust be administered outside of the United States, (2) the trust, in fact, is administered exclusively in the United States, and (3) the trust is not subject to an automatic migration (change of situs to a foreign jurisdiction) provision.²¹ A trust will not fail the court test if the governing instrument provides that it will migrate from the United States only in the event of a

15. I.R.C. § 7701(a)(31)(B).

16. I.R.C. § 7701(a)(30)(E).

17. Treas. Reg. § 301.7701-7(c).

18. Treas. Reg. § 301.7701-7(d). The definition of a foreign trust applies for tax years beginning after December 31, 1996. For earlier years, whether a trust was a domestic (U.S.) taxpayer or a foreign one was based upon a “circular” definition contained in I.R.C. § 7701(a)(31)(A) (a foreign trust is one “the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A”). See generally J. Blattmachr & H. White, *Proposed Tax Legislation in the House May Affect U.S. Citizens Who Become Expatriates As Well As Foreign Trust Beneficiaries*, 35 NAT’L L.J., May 1995, at B-4. See also Martin, *New Reporting Rules, Stiffer Penalties for Foreign Trusts Seek to Curb Perceived Abuses*, 85 J. TAX’N 334 (Dec. 1996). McCarthy & Wamer, *Regulations Clarify Rules Regarding Residency Classification of Trust*, FLA. BUS. J., Oct. 1997, at 53, 56.

19. I.R.C. § 7701(a)(31)(B).

20. H.R. REP. NO. 104-542, Part 2, at 31 (1996).

21. Treas. Reg. § 301.7701-7(c)(1). See generally Whitaker, *Final Regulations: What Is a Foreign Trust?*, 4 J. ASSET PROTECTION, no. 5, at 73 (May/June 1999); Morris, *New Regulations Address Inbound Grantor Trusts with Foreign Grantors*, 27 EST. PLAN. 65 (Feb. 2000).

foreign invasion of the United States or widespread confiscation or nationalization of property within the United States.²²

For purposes of determining whether U.S. fiduciaries have authority to control all substantial decisions of the trust, all persons with any power over those decisions, whether or not acting in a fiduciary capacity, must be counted.²³ Individual retirement accounts, qualified plans, and other employee benefit plan trusts satisfy the U.S. fiduciary control test if the fiduciaries control all of the substantial decisions made by the trustees or other fiduciaries.²⁴ A substantial decision includes a power to appoint a successor fiduciary to succeed another unless the power is limited so it cannot be exercised in a manner that would change the trust's residency from domestic to foreign or foreign to domestic.²⁵ The legislative history suggests that if the U.S. fiduciaries' exercise of power is subject to the veto power of a foreign fiduciary, such as a trust protector, the test apparently is not met.²⁶

The power to make investment decisions is a substantial one. The U.S. fiduciary is treated as retaining control over investment decisions made by an investment adviser if the adviser's power to make those decisions may be terminated at will by the domestic fiduciary.²⁷

A trust that was in existence on August 20, 1996, and that was treated as domestic on August 19, 1996 (under rules then in effect), may elect to continue to be treated as a domestic trust even if the court test and the U.S. fiduciary control test are not met.²⁸

The regulations provide extensive details concerning the application of this definition including some safe harbors and a number of examples.²⁹

§ 6:3.2 Foreign Estates

The Code defines a foreign estate differently than it defines a foreign trust.³⁰ It is "an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not

22. Treas. Reg. § 301.7701-7(c)(4)(ii).

23. Treas. Reg. § 301.7701-7(d)(1)(iii).

24. Treas. Reg. § 301.7701-7(d)(1)(iv).

25. Treas. Reg. § 301.7701-7(d)(1)(ii)(I). *See generally* Galligan, *Maintaining a Trust's U.S. Tax Status*, N.Y.L.J., Mar. 24, 1999, at 1.

26. H.R. REP. NO. 104-542, at 31.

27. Treas. Reg. § 301.7701-7(d)(1)(ii)(J).

28. Treas. Reg. § 301.7701-7(f). This regulation incorporates the guidance provided in I.R.S. Notice 98-25, 1998-1 C.B. 979.

29. Treas. Reg. § 301.7701-7. *See also* Chief Couns. Adv. 201509035.

30. I.R.C. § 7701(a)(31)(A).

includible in gross income under subtitle A.”³¹ This is essentially the same definition that existed before 1996 for foreign trusts.

In a number of rulings, the Service has provided some guidance on the meaning of the definition of a foreign estate. For example, Revenue Ruling 62-154³²

held that the estate of a nonresident alien decedent which is subject to domiciliary administration abroad is not ipso facto a nonresident alien estate. In each case consideration should be given to all of the facts involved, including the appointment of an ancillary administrator who is a citizen or resident of the United States and the extent and duration of the activities of such ancillary administrator in the United States, in connection with the estate before determining whether the estate of a nonresident alien decedent is a resident or nonresident alien entity.³³

In Revenue Ruling 81-112,³⁴ the decedent was a U.S. citizen, but a resident of a foreign country where the decedent had lived for twenty years. The decedent had no assets or business interests in the United States and there was no domestic administration of the estate, although there was an estate administration in the foreign country of residence. The Service ruled that the

estate is a nonresident alien entity and, therefore, is a foreign estate for purposes of section 7701(a)(31) of the Code. Thus, the estate is only subject to federal income tax on income that is derived from sources within the United States or income that is effectively connected with the conduct of a trade or business within the United States.³⁵

See also Revenue Ruling 64-307,³⁶ Revenue Ruling 57-245,³⁷ and Revenue Ruling 58-232³⁸ concerning foreign estates.

31. *Id.*

32. Rev. Rul. 62-154, 1962-2 C.B. 148.

33. *Id.*

34. Rev. Rul. 81-112, 1981-1 C.B. 598.

35. *Id.*

36. Rev. Rul. 64-307, 1964-2 C.B. 163, concerning a decedent with two wills that were separately administered in two countries (the United States and another). The Service ruled there was still only one estate.

37. Rev. Rul. 57-245, 1957-1 C.B. 286, concerning a foreign decedent whose estate was administered in the United States. The Service ruled that decedent's estate was foreign.

38. Rev. Rul. 58-232, 1958-1 C.B. 261, concerning a U.S. ancillary administration with a U.S. person as both domiciliary and ancillary administrator, superseded by Rev. Rul. 58-232, 1958-1 C.B. 261.

§ 6:4 Limitation on Application of Grantor Trust Rules to Trusts with Foreign Grantors—Section 672(f)

Under the “grantor trust” rules,³⁹ the income, deductions, and credits against tax of a trust are attributed to a trust’s grantor (or another treated as the substantial owner of the trust)⁴⁰ as though the trust did not exist to the extent the trust is treated as “owned” by its grantor (or such other). In these circumstances, distributions by the trust to its beneficiary are not treated as income for tax purposes in the hands of the beneficiary, because the income is already taxed to the grantor (or another).

When a trust was established in a “tax haven” by a foreign grantor and the beneficiary was a U.S. person, trust distributions might not be subject to tax anywhere. To prevent that from occurring, section 672(f) was amended in 1996⁴¹ to provide that the grantor trust rules apply only to the extent they result in an amount being currently taken into account in computing the income of a citizen or resident of the United States or a U.S. corporation.⁴² As a result, the grantor trust rules will not apply to any portion of a trust (whether U.S. or foreign) if they would otherwise treat a foreign person as the owner of the trust. Thus, distributions from a foreign (grantor) trust to a U.S. beneficiary generally will be includible in the beneficiary’s income to the extent ordinarily required under U.S. tax trust rules.⁴³

The regulations under section 672(f) provide that the grantor trust rules other than section 672 must be applied to determine whether any part of a trust would be treated as owned by a person other than a U.S. citizen, resident, or domestic (U.S.) corporation.⁴⁴ This determination is made based upon the terms of the trust and the application of the applicable grantor trust regulations.⁴⁵ If it is determined that any portion of the trust would be treated as owned by a person other than a U.S. citizen, resident, or domestic corporation, this person will be treated as the owner of that portion of the trust only if the person is a foreign corporation⁴⁶ or if the portion of the trust qualifies for one of the exceptions in the regulations.⁴⁷

39. See I.R.C. §§ 671–79.

40. I.R.C. § 678.

41. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1904, 110 Stat. 1755, 1911.

42. *Id.*

43. I.R.C. § 672(f).

44. Treas. Reg. § 1.672(f)-1 to -5.

45. Treas. Reg. §§ 1.671-1 *et seq.*

46. That is, a corporation described in Treas. Reg. § 1.672(f)-2.

47. Treas. Reg. § 1.672(f)-3.

The grantor trust rules will apply, however, to any portion of a foreign trust that is revocable by its foreign grantor alone or with the consent of a related or subordinate party who is subservient to the wishes of the grantor within the meaning of section 672(c).⁴⁸ Trusts are considered revocable for this purpose if revocable for more than half the tax year.⁴⁹

The grantor trust rules also will apply to any portion of the trust with a foreign grantor where amounts attributable to that portion are distributable only to the grantor and/or the grantor's spouse during the grantor's lifetime,⁵⁰ or to satisfy either of their legal obligations.⁵¹

In Field Service Advice 199952014, the Service ruled that a foreign trust was not a grantor trust. Although the husband was the trust "protector," he had no power to pay trust assets to himself. The Service noted it would be a grantor trust if additional facts revealed that in fact he had provided some of the funding of the trust.

Also, section 672(f) will not apply to any portion of a trust that is taxable as compensation for services rendered, except to the extent prescribed in regulations.⁵² Presumably, this would cover a circumstance where a foreign company, for example, used a trust to make distributions to a U.S. employee.

The rule denying grantor trust status to a trust with a foreign grantor (or other substantial owner) does not apply if the trust was in existence on September 19, 1995, and was treated as owned by a grantor under section 676 or section 677 (other than section 677(a)(3)),⁵³ except for additions made after that date.

When appropriate, the Treasury Department is authorized to re-characterize any direct or indirect transfer from a partnership or foreign corporation that the transferee treats as a gift or bequest to prevent avoidance of the rule that the grantor trust rules do not apply to certain foreign persons.⁵⁴ This rule does not apply if the gifts do not exceed \$10,000 during a taxable year,⁵⁵ or if gifts are to

48. Treas. Reg. § 1.672(c)-1.

49. Treas. Reg. § 1.672(f)-3(a)(2).

50. I.R.C. § 672(f)(2)(A).

51. Treas. Reg. § 1.672(f)-3(b)(2) explains the parameters of legal obligations.

52. I.R.C. § 672(f)(2)(B); Treas. Reg. § 1.672(f)-3(c).

53. I.R.C. § 677(a)(3) relates to certain trusts that may use their income to pay premiums on insurance on the life of the grantor or the grantor's spouse.

54. I.R.C. § 672(f)(4); Treas. Reg. § 1.672(f)-4.

55. Treas. Reg. § 1.672(f)-4(f). The regulation was drafted at a time when the gift tax annual exclusion under I.R.C. § 2503 was \$10,000. It is not known if this amount might be higher now that the annual exclusion is indexed for inflation.

qualified charities.⁵⁶ The regulations provide a number of examples of how this rule is applied.⁵⁷

The regulations provide an example applying section 672(f):

- (i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.
- (ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in §1.672(f)-3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to B, who is neither a grantor nor a spouse of a grantor, and the trust is not a compensatory trust. Therefore, pursuant to paragraph (a)(1) of this section, A is not treated as an owner under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.
- (iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the owner of the portion of the trust consisting of the Y stock.⁵⁸

If the U.S. beneficiary of a trust created by foreign grantor has at any time made gifts to the foreign grantor, the U.S. beneficiary is deemed the grantor of the trust to the extent the gifts exceed the

56. Treas. Reg. § 1.672(f)-4(b)(4).

57. Treas. Reg. § 1.672(f)-4(g).

58. Treas. Reg. § 1.672(f)-1(b).

section 2503(b) gift tax annual exclusion.⁵⁹ The regulations provide two examples of this rule:

Example 1: *A*, a nonresident alien, contributes property to *FC*, a foreign corporation that is wholly owned by *A*. *FC* creates a foreign trust, *FT*, for the benefit of *A* and *A*'s children. *FT* is revocable by *FC* without the approval or consent of any other person. *FC* funds *FT* with the property received from *A*. *A* and *A*'s family move to the United States. Under paragraph (a)(1) of this section, *A* is treated as a grantor of *FT*. (*A* may also be treated as an owner of *FT* under section 679(a)(4).)

Example 2: *B*, a U.S. citizen, makes a gratuitous transfer of \$1 million to *B*'s uncle, *C*, a nonresident alien. *C* creates a foreign trust, *FT*, for the benefit of *B* and *B*'s children. *FT* is revocable by *C* without the approval or consent of any other person. *C* funds *FT* with the property received from *B*. Under paragraph (a)(1) of this section, *B* is treated as a grantor of *FT*. (*B* also would be treated as an owner of *FT* as a result of section 679.)⁶⁰

§ 6:5 Grantor Trust Rule for Foreign Trust with U.S. Beneficiary—Section 679

In addition to basic grantor trust rules applicable to determine if a domestic trust is a grantor trust,⁶¹ section 679 provides additional rules that may result in a foreign trust being treated as a grantor trust. This section, which was enacted as a part of the Tax Reform Act of 1976,⁶² provides, in general, that a U.S. person who directly or indirectly transfers property to a foreign trust⁶³ is treated as the owner for income tax purposes. If a U.S. grantor establishes a foreign trust within the grantor trust provisions,⁶⁴ the worldwide income attributable to the grantor of the trust is taxed to the grantor.⁶⁵ In addition, if a U.S. person establishes a foreign trust with a U.S. beneficiary, the trust is a grantor trust.⁶⁶ This rule applies during

59. I.R.C. § 672(f)(5); Treas. Reg. § 1.672(f)-5.

60. Treas. Reg. § 1.672(f)-5(a).

61. See I.R.C. §§ 671–78, discussed in chapter 5.

62. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1013(a), 90 Stat. 1520.

63. Other than a trust described in sections 402(b), 404(a)(4), 404A, or is determined by the IRS to be a charitable trust described in section 501(c)(3).

64. Subpart E of part I of subchapter J of the Code.

65. I.R.C. § 679(a)(1).

66. I.R.C. § 679.

each taxable year for the portion of the trust attributable to the property transferred for any year in which there is a U.S. beneficiary of that portion of the trust. To the extent that the U.S. person is treated as the owner, the existing grantor trust rules apply.⁶⁷

Chief Counsel Advice 200445025 held that gain on the sale of stock held by foreign trusts, including a charitable trust that had not received a letter of exemption under section 501(c)(3) from the Internal Revenue Service, was taxable to the U.S. taxpayer-grantor on several grounds, including that his wife was still a beneficiary of the trust (making the trust a grantor trust).⁶⁸ The fact that certain U.S. persons could receive distributions made the trust a grantor trust under section 679, the anticipatory assignment of income doctrine, and section 684, because he was deemed as the owner of the assets held by the trust while it was intended to be grantor trust and, therefore, he was the transferor of the assets to the trust when it became a foreign non-grantor trust.

On the other hand, if a U.S. taxpayer is a beneficiary of a nongrantor foreign trust, distributions to the beneficiary are taxed in basically the same manner as distributions to the beneficiary of a domestic trust, although certain special rules apply, such as the inclusion of capital gains in distributable net income⁶⁹ and the application of the throwback rules. However, if the U.S. beneficiary has at any time made gifts to the foreign grantor, the U.S. beneficiary is deemed the grantor of the trust to the extent the gifts exceed the section 2503(b) gift tax annual exclusion.⁷⁰

The foreign trust rules apply also when a domestic (U.S.) trust created by a U.S. citizen or resident becomes a foreign trust during the individual's lifetime.⁷¹ The regulations provide that a transfer is deemed to occur on the date the trust becomes a foreign trust⁷² and includes accumulated income, but only for purposes of determining the portion of property deemed transferred by the person.⁷³ The regulations provide an example:

Outbound migration of domestic trust [DT]. On January 1, 2002, *A* transfers property to *DT*, for the benefit of *B*. On January 1, 2003, *DT* acquires a foreign trustee who has the power to determine whether and when distributions will be made to *B*. Under section 7701(a)(30)(E) and § 301.7701-7(d)(ii)(A) of this chapter, *DT*

67. I.R.C. § 679(a)(1).

68. Chief Couns. Adv. 200445025. Under I.R.C. § 6110(k)(3), a Chief Counsel Advice may not be cited or used as precedent.

69. See I.R.C. § 643(a)(6).

70. I.R.C. § 672(f)(5); Treas. Reg. § 1.672(f)-5.

71. I.R.C. §§ 679(a)(5), 684(c).

72. Treas. Reg. § 1.679-6(a).

73. Treas. Reg. § 1.679-6(b).

becomes a foreign trust on January 1, 2003. Under paragraph (a) of this section, A is treated as transferring property to a foreign trust on January 1, 2003. Under paragraph (b) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred.⁷⁴

Information reporting under section 6048 starts then as well, that is, when a domestic trust becomes a foreign trust.⁷⁵

For purposes of applying section 679, loans by the grantor may be deemed as transfers of corpus so that the grantor is deemed the owner of that portion of the trust.⁷⁶ However, if another U.S. person is treated as the owner of the same portion of the trust under the grantor rules of Code section 678, the other person is not treated as the owner for income tax purposes.⁷⁷

Section 679 does not apply to transfers by reason of the death of the transferor or to any transfer to the trust in exchange for consideration of at least the fair market value of the transferred property.⁷⁸ In determining if consideration of at least the fair market value has been transferred, consideration other than cash is taken into account at its fair market value. The regulations provide an example: "rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services

74. Treas. Reg. § 1.679-6(c).

75. See *infra* section 6:9. See generally Lipari & Cotton, *Transfer to Foreign Trusts: Treasury Proposes Regulations Under Section 679 and 684*, 30 TAX MGMT. INT'L J. 3 (2001).

76. H.R. REP. NO. 94-658, 209 (1975); STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 221 (Comm. Print 1976) [hereinafter GENERAL EXPLANATION]. The House Report, unlike the GENERAL EXPLANATION, states that loans are to be "disregarded." Compare H.R. REP. NO. 94-658, at 209 n.9, with GENERAL EXPLANATION, *supra*, at 221 n.7. Cf. I.R.C. §§ 1274, 7872. See Priv. Ltr. Rul. 9332006 (example involving two grantors). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. A guarantee of a loan to the trust by a U.S. person related to the trust is treated as a transfer to the trust for purposes of I.R.C. § 679. Treas. Reg. § 1.679-3(e).

77. H.R. REP. NO. 94-658, at 209; GENERAL EXPLANATION, *supra* note 76, at 221. Treas. Reg. § 1.679-1(b). Having the person treated as the trust's owner under I.R.C. § 678 instead of the actual grantor in this limited circumstance seems contrary to the long-held (unofficial) position of the Service. See generally J. Blattmachr & F. Sembler, *Crummey Powers and Income Taxation*, CHASE REV. July 1995.

78. I.R.C. § 679(a)(2).

rendered by, the trust.”⁷⁹ A transfer for this purpose is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust.⁸⁰ In addition, “an interest in the trust is not property received from the trust.”⁸¹

Only “qualified obligations”⁸² are taken into account in determining the extent to which the transfer is for fair market value.⁸³ The regulations provide extensive rules concerning qualified obligations and a number of examples to explain the applications of the rules.⁸⁴

If a transfer is for partial consideration, this rule applies only to the value of the transfer that exceeds the consideration received. The regulations provide an example:

A, a U.S. citizen, transfers property that has a fair market value of 1000X to *FT*, a foreign trust, in exchange for 600X of cash. Under this paragraph (b), § 1.679-1 applies with respect to the transfer of 400X (1000X less 600X) to *FT*.⁸⁵

When a nonresident alien individual becomes a U.S. person and has a “residency starting date,”⁸⁶ that is, becomes a U.S. income taxpayer, “within five years after directly or indirectly transferring property to a foreign trust,” generally he or she is treated as having transferred property to the trust.⁸⁷ The regulations provide an example:

Nonresident alien becomes resident alien. On January 1, 2002, A, a nonresident alien individual, transfers property to a foreign trust, *FT*. On January 1, 2006, A becomes a resident of the United States within the meaning of section 7701(b)(1)(A) and has a residency starting date of January 1, 2006, within the meaning of section 7701(b)(2)(A). Under paragraph (a) of this section, A is treated as a U.S. transferor and is deemed to transfer the property to *FT* on January 1, 2006. Under paragraph (b)(2) of this section, the property deemed transferred to *FT* on January 1, 2006, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property originally transferred.⁸⁸

79. Treas. Reg. § 1.679-4(b)(1).

80. *Id.*

81. *Id.*

82. Treas. Reg. § 1.679-4(d).

83. Treas. Reg. § 1.679-4(c).

84. Treas. Reg. § 1.679-4(d).

85. Treas. Reg. § 1.679-4(b)(2)(ii).

86. Residency starting date is defined in I.R.C. § 7701(b)(2)(A).

87. Treas. Reg. § 1.679-5(a).

88. Treas. Reg. § 1.679-5(c), ex. 1.

Alternatively, if a nonresident alien is treated as owning any portion of the foreign trust under this grantor trust rule, but subsequently the trust ceases to be treated as a grantor trust, the grantor is treated as having made the original transfer to a foreign trust, immediately before the trust ceases to be a grantor trust.⁸⁹ The regulations provide an example of this rule:

Nonresident alien loses power to revest property. On January 1, 2002, A, a nonresident alien individual, transfers property to a foreign trust, FT. A has the power to revest absolutely in himself the title to such property transferred and is treated as the owner of the trust pursuant to sections 676 and 672(f). On January 1, 2008, the terms of FT are amended to remove A's power to revest in himself title to the property transferred, and A ceases to be treated as the owner of FT. On January 1, 2010, A becomes a resident of the United States. Under paragraph (b)(1) of this section, for purposes of paragraph (a) of this section A is treated as having originally transferred the property to FT on January 1, 2008. Because this date is within five years of A's residency starting date, A is deemed to have made a transfer to the foreign trust on January 1, 2010, his residency starting date. Under paragraph (b)(2) of this section, the property deemed transferred to the foreign trust on January 1, 2010, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property deemed transferred.⁹⁰

Transfers by a domestic or foreign entity in which the U.S. person has an interest may be regarded as an indirect transfer covered by section 679, if the entity merely serves as a conduit or if the person has sufficient control to direct the transfer. If a foreign trust borrows money or other property and the repayment is guaranteed by a U.S. person, the guarantor will be treated as having transferred property to the trust.⁹¹

Under special attribution rules, a trust is treated as having a U.S. beneficiary if the trust has a foreign corporation as a beneficiary and if more than 50% of the total combined voting power of all classes of the corporation's stock is owned or is to be considered to be owned by U.S. shareholders under the rules for determining stock ownership of controlled foreign corporations,⁹² or has a foreign partnership as a

89. Treas. Reg. § 1.679-5(b)(1).

90. Treas. Reg. § 1.679-5(c), ex. 2.

91. H.R. REP. NO. 94-658, at 209; GENERAL EXPLANATION, *supra* note 76, at 221.

92. I.R.C. §§ 958, 951. An amount paid to or accumulated for a foreign corporation, which is a controlled foreign corporation under I.R.C. § 957(a), is treated as paid to or accumulated for a U.S. person. I.R.C. § 679(c)(2).

beneficiary if a U.S. person is a partner, or has a foreign trust or a foreign estate as a beneficiary that has a U.S. beneficiary.⁹³

Section 679 is applicable only if the trust has a U.S. beneficiary. The fact that a named foreign beneficiary could become a U.S. person by residency or citizenship does not cause a foreign trust to be treated as a grantor trust before the event actually occurs.⁹⁴ The determination of whether or not the trust has a U.S. beneficiary is made on a year-by-year basis; moreover, the grantor trust provisions apply beginning with the first tax year of the transferor in which the foreign person becomes a U.S. beneficiary.⁹⁵

In the event that the foreign trust acquires a U.S. beneficiary during any taxable year and has undistributed net income at the time of the close of the immediately preceding tax year, the transferor is treated as having additional income in the first taxable year in which he is treated as the owner of any portion of the trust. The amount of the additional income is equal to the undistributed net income for all prior years to the extent that the undistributed net income remains in the trust at the end of the last tax year before the trust had a U.S. beneficiary.⁹⁶

A trust is treated as having a U.S. beneficiary unless, under the terms of the trust, no part of the income or corpus may be paid to or accumulated for the benefit of the U.S. person and, if the trust were terminated at any time during the taxable year, no part of the income or corpus could be paid to or for the benefit of the U.S. person.⁹⁷ Before 2010, the regulations provided that persons with contingent interests who were neither named as beneficiaries nor were members of a class of beneficiaries of the trust were not treated as U.S. beneficiaries, but only if it was demonstrated to the Commissioner that the contingent interests of the beneficiaries were so remote as to be negligible.⁹⁸ In 2010, section 679(c)(1) was amended to adopt the regulation rule, but on its face, the statutory adoption appears to

93. I.R.C. § 679(c).

94. H.R. REP. NO. 94-658, at 210; GENERAL EXPLANATION, *supra* note 76, at 222.

95. *Id.*

96. I.R.C. § 679(b). Both the House Report and the GENERAL EXPLANATION indicate that for these purposes, any nonresident alien who would be deemed to be the grantor under other provisions of subchapter J is ignored so that accumulation distributions, even though taxed when earned to a nonresident alien under the grantor trust rules, will not prevent the accumulation distribution from being deemed to have occurred. H.R. REP. NO. 94-658, at 211 n.13; GENERAL EXPLANATION, at 223 n.10.

97. I.R.C. § 679(c)(1). Treas. Reg. § 1.679-2(a).

98. Treas. Reg. § 1.679-2(a)(2)(ii).

disregard the negligible remote interest exception.⁹⁹ However, the legislative history indicates that the Code provision is not intended to override the existing regulation.¹⁰⁰

In addition, the 2010 legislation provides that a trust is treated as having a U.S. person as a beneficiary if “any person” has discretion to make distributions from the trust unless the class of recipients is identified and none of them are U.S. persons.¹⁰¹ Moreover, any agreements or understandings concerning distributions “whether written, oral, or otherwise,” are considered a part of the terms of the trust.¹⁰² The 2010 legislation further provides that the uncompensated use of any trust property including below-market loans by a U.S. person is treated as a distribution.¹⁰³ Finally, the 2010 legislation provides a presumption that a foreign trust with a U.S. transferor has a U.S. person as a beneficiary unless the Secretary of the Treasury is satisfied that it does not.¹⁰⁴

A beneficiary is not treated as a U.S. person for purposes of section 679 if the beneficiary first became a U.S. person more than five years after the transfer to the foreign trust.¹⁰⁵ On the other hand, section 679 will apply to a nonresident alien who becomes a resident within five years of transferring property to the trust.¹⁰⁶ Undistributed net income accumulated before an individual’s residency starting date¹⁰⁷ is taken into account in determining the percentage of property transferred by the individual to the trust.¹⁰⁸ The amount of the accumulation distribution is the trust’s undistributed net income within the meaning of section 665 as of the end of the U.S. transferor’s immediately preceding tax year (and is subject to the interest charge under section 668).¹⁰⁹

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99. I.R.C. § 679(c)(1), last sentence. Pub. L. No. 111-147, Act § 531(a).
100. Joint Committee on Taxation, Technical Explanation of Revenue Provisions Contained in Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” under consideration by the Senate (JCX-4-10), February 23, 2010, at page 72.
101. I.R.C. § 679(c)(4). Pub. L. No. 111-147, Act § 531(b).
102. I.R.C. § 679(c)(5). Pub. L. No. 111-147, Act § 531(c).
103. I.R.C. § 643(i). Pub. L. No. 111-147, Act § 533. I.R.C. § 679(c)(6). Pub. L. No. 111-147, Act § 533(c). *See also*, Steven L. Cantor & Arthur J. Dichter, *Rent-free Use of Trust Property: A Trap for Unwary US Beneficiaries of Foreign Trusts*, CAYMAN FIN. REV., Apr. 11, 2015.
104. I.R.C. § 679(c)(6). Pub. L. No. 111-147, Act § 532(a).
105. Treas. Reg. § 1.679-2(a)(3)(i).
106. *Id.*
107. I.R.C. § 7701(b)(2)(A).
108. I.R.C. § 679(a)(4)(B).
109. Treas. Reg. § 1.679-2(c).

Section 679 ceases to apply at the beginning of the tax year following the years in which the trust ceases to have a U.S. beneficiary.¹¹⁰

§ 6:6 Recognition of Gain on Transfers to Non-Grantor Foreign Trusts—Section 684

Section 684 was enacted in 1997 to require recognition of gain when a U.S. person transfers appreciated assets to a foreign trust or a foreign estate.¹¹¹ This provision replaced a 35% excise tax on transfers to foreign trusts based on unrealized appreciation.¹¹² Regulations issued by the Treasury Department in 2001 for section 684 are not very extensive, but instead explain the application of section 684 with a number of examples with various fact patterns.¹¹³

Gains are computed based on the amount that the fair market value of the assets on the date of transfer exceeds the adjusted basis of the assets.¹¹⁴ The regulations provide a simple example:

A transfers property that has a fair market value of 1000X to *FT*. *A*'s adjusted basis in the property is 400X. *FT* has no U.S. beneficiary within the meaning of § 1.679-2, and no person is treated as owning any portion of *FT*. Under paragraph (a)(1) of this section, *A* recognizes gain at the time of the transfer equal to 600X.¹¹⁵

Recognition of losses is not allowed and losses may not offset the gains.¹¹⁶ The regulations provide an example:

A transfers property Q, with a fair market value of 1000X, and property R, with a fair market value of 2000X, to *FT*. At the time of the transfer, *A*'s adjusted basis in property Q is 700X, and *A*'s adjusted basis in property R is 2200X. *FT* has no U.S. beneficiary within the meaning of § 1.679-2, and no person is treated as owning any portion of *FT*. Under paragraph (a)(1) of this section, *A* recognizes the 300X of gain attributable to property Q. Under paragraph (a)(2) of this section, *A* does not recognize the 200X of loss attributable to property R, and may not offset that loss against the gain attributable to property Q.¹¹⁷

110. Treas. Reg. § 1.679-2(c)(2).

111. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1131(b), 111 Stat. 788.

112. Former I.R.C. § 1491 (repealed by Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1131(b), 111 Stat. 978).

113. T.D. 8956 (July 19, 2001), 66 Fed. Reg. 37,897, 2001-2 C.B. 112.

114. Treas. Reg. § 1.684-1(a)(1).

115. Treas. Reg. § 1.684-1(d), ex. 1.

116. Treas. Reg. § 1.684-1(a)(2).

117. Treas. Reg. § 1.684-1(d), ex. 2.

If property is transferred for less than full and adequate consideration, the full amount of the gain is still recognized. The regulations provide an example of a transfer for less than full value.¹¹⁸ Transfers of appreciated assets in exchange for a private annuity will trigger section 684.¹¹⁹ Installment reporting is not permitted even when full value is not paid for the transferred assets. The regulations provide an example:

A transfers property that has a fair market value of 1000X to *FT* in exchange for *FT*'s obligation to make payments to *A* during the next four years. *FT* is related to *A* as defined in § 1.679-1(c)(5). The obligation is treated as a qualified obligation within the meaning of § 1.679-4(d), and no person is treated as owning any portion of *FT*. *A*'s adjusted basis in the property is 100X. *A* is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though *A* might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code. Section 1.684-3(d) provides rules relating to transfers for fair market value to unrelated foreign trusts.¹²⁰

Both direct and indirect transfers are covered by section 684. Indirect transfers are explained in the regulations for section 679.¹²¹ The regulations provide an example:

A creates and funds *FT* for the benefit of *A*'s cousin, who is a nonresident alien. *FT* has no U.S. beneficiary within the meaning of § 1.679-2, and no person is treated as owning any portion of *FT*. In 2004, *A* decides to transfer additional property with a fair market value of 1000X and an adjusted basis of 600X to *FT*. Pursuant to a plan with a principal purpose of avoiding the application of section 684, *A* transfers the property to *I*. *I* subsequently transfers the property to *FT*. Under paragraph (b) of this section and § 1.679-3(c), *A* is treated as having transferred the property to *FT*.¹²²

Constructive transfers to foreign trusts and foreign estates are evaluated under the regulations for section 679 to determine if section 684 applies.¹²³ The use of an intermediary or agent will not avoid the application of section 684. A transfer by a U.S. person to a

118. Treas. Reg. § 1.684-1(d), ex. 3.

119. Treas. Reg. § 1.684-1(d), ex. 4.

120. Treas. Reg. § 1.684-1(d), ex. 5.

121. See Treas. Reg. § 1.679-3(c). The regulation does not identify *I*. But a subsequent example identifies *I* as "a foreign person." See Treas. Reg. § 1.684-2(b)(2), ex. 2.

122. Treas. Reg. § 1.684-2(b)(2), ex. 1.

123. See Treas. Reg. § 1.679-3(c).

foreign entity owned in part by a foreign trust may be subject to section 684.¹²⁴ The regulations provide an example:

A creates and funds *FT* for the benefit of *A*'s cousin, who is a nonresident alien. *FT* has no U.S. beneficiary within the meaning of § 1.679-2, and no person is treated as owning any portion of *FT*. On July 1, 2004, *A* transfers property with a fair market value of 1000X and an adjusted basis of 300X to *I*, a foreign person. On January 1, 2007, at a time when the fair market value of the property is 1100X, *I* transfers the property to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, under § 1.679-3(c)(2)(ii), that *I* acted independently of *A* in making the transfer to *FT*. Under paragraph (b) of this section and § 1.679-3(c), *A* is treated as having transferred the property to *FT*. Under paragraph (b) of this section and § 1.679-3(c)(3), *I* is treated as an agent of *A*, and the transfer is deemed to have been made on January 1, 2007. Under § 1.684-1(a), *A* recognizes gain equal to 800X on that date.¹²⁵

Included within the reach of section 684 are transfers from grantor trusts.¹²⁶ Thus, a transfer from a grantor trust to a foreign trust is taxed as a transfer by the grantor, or from the portion of the trust the grantor is deemed to own. The regulations provide two examples of grantor trusts. In both examples, "*A* is a U.S. person, *DT* is a domestic trust, and *FT* is a foreign trust."¹²⁷

Example 1: Transfer by a domestic trust. On January 1, 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis of 200X to *DT*. *A* retains the power to revoke *DT*. On January 1, 2003, *DT* transfers property which has a fair market value of 500X and an adjusted basis of 100X to *FT*. At the time of the transfer, *FT* has no U.S. beneficiary as defined in § 1.679-2 and no person is treated as owning any portion of *FT*. *A* is treated as having transferred the property to *FT* and is required to recognize gain of 400X, under § 1.684-1, at the time of the transfer by *DT* to *FT*.

Example 2: Transfer by a foreign trust. On January 1, 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis of 200X to *FT1*. At the time of the transfer, *FT1* has a U.S. beneficiary as defined in § 1.679-2 and *A* is treated as the owner of *FT1* under section 679. On January 1, 2003, *FT1* transfers

124. Treas. Reg. § 1.684-2(f) references Treas. Reg. § 1.679-3(f).

125. Treas. Reg. § 1.684-2(b)(2), ex. 2.

126. Treas. Reg. § 1.684-2(d)(1).

127. Treas. Reg. § 1.684-2(d)(2).

property which has a fair market value of 500X and an adjusted basis of 100X to *FT2*. At the time of the transfer, *FT2* has no U.S. beneficiary as defined in § 1.679-2 and no person is treated as owning any portion of *FT2*. *A* is treated as having transferred the property to *FT2* and is required to recognize gain of 400X, under § 1.684-1, at the time of the transfer by *FT1* to *FT2*.¹²⁸

When grantor trust status for any portion or all of a foreign trust is lost, section 684 applies as though the grantor made a transfer.¹²⁹ The deemed transfer occurs immediately before, but on the same day as, the grantor trust status changes. The regulations provide three examples. In all the examples “*A* is a U.S. citizen and *FT* is a foreign trust.”¹³⁰

Example 1: Loss of U.S. beneficiary. (i) On January 1, 2001, *A* transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to *FT*. At the time of the transfer, *FT* has a U.S. beneficiary within the meaning of § 1.679-2, and *A* is treated as owning *FT* under section 679. Under § 1.684-3(a), § 1.684-1 does not cause *A* to recognize gain at the time of the transfer.

- (ii) On July 1, 2003, *FT* ceases to have a U.S. beneficiary as defined in § 1.679-2(c) and as of that date neither *A* nor any other person is treated as owning any portion of *FT*. Pursuant to § 1.679-2(c)(2), if *FT* ceases to be treated as having a U.S. beneficiary, *A* will cease to be treated as owner of *FT* beginning on the first day of the first taxable year following the last taxable year in which there was a U.S. beneficiary. Thus, on January 1, 2004, *A* ceases to be treated as owner of *FT*. On that date, the fair market value of the property is 1200X and the adjusted basis is 350X. Under paragraph (e)(1) of this section, *A* is treated as having transferred the property to *FT* on January 1, 2004, and must recognize 850X of gain at that time under § 1.684-1.

Example 2: Death of grantor. (i) The initial facts are the same as in paragraph (i) of Example 1.

128. *Id.*

129. Treas. Reg. § 1.684-2(e)(1).

130. Treas. Reg. § 1.684-2(e)(2).

- (ii) On July 1, 2003, A dies, and as of that date no other person is treated as the owner of *FT*. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to *FT* immediately before his death, and generally is required to recognize 850X of gain at that time under § 1.684-1. However, an exception may apply under § 1.684-3(c) [if there is a U.S. transferor and basis is determined under § 1014].

Example 3: Release of a power. (i) On January 1, 2001, A transfers property that has a fair market value of 500X and an adjusted basis of 200X to *FT*. At the time of the transfer, *FT* does not have a U.S. beneficiary within the meaning of § 1.679-2. However, A retains the power to revoke the trust. A is treated as the owner of the trust under section 676 and, therefore, under § 1.684-3(a), A is not required to recognize gain under § 1.6841 at the time of the transfer.

- (ii) On January 1, 2007, A releases the power to revoke the trust and, as of that date, neither A nor any other person is treated as owning any portion of *FT*. On that date, the fair market value of the property is 900X, and its adjusted basis is 200X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to *FT* on January 1, 2007, and must recognize 700X of gain at that time.¹³¹

Section 684 applies also to a domestic trust that becomes a foreign trust, to the extent the trust's assets are attributable to U.S. persons, unless both trusts are grantor trusts.¹³² The date of transfer is the day the trust becomes a foreign trust. The regulations provide two examples of outbound migration. In the examples, A and B are U.S. citizens, C is a nonresident alien, and T is a trust.

Example 1: Migration of domestic trust with U.S. beneficiaries.—A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to T, a domestic trust, for the benefit of A's children who are also U.S. citizens. B is the trustee of T. On January 1, 2001, while A is still alive, B resigns as trustee and C becomes successor trustee under the terms of the trust. Pursuant to § 301.7701-7(d) of this chapter, T becomes a foreign trust. T has

131. *Id.*

132. I.R.C. § 684(c); Treas. Reg. § 1.684-4(a).

U.S. beneficiaries within the meaning of § 1.679-2 and *A* is, therefore, treated as owning *FT* under section 679. Pursuant to § 1.684-3(a), neither *A* nor *T* is required to recognize gain at the time of the migration. Section 1.684-2(e) provides rules that may require *A* to recognize gain upon a subsequent change in the status of the trust.

Example 2: Migration of domestic trust with no U.S. beneficiaries.—*A* transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *T*, a domestic trust for the benefit of *A*'s mother who is not a citizen or resident of the United States. *T* is not treated as owned by another person. *B* is the trustee of *T*. On January 1, 2001, while *A* is still alive, *B* resigns as trustee, and *C* becomes successor trustee under the terms of the trust. Pursuant to § 301.7701-7(d) of this chapter, *T* becomes a foreign trust, *FT*. *FT* has no U.S. beneficiaries within the meaning of § 1.679-2 and no person is treated as owning any portion of *FT*. *T* is required to recognize gain of 600X on January 1, 2001. Paragraph (c) of this section provides rules with respect to an inadvertent migration of a domestic trust.¹³³

If an inadvertent migration occurs, relief may be sought under the section 301.7701 regulations.¹³⁴

Section 684 does not apply to the extent grantor trust rules of section 671 treat the transferor as the grantor of the donee trust.¹³⁵ Of course, if grantor trust status is subsequently lost, section 684 will apply as explained above.¹³⁶

In 2010, section 684 does not apply to *inter vivos* gifts to non-resident aliens.¹³⁷

Section 684 does not apply to a transfer to certain charitable trusts¹³⁸ and to testamentary trusts if basis in the hands of the transferee is determined under section 1014(a).¹³⁹ The 2001 Tax Relief Act amended section 684 for tax year 2010.¹⁴⁰ The amendment makes section 684(a) applicable to transfers by a U.S. person's estate to a nonresident alien and thus gain will be triggered. However, section 684(a) will not apply in 2010 to *inter vivos* transfers to a nonresident alien.

133. Treas. Reg. § 1.684-4(d).

134. Treas. Reg. § 1.684-4(c).

135. I.R.C. § 684(b); Treas. Reg. § 1.684-3(a).

136. See *supra* note 129 and accompanying text.

137. I.R.C. § 684(b)(2) (effective only in 2010, Pub. L. No. 107-16, 115 Stat. 38, Economic Growth and Tax Reconciliation Act of 2001).

138. Treas. Reg. § 1.684-3(b).

139. Treas. Reg. § 1.684-3(c).

140. Pub. L. No. 107-16, §§ 541, 542, 115 Stat. 38.

Section 684 does not apply to transfers for fair market value to an unrelated foreign trust,¹⁴¹ or in certain other special situations such as liquidating trusts and environmental remediation trusts.¹⁴² Section 684 does not apply to transfers that qualify under section 1032.¹⁴³ The regulations provide several example of the exceptions:

Example 1: Transfer to owner trust. In 2001, A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to FT. At the time of the transfer, FT has a U.S. beneficiary within the meaning of § 1.679-2, and A is treated as owning FT under section 679. Under paragraph (a) of this section, § 1.684-1 does not cause A to recognize gain at the time of the transfer. See § 1.684-2(e) for rules that may require A to recognize gain if the trust is no longer owned by A.

Example 2: Transfer of property at death: Basis determined under section 1014(a). (i) The initial facts are the same as Example 1.

- (ii) A dies on July 1, 2004. The fair market value at A's death of all property transferred to FT by A is 1500X. The basis in the property is 400X. A retained the power to revoke FT, thus, the value of all property owned by FT at A's death is includible in A's gross estate for U.S. estate tax purposes. Pursuant to paragraph (c) of this section, A is not required to recognize gain under § 1.684-1 because the basis of the property in the hands of the foreign trust is determined under section 1014(a).

Example 3: Transfer of property at death: Basis not determined under section 1014(a). (i) The initial facts are the same as Example 1. (ii) A dies on July 1, 2004. The fair market value at A's death of all property transferred to FT by A is 1500X. The basis in the property is 400X. A retains no power over FT, and FT's basis in the property transferred is not determined under section 1014(a). Under § 1.684-2(e)(1), A is treated as having transferred the property to FT immediately before his death, and must recognize 1100X of gain at that time under § 1.684-1.

Example 4: Transfer of property for fair market value to an unrelated foreign trust. A sells a house with a fair market value of 1000X to FT in exchange for a 30-year note issued by FT. A is not related to FT as defined in § 1.679-1(c)(5). FT is not treated as owned by any person.

141. Treas. Reg. § 1.684-3(d).

142. Treas. Reg. § 1.684-3(f).

143. Treas. Reg. § 1.684-3(e). I.R.C. § 1032 provides for non-recognition of gain when a corporation receives money or property for its own stock.

Pursuant to paragraph (d) of this section, A is not required to recognize gain under § 1.684-1.¹⁴⁴

§ 6:7 Income Taxation of Foreign Estates

U.S. beneficiaries of foreign estates are taxable on the income the foreign estate distributes to them to the extent of distributable net income (DNI). Therefore, the computation of DNI is critical to the determination of the beneficiaries' income tax liability. Although section 643(a)(6) adds foreign source income to DNI of a foreign trust, that rule is not applicable to foreign estates. Thus, a foreign estate with only foreign source income has no DNI because DNI starts with U.S. taxable income, that is, income otherwise taxable in the United States, and it would have none.

A foreign estate and its beneficiaries are taxable on U.S. source income and are subject to withholding at the source rules discussed below in section 6:12.

A foreign estate files IRS Form 1040NR if it has U.S. source gross income of more than \$600.¹⁴⁵

In Private Letter Ruling 200203006,¹⁴⁶ the Service ruled that interest on bank accounts and dividends on stock held by non-resident alien decedent should be included in gross income of his foreign estate in the year received. Because the foreign estate representative could not act in the United States, a U.S. estate representative was appointed and wrote to the treasurer of all fifty states to inquire about abandoned property in decedent's name. This resulted in a delay between the time the income accrued and when it was received.

§ 6:8 Accumulation Distributions and Interest Charge on Accumulation Distributions from Foreign Trusts

The "short-cut" method of computing the beneficiary's taxes on accumulation distributions applies to foreign trusts as well as to domestic trusts.¹⁴⁷ The rules concerning accumulation distributions, also known as the throwback rules, are discussed in detail in section 3:6 above.

As to be provided in regulations, for purposes of computing the tax on accumulation distributions under section 665, taxes imposed on the trust includes an allocable amount of any income, war profits,

144. Treas. Reg. § 1.684-3(g).

145. I.R.C. § 6012(a)(1)(D)(4), (b)(4); Treas. Reg. § 1.6012-3.

146. Priv. Ltr. Rul. 200203006. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

147. I.R.C. § 667(b). However, the throwback rule was repealed for U.S. trusts for tax years beginning after August 5, 1997. See *supra* section 3:6.

and excess profits taxes imposed by a foreign country or U.S. possession on the trust's grantor or another who would be treated as the substantial owner of the trust under section 678, but for section 672(f) (which, in general, makes the grantor trust rules inapplicable to a trust with a foreign grantor or substantial owner).¹⁴⁸

In addition, after 1995, a nondeductible, compound interest equal to the underpayment of tax rate under section 6621(a)(2) is imposed on a U.S. beneficiary of a foreign trust who receives an accumulation distribution based on the length of time tax was deferred by virtue of an accumulation of distributable net income. Before 1996, simple 6% interest was charged. The total interest charge may not exceed the amount of the accumulation distribution when added to the beneficiary's tax computed under the short-cut method on the distribution.¹⁴⁹ For purposes of computing the interest, the accumulation distribution from a foreign trust is allocated proportionately to prior trust years in which the trust has undistributed net income and the beneficiary receiving it is a U.S. citizen or resident.¹⁵⁰ An accumulation distribution is treated as reducing proportionately the undistributed net income from prior years.¹⁵¹

The exclusion from treating a distribution as an accumulation distribution before the birth or during the minority of the beneficiary does not apply to foreign trusts.¹⁵² However, the domestic trust rule that amounts properly paid, credited, or required to be distributed by a trust for a taxable year that do not exceed the income of the trust are not considered as an accumulation distribution for that year, applies to foreign trusts as well. The multiple-trust rules,¹⁵³ including the \$1,000 de minimis rule,¹⁵⁴ apply to foreign trusts.

Although the conduit rule of passing the character of the trust's income through to its beneficiaries is retained for current distribution of distributable net income of a domestic trust, the character of the income is disregarded for purposes of taxing accumulation distributions to the beneficiary, except with respect to interest income not taxed by virtue of the provisions of Code section 103.¹⁵⁵ Those rules apply to foreign trusts as well.¹⁵⁶

148. I.R.C. § 665(d)(2).

149. I.R.C. § 668(a)-(b).

150. I.R.C. § 668(a)(3), (4). For distributions before August 21, 1996, the interest charges are calculated by averaging the years in which the amounts were actually earned.

151. I.R.C. § 668(a)(5).

152. I.R.C. § 665(b).

153. I.R.C. § 667(c)(1).

154. I.R.C. § 667(c)(2).

155. I.R.C. § 667(a).

156. I.R.C. §§ 667(a)(3), 668.

Capital gains are included in distributable net income of all foreign trusts.¹⁵⁷ This prevents a foreign trust from being a simple trust for throwback rule purposes. Under the regulations, a simple trust is considered complex for any year that it has “outside income,” which is defined as an item forming part of distributable net income but not forming part of accounting income; this will be the case for most foreign trusts.¹⁵⁸ The effect of this rule is to treat capital gains income as ordinary income when it is distributed from a foreign trust as an accumulation distribution.¹⁵⁹

No exclusion or deduction for the long-term capital gains deduction under section 1202 is available to the beneficiary of a foreign trust on an accumulation distribution of capital gains. However, a foreign trust is permitted to reduce undistributable net income as of the beginning of the next taxable year beginning after December 31, 1975, by the amount of the 50% long-term capital gains deduction that would be permitted to any beneficiary upon the distribution of any or all undistributed net income attributable to income from capital gains for any taxable year beginning before January 1, 1976. Nevertheless, the reduction in undistributed net income is not permitted for foreign trusts attributable to income from capital gains earned after December 31, 1975.¹⁶⁰

§ 6:9 Foreign Trust Reporting Requirements

The Small Business Job Protection Act of 1996¹⁶¹ expanded the reporting requirements for foreign trusts if there is a U.S. grantor or a

157. I.R.C. § 643(a)(6)(C).

158. See Treas. Reg. § 1.665(e)-1A(b).

159. H.R. REP. NO. 94-658, at 213; GENERAL EXPLANATION, *supra* note 76, at 225.

160. I.R.C. § 643(a)(6)(D) (repealed Pub. L. No. 101-239, § 7811(b)(2)). Note that under the Tax Reform Act of 1986, no capital gains deduction is allowed for tax years after 1986. An ambiguity may have been created under these provisions. Previously, for a trust that did not always distribute all income currently, capital gains allocated to corpus became undistributed capital gain (UCG), which could ultimately be taxed to the beneficiaries under the throwback rules, although under various circumstances it could escape. Under pre-1977 law, undistributed net income (UNI) did not include UCG. Under post-1976 law, the concept of UCG is eliminated and for foreign trusts capital gains not currently distributed are included in UNI. In the post-1976 application of the throwback rules, is UNI for a past year determined under the tax law in effect during that year or is it redetermined under the new definitions? If the former, UCG would seem to escape tax due to the new provisions; if the latter, UCG would be taxed where it might not have been under the previous law.

161. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1901(a), 110 Stat. 1755; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1027(b).

distribution is made to a U.S. person. Failure to comply may result in penalties.

For outbound transfers, section 6048 requires a grantor, transferor, or a personal representative to notify the Treasury Department upon

- (i) the creation of any foreign trust,
- (ii) the transfer, directly or indirectly, of assets to a foreign trust (including a transfer by reason of death), or
- (iii) the death of a U.S. citizen or resident if the trust was a grantor trust or any portion of it is includible in the gross estate of the decedent.

The terms “grantor,” “beneficiary,” and “obligation” are defined in Notice 97-34.¹⁶²

Excluded are transfers for full and adequate consideration, as well as transfers to certain pension and charitable trusts.¹⁶³

Transfers covered by section 6048 are reportable on IRS Form 3520, which is filed with the taxpayer’s income tax return for the year.¹⁶⁴ Pre-August 20, 1996 foreign trusts that were treated as domestic trusts under prior law but that would be treated as foreign trusts under the changes made in 1996¹⁶⁵ could elect to continue to be deemed a domestic trust.¹⁶⁶

Any U.S. person who is treated as the owner of any portion of a foreign trust under the grantor trust rules is required to ensure the trust files an annual IRS Form 3520-A by the fifteenth day of the third month following the close of the trust’s tax year.¹⁶⁷

A foreign trust may appoint an agent for U.S. tax compliance.¹⁶⁸ However, unless a U.S. person is authorized to act on behalf of the trust in certain dealings with the Treasury Department, the Treasury is entitled to determine the tax consequences of amounts to be taken into account for income tax purposes.¹⁶⁹

162. I.R.S. Notice 97-34, § II, 1997-1 C.B. 422, *superseded in part by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

163. I.R.C. § 6048(a).

164. I.R.S. Notice 97-34, § VIII, 1997-1 C.B. 422, *superseded in part by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

165. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.

166. Treas. Reg. § 301.7701-7(f).

167. I.R.S. Notice 97-34, § VIII, 1997-1 C.B. 422, *superseded in part by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

168. I.R.S. Notice 97-34, § IV, 1997-1 C.B. 422, *superseded in part by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

169. According to the legislative history, it is intended that there be limited judicial review of such determinations. H.R. REP. NO. 104-542, Part 2, at 33 (1996).

A U.S. person who receives any distribution from a foreign trust is required to file an IRS Form 3520, if the beneficiary knows or has reason to know that the distribution came from a foreign trust.¹⁷⁰ Distributions include both actual and constructive distributions. If adequate records are not provided to the Treasury Department to determine the proper treatment of the distribution, the distribution is includible in gross income of the U.S. person as an accumulation from the “middle year” of the foreign trust (computed by taking the number of years the trust has been in existence divided by two), and includes an interest charge on the delayed taxes.¹⁷¹ The accumulation treatment may be avoided if the beneficiary receives from the foreign trust a written statement: either a “Foreign Grantor Trust Beneficiary Statement”¹⁷² or a “Foreign Nongrantor Beneficiary Statement.”¹⁷³

Failure to provide the reports and returns may subject the U.S. person to an initial penalty of 35% of the amount properly reportable (on Form 3520) and a failure to provide annual reports (Form 3520A) will result in initial penalties of 5% of the gross amount properly reportable. In addition, a \$10,000 penalty is imposed for the continued failure for each thirty-day period (or any fraction thereof) beginning ninety days after the Treasury Department notifies the responsible party of the failure, subject to a reasonable cause exception. The penalties cannot exceed the gross amount properly reportable.

A foreign trust which does not have an office or place of business in the United States is required to file its return on the fifteenth day of the sixth month after the close of its tax year.¹⁷⁴

§ 6:10 Loans from Foreign Trusts

Under section 643(i), loans made by a foreign trust of cash¹⁷⁵ or marketable securities to a grantor of the trust who is a U.S. taxpayer, to a U.S. beneficiary of the trust, or to any person who is related¹⁷⁶ to the grantor or a beneficiary, is treated as a distribution to the grantor or beneficiary, unless the regulations to be issued provide otherwise.¹⁷⁷ The rule applies whether the loan is direct or indirect and is effective

170. I.R.C. § 6048(c).

171. *Id.*; I.R.S. Notice 97-34, § V, 1997-1 C.B. 422, *superseded in part by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

172. I.R.S. Form 3520A.

173. Instructions for line 30 of Form 3520 set forth the information that should be contained in a Foreign Nongrantor Trust Beneficiary Statement.

174. Treas. Reg. § 1.6072-1(c).

175. Includes foreign currency and “cash equivalents.” I.R.C. § 643(i)(2)(A).

176. Within the meaning of section 267 or 707(b) or the spouse of any such related person. I.R.C. § 643(i)(2)(B); Treas. Reg. § 1.643(h)-1(e).

177. I.R.C. § 643(i).

for loans made after September 19, 1995.¹⁷⁸ It does not apply to loans made to an entity that is exempt from tax.¹⁷⁹ The regulations are expected also to exclude loans made on arm's-length terms.¹⁸⁰ Regulations will also provide rules to determine which grantor or beneficiary a loan should be attributed where the recipient is "related" to more than one person under the attribution rules.¹⁸¹

A foreign trust described in section 651(a)(1) that would otherwise constitute a "simple" trust¹⁸² that makes a loan or distribution covered by section 643(i) is not treated as a simple trust.¹⁸³ This is significant as the accumulation throwback rules do not, in general, apply to distributions from simple trusts.¹⁸⁴ Therefore, distributions by an otherwise simple trust that makes such a loan may be treated as accumulation distributions to which the throwback rules and interest charge may apply.

§ 6:11 Indirect Distributions

Any amount paid to a U.S. person that was derived, directly or indirectly, from a foreign trust is treated as if paid directly to the U.S. person by the trust.¹⁸⁵ It appears that the rule applies whether or not the trust was created by a U.S. person. The rule does not to apply to withdrawal from a grantor trust by its grantor with a subsequent gift or payment to a U.S. person.¹⁸⁶

A U.S. person who receives property (including cash¹⁸⁷) from an intermediary, who received the property from a foreign trust, is treated as having received the property directly from the foreign trust, if the principal purpose of the arrangement was avoidance of U.S. tax.¹⁸⁸ Unless the taxpayer demonstrates or the Service determines

178. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1904(c)(1), 1906(b), (c)(1), 110 Stat. 1755.

179. I.R.C. § 643(i)(2)(C); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1904(c)(1), 1906(b), (c)(1), 110 Stat. 1755, Conf. Rep. No. 104-737.

180. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §§ 1904(c)(1), 1906(b), (c)(1), 110 Stat. 1755; H.R. REP. NO. 104-737 (Conf. Rep.).

181. I.R.C. § 643(i)(2)(B)(ii).

182. A simple trust is a trust required to distribute all of its accounting income currently, makes no provision for payment to charity, and does not distribute corpus even if authorized to do so. *See supra* section 3:4.

183. I.R.C. § 643(i)(2)(D).

184. *See supra* section 3:4.

185. I.R.C. § 643(h).

186. H.R. REP. NO. 104-542, Part 2, at 28 (1996).

187. Treas. Reg. § 1.643(h)-1(f).

188. Treas. Reg. § 1.643(h)-1(a)(1) (generally effective for transfers after August 10, 1999).

that the intermediary is the agent of the U.S. person, property transferred to the U.S. person by the trust is treated as having been transferred to the U.S. person by the trust in the year transferred by the intermediary to the U.S. person.¹⁸⁹ The principal purpose of a transfer is deemed to be for the avoidance of U.S. tax if:

- (1) the U.S. person is related to the grantor of the foreign trust or has some other relationship with the grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person,
- (2) within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, the U.S. person receives either the property, the proceeds from the property or property in substitution for the property from the intermediary, and
- (3) the U.S. person cannot demonstrate that
 - (a) the intermediary has a relationship with the U.S. person that would provide a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the U.S. person,
 - (b) the intermediary acted independently of the grantor and the trustee of the foreign trust,
 - (c) the intermediary is not an agent of the U.S. person under generally applicable agency principles, and
 - (d) the U.S. person, if the intermediary is foreign, timely complied with the reporting requirements of section 6039F, if applicable.¹⁹⁰

The regulations provide an example of when the principal purpose is tax avoidance:

F[oreign] *T*[rust] was created in 1980 by *A*, a nonresident alien, for the benefit of his children and their descendants. *FT*'s trustee, *T*, determines that 1000X of accumulated income should be distributed to *A*'s granddaughter, *B*, who is a resident alien. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, *T* causes *FT* to make a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) of 1000X to *I*, a foreign person. *I* subsequently makes a gratuitous transfer of 1000X to *B*. Under paragraph (a)(1) of this section, *FT*

189. Treas. Reg. § 1.643(h)-1(c).

190. Treas. Reg. § 1.643(h)-1.

is deemed to have made an accumulation distribution of 1000X directly to B.¹⁹¹

The intermediary trust rules apply only to gratuitous transfers,¹⁹² to transfers for the year that do not exceed \$10,000,¹⁹³ or to transfers if the grantor is the intermediary.¹⁹⁴ If property is treated as transferred directly by a foreign trust to a U.S. person, the property will not be taken into account in computing the intermediary's gross income.¹⁹⁵

The regulations provide eleven examples explaining how section 643(h) applies in various factual situations.¹⁹⁶

Transfers covered by section 643(h) are also subject to the reporting requirements of section 6048.¹⁹⁷ See section 6:9 above for a discussion of section 6048.

§ 6:12 Withholdings at the Source

Section 1441 requires persons who make payments of income to nonresident estates and trusts to withhold a portion of the payment that is a fixed or determinable annual or periodic income.¹⁹⁸ Generally, the withheld amount equals 30% of the payment. The payments are reported in IRS Form 1042-S.¹⁹⁹ The withholding applies to income from sources within the United States unless connected with a trade or business.²⁰⁰ The withholding rules apply unless the payor establishes that the payee is a U.S. person or is a foreign person entitled to a lower withholding rate.²⁰¹ The regulations provide guidance for payments to foreign trusts and foreign estates.²⁰² The guidance is divided between payments to (a) foreign complex trusts and foreign estates, and (b) simple foreign trusts and foreign grantor trusts. The rate of withholding may be less based on treaties.²⁰³

Section 1446 provides for withholding by partnerships with foreign partners.²⁰⁴ Grantor trusts must provide the partnership with information to identify the owner.²⁰⁵ Foreign estates or trusts must provide

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- 191. Treas. Reg. § 1.643(h)-1(g), ex. 1.
 - 192. Treas. Reg. § 1.643(h)-1(b)(1).
 - 193. Treas. Reg. § 1.643(h)-1(d).
 - 194. Treas. Reg. § 1.643(h)-1(b)(2).
 - 195. Treas. Reg. § 1.643(h)-1(c)(3).
 - 196. Treas. Reg. § 1.643(h)-1(g), exs. 1–11.
 - 197. Treas. Reg. § 1.643(h)-1(a).
 - 198. I.R.C. § 1441(a); Treas. Reg. § 1.1441-5.
 - 199. Treas. Reg. § 1.1441.
 - 200. I.R.C. § 1441(c)(1).
 - 201. Treas. Reg. § 1.1441-1(b).
 - 202. Treas. Reg. § 1.1441-5(e).
 - 203. Treas. Reg. § 1.1441-6(a).
 - 204. I.R.C. § 1446.
 - 205. Treas. Reg. § 1.1446-1(c)(2)(ii)(E).

the partnership with information to establish their status under section 1446.²⁰⁶

In Revenue Ruling 59-177²⁰⁷ the Service ruled that a domestic fiduciary of a domestic trust was not required to withhold except to the extent the distribution was DNI and thus gross income from U.S. sources. However, if the distribution in excess of DNI is an accumulation distribution, then withholding would apply.²⁰⁸

Revenue Ruling 68-621²⁰⁹ did not require withholding at the source for capital gains realized by an ancillary administrator of a nonresident alien estate because the payments were not fixed or determinable annual or periodic income; however, distributions of dividend income would be subject to withholding. Revenue Ruling 70-599,²¹⁰ similarly held that a domestic fiduciary of a nonresident alien was not required to withhold on capital gains of a trust that were distributable to a nonresident alien.

The Heroes Earnings Assistance and Relief Tax Act of 2008²¹¹ added section 877A, which requires trustees of nongrantor trusts to withhold 30% of the taxable portion of a distribution to a “covered expatriate.”²¹² In addition, if appreciated property is distributed to a “covered expatriate,” gain is recognized by the trust as though the property were sold to the expatriate.²¹³ “Covered expatriate” is defined in section 877A(g)(1).

A full discussion of withholding rules is beyond the scope of the book.

206. Treas. Reg. § 1.1446-1(c)(2)(ii)(H).

207. Rev. Rul. 59-177, 1959-1 C.B. 229.

208. Rev. Rul. 68-605, 1968-2 C.B. 390.

209. Rev. Rul. 68-621, 1968-2 C.B. 286.

210. Rev. Rul. 70-599, 1970-2 C.B. 172.

211. Pub. L. No. 110-245, 122 Stat. 1624 (codified as amended in scattered sections of 26 U.S.C.).

212. I.R.C. § 877(f)(1)(A).

213. I.R.C. § 877A(f)(1)(B).

Chapter 7

Special Trusts

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§ 7:1 Common Trust Funds

A common trust fund is a fund maintained by a bank, in accordance with the rules and regulations of the Board of Governors of the Federal Reserve System, for the collective investment of moneys

contributed to the fund by the bank in its capacity as trustee, executor, administrator, or guardian.¹ Common trust funds are treated specially to avoid the possibility that they might be taxed as associations.² The fund is exempt from tax, but each participant reports its share of the net income of the fund.³ The net income is computed in substantially the same manner and on the same basis as an individual, except that the fund is not allowed deductions for charitable contributions,⁴ net operating losses,⁵ or capital loss carryovers under section 1212.⁶ Capital gains and losses, dividends,⁷ and partially exempt interest retain their character and are treated as such in the hands of the participants. The 2% rule of section 67 is applied at the beneficiary level rather than to the trust.⁸

Every bank maintaining a common trust fund must file a return showing gross income, deductions, and the proportionate share of each participant.⁹ Common trust funds must use calendar tax years.¹⁰

§ 7:2 Alimony Trusts

§ 7:2.1 Post-1983 Rules—Revised Section 682 Trusts

The Tax Reform Act of 1984¹¹ changed the rules controlling the taxation of alimony trusts. Under revised section 682, the beneficiary of an alimony trust is taxed on the income distributable to him or her.¹² This happens even though the payments discharge a legal

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1. I.R.C. § 584; Treas. Reg. §§ 1.584-1 to -6; Rev. Rul. 64-59, 1964-1 C.B. 193.
 2. See H.R. REP. NO. 75-1860 (1938) (with respect to 1938 Act § 169), *reprinted in* 1939-1 (pt. 2) C.B. 759; S. REP. NO. 74-2156 (1936), *reprinted in* 1939-1 (pt. 2) C.B. 691. See section 7:3, *infra*, for a discussion of when a trust may be taxed as an association.
 3. See I.R.C. § 584(b).
 4. See I.R.C. § 584(d)(3).
 5. See I.R.C. § 584(g); Treas. Reg. § 1.584-6.
 6. See Treas. Reg. § 1.584-3(b).
 7. Dividends that qualify for special tax treatment under I.R.C. § 1(h)(11) are treated as received proportionally by the beneficiaries. See I.R.C. § 584(c).
 8. See Treas. Reg. § 1.67-2T(d).
 9. See Treas. Reg. § 1.584-5; I.R.C. § 6032. Tax preference items are picked up pro rata. I.R.C. § 59(d)(1)(B). No gain or loss is realized on the merger of two such funds or upon conversion to a regulated investment company. See I.R.C. § 584(h).
 10. I.R.C. § 584(i).
 11. Pub. L. No. 98-369, 98 Stat. 494 (effective for transfers after July 17, 1984, and for transfers between January 1, 1984, and July 17, 1984, if the parties elected to have I.R.C. § 682 apply).
 12. I.R.C. § 682(a). I.R.C. § 682 refers to the trust beneficiary as “wife.” However, I.R.C. § 7701(a)(17) provides that all references to “wife” mean “husband” as well. Treas. Reg. § 1.682(c)-1.

obligation of the grantor spouse.¹³ Section 682 overrides the potential application of section 71, section 677, and section 672(e).¹⁴ Section 682(b) refers to estates as well as trusts, which suggests that an estate should receive a distribution deduction for amounts paid to a surviving ex-spouse.

Section 682 applies to trust income paid to a beneficiary-spouse after a decree of divorce, after a decree of separate maintenance, or after a written separation agreement is signed.¹⁵ However, it does not apply to oral or informal agreements.

Trusts subject to the rules of section 682 do not need to be created pursuant to the divorce or legal separation, and the trust need not be referred to in a decree.¹⁶ Because section 682 does not require the trust to be created specifically to make alimony payments pursuant to the decree of divorce or separate maintenance, section 682 may apply to trusts that a grantor-spouse created, before divorce or separation and not in contemplation of it, for more general estate planning goals. For example, a monied spouse might create an *inter vivos* QTIP trust for his or her spouse to increase the non-monied spouse's net worth to take full advantage of that spouse's unified estate and gift tax credit under section 2010. If the spouses subsequently divorce, section 682 will relieve the donor spouse of the tax liability for the trust's income that sections 677 and 672(e) would otherwise provide.

Section 215 provides a payor-spouse a tax deduction for alimony paid. However, section 215(d) provides that a deduction is not available if section 682 excluded trust distributions from the payor-spouse's income.¹⁷

Section 682 does not apply to a trust created to support dependent children of a divorced or separated couple.¹⁸

13. Priv. Ltr. Rul. 9235032 (trust created by one spouse for the other in connection with the settlement of their separation agreement is not treated as a grantor trust by reason of I.R.C. § 682, but as a complex trust, even though trust created to fulfill grantor's obligation to make fixed monthly payments to ex-spouse). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

14. *Id.*

15. I.R.C. § 682(a); Treas. Reg. § 1.682(a)-1(a).

16. Treas. Reg. § 1.682(a)-1, ex. 2.

17. Treas. Reg. § 1.215-1(b) provides: "The deduction . . . is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse." *See also* Chief Couns. Adv. 200923027. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

18. I.R.C. § 682(a); Treas. Reg. § 1.682(a)-1(b).

§ 7:2.2 Pre-1984 Rules—Section 71 and Section 682 Trusts

The revisions to section 682 do not apply to transfers before January 1, 1984, or to transfers between January 1, 1984, and July 17, 1984, unless the parties elected to have revised section 682 apply. Thus for trusts that are not covered by revised section 682, the old and somewhat confusing rules, discussed below, still apply.

In keeping with the rules governing outright payments, pre-1984 section 682 provided that certain “payments,” made subsequent to a decree of divorce or of separate maintenance, from an alimony trust created by one spouse are includible in the other spouse’s gross income, but section 215 provided that they are neither includible in, nor deductible from, the gross income of the spouse who created the trust.¹⁹ However, this provision applied only to property transferred to discharge a legal obligation imposed or incurred because of the marital or family relationship, under the divorce or separation decree, or pursuant to an agreement incident to the divorce or separation. It, therefore, did not necessarily include a trust created before or independent of the divorce or the separation agreement, even if used to discharge the grantor-spouse’s obligation to support.

Although sections 71 and 682 seemed to cover the same situations, according to the regulations, section 682 applied to a trust created before divorce or separation and not in contemplation of it, while section 71 applied if the creation of the trust, or payments by a previously created trust, was in discharge of an obligation imposed upon or assumed by the spouse creating the trust (or made specific) under the court order, divorce decree, or a written separation agreement.²⁰

Section 71 was supplemented in some respects by section 682, which provided that there was included in the gross income of a spouse who is divorced, or judicially separated from the other spouse under a written separation agreement, “the amount of the income” of any trust that the first spouse is entitled to receive and that, except for section 682, would be includible in the gross income of the spouse who created the trust despite the fact that it is meeting an obligation of that spouse. (If no support obligation is being discharged by the trust, and if the grantor-spouse has retained no power, the

19. See *supra* note 17.

20. Treas. Reg. § 1.682(a)-1(a)(2); Rev. Rul. 74-94, 1974-1 C.B. 26 (wife taxed under “normal” trust rules and not I.R.C. § 71 or 682 on discretionary trust to extent husband not taxed, as he was on income used for children’s support).

question of taxability to that spouse does not arise and the sections are inapplicable.)²¹

One effect of these two provisions together was that the income of any trust paid to a spouse (except sums payable for the support of minor children of the other spouse) after a written separation agreement or a decree of divorce or separate maintenance, was taxable as income to the spouse who is the trust beneficiary and not to the grantor-spouse regardless of whether the latter may or may not have a continuing obligation to support the former; and regardless of any retained powers of the grantor-spouse—at least if the payments, in the case of a section 71 trust, are “periodic payments.”²²

Before the enactment of the Tax Reform Act of 1984, the regulations and at least one case indicated that “periodic payments” from a trust subject to section 71 (as distinguished from “the amount of the income” of a trust subject to section 682) are includible in the gross income of the payee-spouse irrespective of whether they represent income or corpus.²³ This interpretation was made in spite of the provisions of section 682(b), which stated that the beneficiary-spouse of an alimony trust will be considered to be a “beneficiary” as specified in all of part I of subchapter J.²⁴

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21. See *Kitch v. Comm’r*, 103 F.3d 104 (10th Cir. 1996) (providing legislative history of I.R.C. § 682, pointing out that I.R.C. §§ 682 and 71 seem contradictory on their face, and refusing to treat a decedent’s estate as an alimony trust under I.R.C. § 682).
 22. Treas. Reg. §§ 1.682(a)-1(a)(3), 1.71-1(c)(3), 1.671-1(b). “Periodic payments” may exclude discretionary payments, and such payments to the payee-spouse, if not for support, would be taxable to that person only to the extent provided for ordinary beneficiaries (and, if for support, would apparently be taxable to the payor-spouse). Rev. Rul. 74-94, 1974-1 C.B. 26; see Note, *Wife May Avoid Tax on Income from Divorce-Connected Trust*, 40 J. TAX’N 333, 333–34 (1974).
 23. Treas. Reg. §§ 1.682(a)-1(a)(2), 1.682(b)-1(b), 1.71-1(c)(3), 1.215-1(c), ex. 2; *Trust Under Deed of Albert R. Gallatin Welsh Trust v. Comm’r*, 16 T.C. 1398, 1401, *aff’d sub nom. Girard Trust Corn Exch. Bank v. Comm’r*, 194 F.2d 708 (3d Cir.), *cert. denied*, 344 U.S. 821 (1952). On the other hand, under I.R.C. § 71(c), as in effect before, “periodic payments” do not include installment payments in discharge of an obligation fixed as a principal sum in terms of money or property, unless the principal sum is required or permitted to be paid over a period exceeding ten years, and then only 10% of such sum is includible by the payee-spouse in any year. I.R.C. § 682 does not similarly except short-term installment payments of a fixed total.
 24. Because I.R.C. § 682(b), before and after amendment by the Tax Reform Act of 1984, also refers to estates, an estate that makes an I.R.C. § 71 payment is probably allowed a deduction for thus making a distribution to a beneficiary. *Laughlin’s Estate v. Comm’r*, 167 F.2d 828 (9th Cir. 1948); *Estate of Reid v. Comm’r*, 15 T.C. 573 (1950), *aff’d sub nom. Izrastzoff v. Comm’r*, 193 F.2d 625 (2d Cir. 1952); Gen. Couns. Mem. 25,999, 1949-1 C.B. 116; *cf. Twinam v. Comm’r*, 22 T.C. 83 (1954), *acq.* 1954-2 C.B. 3;

The scope of section 682(b) was interpreted to hold that a divorced beneficiary-spouse of a section 71 trust was entitled to exclude from income his or her share of tax-exempt interest. The government contention that section 682(b) applied only to determining the taxable year of inclusions was rejected; the court referred to the “accepted proposition,” based upon legislative history, that even corpus payments from section 71 alimony trusts are includible in income. However, the court declined to extend the logic to tax-exempt income because neither the Code nor legislative history compelled it.²⁵

§ 7:3 Trusts Taxable As Corporations

The trust as a legal entity offers many of the state law advantages of a corporation for conducting a business, but without the disadvantage of a tax on both the corporate profits and the distribution of those profits to beneficial owners. For example, a trust, like a corporation, permits continuity of life, transferability of interests, centralization of management, and limited liability. As a result, the trust form is sometimes used as a substitute for a corporation. However, case law and the regulations have placed limits on the successful use of trusts for this purpose: a trust may be classified as an association under the regulations and taxed as a corporation.²⁶

A particular exemption from this risk was enacted in 1961. A closely defined “real estate investment trust,” having 100 or more beneficial owners and distributing most of its ordinary income, can be free of the so-called double tax on a corporation’s distributed profits.²⁷

Dixon v. Comm’r, 44 T.C. 709 (1965) (rejecting taxpayer’s argument that amounts received after husband’s death are not taxable because New York law does not allow alimony after the death of the husband). Rev. Rul. 67-304, 1967-2 C.B. 224, allows the estate a distribution deduction under I.R.C. § 661 (relating to distributions to beneficiaries) for payments made to a spouse based on a claim for periodic payments to be made by the estate, under a property settlement agreement, incorporated into a divorce decree. See I.R.C. § 682(b); *Laughlin*, 167 F.2d 828; Gen. Couns. Mem. 25,999, 1949-1 C.B. 116; *Estate of Reid*, 15 T.C. 573.

25. *Ellis v. United States*, 416 F.2d 894 (6th Cir. 1969); see also *Stewart v. Comm’r*, 9 T.C. 195 (1947), *aff’d*, 196 F.2d 397 (5th Cir. 1952); *Daniel v. Comm’r*, 56 T.C. 655 (1971), *aff’d per curiam*, 461 F.2d 1265 (5th Cir. 1972) (no beneficial interest in trust had been transferred to wife: husband remained taxable). *But cf.* Rev. Rul. 65-283, 1965-2 C.B. 25. See generally Philip R. Fink, *Income, Gift, and Estate Tax Aspects of Alimony Trusts*, 119 TR. & EST. 54 (1980).

26. Treas. Reg. §§ 301.7701-2(b)(2), 301.7701-4(b).

27. I.R.C. §§ 856–59. The Tax Reform Act of 1976 made numerous changes to these sections. See generally STAFF OF THE JOINT COMM. TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 443–59 (Comm. Print 1976).

But applicable to all other cases, the regulations state that the term “trust,” as used in the Code, refers

to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. . . . Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.²⁸

The regulations further indicate that the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association.²⁹

The 1996 check-the-box regulations issued by the Treasury Department were aimed primarily at ending disputes between the Service and taxpayers concerning the taxable entity classification of partnerships and limited liability companies³⁰ and did not specifically address trusts.³¹ However, the check-the-box regulations provide that domestic entities not incorporated under state law that have two or more “members” are treated as a partnership unless an election is made to be taxed as an association.³² An entity with only one member is ignored for tax purposes, unless an election to be taxed as an association is made.³³ Thus, as a general matter, a domestic trust will not be subject to taxation at the entity level and the beneficiaries taxed a second time when distributions are made. However, it is possible, but not likely, that a domestic trust might be reclassified as a partnership,^{33.1} but that would not result in double taxation.

28. Treas. Reg. § 301.7701-4(a).

29. Treas. Reg. § 301.7701-4(b).

30. Treas. Reg. §§ 301.7701-2, 301.7701-3, 301.7701-4 (as amended by T.D. 8697, 1997-16 C.B. 215).

31. Treas. Reg. § 301.7701-3(a).

32. Treas. Reg. § 301.7701-3(b)(1)(i).

33. Treas. Reg. §§ 301.7701-2(c), -3(b)(1)(ii).

33.1. In a private letter ruling that predates the check-the-box regulations, the Service ruled that “[i]f an entity has both associates and a business purpose, it cannot be classified as a trust for federal income tax purposes.” For the taxpayer in the ruling, it meant that a charitable remainder trust did not qualify because it was not a trust for tax purposes. *See* Priv. Ltr. Rul. 9547004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

Foreign entities are dealt with differently by the check-the-box regulations. Some foreign entities are automatically considered to be associations.³⁴ All other foreign entities fall into one of three categories:

- (i) Entities with at least two members, but with at least one of them with personal liability, are partnerships.³⁵
- (ii) Entities in which no member has personal liability are associations.³⁶
- (iii) Single-member entities with one member and unlimited liability are ignored.³⁷

This all means that a typical foreign trust, which will provide limited liability for everyone associated with it, may need to affirmatively elect out of being taxed as an association if permitted and desirable.³⁸

The check-the-box regulations apply retroactively if the entity had a reasonable basis for the claimed classification.³⁹ As noted above, the check-the-box regulations are not specifically applicable to trusts, but a reclassification of a trust as a business entity would result in coverage.⁴⁰

In decisions before the check-the-box regulations, courts have taken into account a number of factors.⁴¹ In addition to emphasizing the question of who supplies the property, courts apparently had been influenced to treat trusts as associations where there had been assignable share certificates;⁴² large numbers of beneficiaries;⁴³ broad

34. Treas. Reg. § 301.7701-2(b)(8).

35. Treas. Reg. § 301.7701-3(b)(2)(i)(A).

36. Treas. Reg. § 301.7701-3(a).

37. Treas. Reg. § 301.7701-3(b)(2)(i)(C).

38. See Rev. Proc. 2010-32, 2010-36 I.R.B. 320, concerning the election.

39. Treas. Reg. § 301.7701-3(h)(2). The regulation also contains two transitional rules.

40. See *supra* notes 30–33 and accompanying text.

41. *Morrissey v. Comm’r*, 296 U.S. 344, 359 (1935).

42. See *id.* at 344; *Swanson v. Comm’r*, 296 U.S. 362 (1935); *Helvering v. Combs*, 296 U.S. 365 (1935).

43. Cf. *Lombard Trs. v. Comm’r*, 136 F.2d 22 (9th Cir. 1943) (trust with only one beneficiary taxed as association). Moreover, there can be treatment as an association even where the beneficiaries do not supply the property). See Rev. Rul. 57-534, 1957-2 C.B. 924. *But cf.* *Curt Teich Trust No. 1 v. Comm’r*, 25 T.C. 884 (1956). See also Priv. Ltr. Rul. 200203034 (charitable remainder trust to be created by an S corporation for benefit of a shareholder and would not be treated as a trust because part of trust contribution will be treated as being provided by shareholder, so corporation and shareholder will be treated as co-grantors and having a joint investment). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

powers of trustees;⁴⁴ corpus consisting of business property rather than of securities or the like;⁴⁵ and perhaps where the trust has been *inter vivos* rather than testamentary.⁴⁶

In old decisions, the Supreme Court has held taxable as a corporation a trust that managed and operated twenty apartment houses for five grantor-beneficiaries,⁴⁷ and a trust whose operations were limited to the first and only apartment building it acquired,⁴⁸ in both cases the trustees had wide powers. On the other hand, trusts in business have been treated as true trusts in instances where the trust was to benefit charities rather than the grantors.⁴⁹

Not all courts ruled that a business operated by a trust was taxable as a corporation. For example, the Tax Court in *Estate of Bedell*⁵⁰ ruled that a testamentary trust lacked "associates" and, thus, could not be taxed as corporation.

Lower courts have held a so-called liquidating trust, created to liquidate a particular piece of property of an estate, to be a true trust rather than an association.⁵¹ Similarly, it has been held that a trust established to liquidate for a corporation's shareholders certain assets not distributable in kind is a liquidating trust, and a special New York

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44. See *Abraham v. United States*, 406 F.2d 1259, 1264 (6th Cir. 1969) ("[T]he basis for our affirmation . . . is the power granted to the trustees to conduct a business for profit rather than the acts performed by them in doing so."); *Anderson v. Lamb*, 222 F.2d 176 (8th Cir. 1955), *aff'g* 120 F. Supp. 99 (D.N.D. 1954); *Marshall's Heirs v. Comm'r*, 111 F.2d 935 (3d Cir.), *cert. denied*, 311 U.S. 658 (1940). *But cf.* *Rohman v. United States*, 275 F.2d 120 (9th Cir. 1960) (treated as trust for tax purposes where little centralized management).
 45. Compare *Nee v. Main St. Bank*, 174 F.2d 425 (8th Cir.), *cert. denied*, 338 U.S. 823 (1949), with *Nee v. Linwood Sec. Co.*, 174 F.2d 434 (8th Cir. 1949).
 46. *Cf.* *Nat'l Metro. Bank v. Comm'r*, 145 F.2d 649 (4th Cir. 1944); *Keatts v. United States*, 52-2 U.S. Tax Cas. (CCH) ¶ 9446, 44 A.F.T.R. (P-H) 902 (W.D. Tenn. 1952) (testamentary trust for benefit of former employees taxed as association).
 47. *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369 (1935).
 48. *Swanson v. Comm'r*, 296 U.S. 362 (1935); see also *Hecht v. Malley*, 265 U.S. 144 (1924). *But see* *Crocker v. Malley*, 249 U.S. 223 (1919); *A.A. Lewis & Co. v. Comm'r*, 301 U.S. 385 (1937).
 49. *John Danz Charitable Trust v. Comm'r*, 18 T.C. 454, 462-63 (1952), *aff'd*, 231 F.2d 673 (9th Cir. 1955), *cert. denied*, 352 U.S. 828 (1956); *Arthur Jordan Found. v. Comm'r*, 12 T.C.M. (CCH) 109 (1953), *rev'd on other grounds*, 210 F.2d 885 (7th Cir. 1954) (increasing charitable deduction).
 50. *Estate of Bedell v. Comm'r*, 86 T.C. 1207 (1986).
 51. *Comm'r v. Morris Realty Co. Trust No. 2*, 68 F.2d 648 (7th Cir. 1934); *Comm'r v. Atherton*, 50 F.2d 740 (9th Cir. 1931); *Blair v. Wilson Syndicate Trust*, 39 F.2d 43 (5th Cir. 1930); *Negus v. Comm'r*, 12 T.C.M. (CCH) 243 (1953); *cf.* *Reilly v. Comm'r*, 46 B.T.A. 1246 (1942). But a trust taxable as an association did not revert to trust status during its final years, in which

real estate company liquidation trust was held to be a true trust whose income is currently distributable.⁵²

§ 7:4 Charitable Remainder Trusts

§ 7:4.1 General Overview

The 1969 Tax Reform Act added requirements to qualify a remainder interest in trust for a charitable deduction⁵³ for income,⁵⁴ estate,⁵⁵ or gift tax purposes.⁵⁶ The transfer must be in the form of a charitable remainder unitrust, a charitable annuity trust, or a pooled income fund.⁵⁷ The trust itself is exempt from income taxation, unless it has

it had an ultimate purpose of liquidation. *Mullendore Trust Co. v. United States*, 271 F.2d 748 (10th Cir. 1959). A liquidating trust created by creditors pursuant to a bankruptcy was treated as a grantor trust in Rev. Rul. 63-228, 1963-2 C.B. 229. *But cf.* Rev. Rul. 69-300, 1969-1 C.B. 167 (liquidating trust not a grantor trust where trustee has very broad powers, but taxed as separate trust under I.R.C. § 641). *See generally* Del Negro, *Liquidating Trusts: Their Nature and Uses*, 38 INST. ON FED. TAX'N § 23 (1980).

52. Rev. Rul. 75-379, 1975-2 C.B. 505 (ten-year notes possibly to be held to maturity); Rev. Rul. 56-78, 1956-1 C.B. 648; *see* Treas. Reg. § 301.7701-4(d).
53. The deduction is allowable in an amount equal to the present value of the interest which is deemed for the benefit of charity. Treas. Reg. §§ 1.664-2(c), 1.664-4, 1.642(c)-6, 20.2031-7, 20.2031-8. *See generally* Robert S. Ashby, *Charitable Remainder Trusts*, 111 TR. & EST. 530 (1972). The deduction may be maximized by providing for payment only once at the end of each year rather than more frequently. Treas. Reg. § 20.2031-7. Under I.R.C. § 7520, the interest rate assumption currently used for charitable remainder trusts and for other purposes changes monthly, although the taxpayer may use the interest rate for the month of the transfer to the charitable remainder trust or either of the two prior months.
54. I.R.C. § 170(f)(2).
55. I.R.C. § 2055(e)(2).
56. I.R.C. § 2522(c)(2).
57. Under prior law, the deduction generally was allowable for transfers before August 1, 1969, if the remainder interest passed to a charity was "presently ascertainable, and hence severable from the noncharitable interest" even if the charity's interest was subject to a contingency, at least if the contingency was so remote as to be negligible. *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929); Treas. Reg. §§ 20.2055-2(b), 25.2522(a)-2(b). Rev. Rul. 77-374, 1977-2 C.B. 329, states that no charitable deduction will be allowed if the probability is greater than 5% that the noncharitable annuitant will survive the exhaustion of the charitable remainder trust. *See* Teitell, *Estate Planning and Philanthropy*, N.Y.L.J., Nov. 14, 1977, at 1, col. 1, which discusses the ruling and sets forth a form to compute whether the 5% probability is met (which is a different determination of whether the value of the remainder interest is 5% of the fund or whether the annuitant is entitled to an annuity of at least 5% a year). Charles M.

any unrelated business income (UBI).⁵⁸ A major planning benefit of a charitable remainder trust is its tax exemption.⁵⁹

The rules for a charitable remainder unitrust and a charitable remainder annuity trust are contained in section 664. (The taxation of pooled income funds is discussed in section 7:6 below.)

The determination of the amount of the annual payment is different, however, for the two types of trusts, as explained below.

A charitable remainder annuity trust is defined by section 664 as a trust from which a sum certain (which is not less than 5% for transfers in trust nor more than 50% of the initial net fair market value of the property placed in trust) is to be paid at least annually to one or more persons (at least one of whom is not an organization described in section 170(c)) for a term of years, which may not exceed twenty years, or for the life or lives of an individual or individuals. In addition, the value of the remainder interest passing to charity must be at least 10%

Aulino, *Estate Distributions to Charitable Remainder Trusts*, 114 TR. & EST. 458 (1975). See Priv. Ltr. Rul. 9440010 (holding that, although violating the 5% probability test would result in a loss of deduction for the value of the remainder, the trust would still be a qualified charitable remainder trust entitled to exemption from income taxation under I.R.C. § 664(c)). But see Priv. Ltr. Rul. 9532006 (holding changed). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

58. I.R.C. §§ 664(c), 512(b). In certain instances, debt-financial income on encumbered property can produce unrelated business income. See I.R.C. § 514. Moreover, many of the restrictions imposed upon private foundations, within the meaning of I.R.C. § 508(e), apply to charitable remainder trusts. I.R.C. § 4947. *Leila G. Newhall Unitrust v. Comm'r*, 104 T.C. 236 (1995) (any amount of unrelated business income causes charitable remainder trust to lose its entire exemption from taxation under I.R.C. § 664(c) for the year). Priv. Ltr. Rul. 9952086 (charitable remainder trust will not have unrelated business taxable income on distributions from a wholly owned corporation that is treated as a corporation for U.S. income tax purposes and that owns interest in a U.S. partnership that uses debt financing). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
59. For an excellent discussion, see Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1 (1984); William L. Hoisington, *The Truth About Charitable Remainder Trusts (How to Separate the Help from the Hype)*, 45 TAX LAW. 293 (1992). See also Priv. Ltr. Rul. 9237020 (proceeds of individual retirement account paid to charitable remainder trust not subject to tax in hands of trust on account of its exemption from taxation under I.R.C. § 664(c), even though proceeds constitute income in respect of a decedent under I.R.C. § 691(a)). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

of the fair market value of the property contributed to the trust at the time of the contribution.^{59.1} No other payments may be made to or for the use of any person other than an organization described in section 170(c). Upon the termination of the non-charitable term, the remainder interest in the trust must be transferred to or for the use of an organization described in section 170(c) or retained by the trust for the use of a qualified charity.

There are three types of qualifying charitable remainder unitrusts. One is defined as a trust from which a fixed percentage (not less than 5% or greater than 50% for transfers after June 18, 1997) of the net fair market value of its assets,⁶⁰ valued annually, is paid at least annually to one or more persons (at least one of whom is not an organization described in section 170(c)) for a term of years, which may not exceed twenty years, or for the life or lives of an individual or individuals.

The second and third types of charitable remainder unitrusts are defined in the same manner as the first type, except that the governing instrument in the second type may provide that the trustee may pay the noncharitable recipient for any year the amount of trust income (if less than the fixed percentage amount prescribed by the governing instrument described above).⁶¹ In the third type, the trustee pays the noncharitable recipient (1) the amount of trust income (if less than the fixed percentage amount prescribed by the governing instrument described above) and (2) any amount of the trust income in excess of the amount required to be distributed, to the extent that the aggregate of the amounts paid in prior years was less than the aggregate of the amounts required to be paid at the fixed annual percentage required above.⁶²

Although the regulations provide that income for an income-only charitable remainder unitrust generally means income as defined in

59.1. I.R.C. § 664(d)(1)(D), (d)(2)(D). *See also* Estate of Schaefer v. Comm’r, 145 T.C. __ (No. 4) (July 28, 2015).

60. The annual valuation date may be a date or combination of several dates, so long as the same valuation date or dates and methods of valuation are used each year. The trustee selects the date or dates on the first tax return for the trust if the governing instrument fails to designate a date or dates. Treas. Reg. § 1.664-3(a)(1)(iv).

61. Treas. Reg. § 1.664-3(a)(1)(i)(b).

62. *Id.* This “make-up” provision for the recipient’s having received less than the full unitrust payment and only trust income is permissive. *See* Treas. Reg. § 1.664-3(a)(1)(i)(b)(1); Rev. Rul. 72-395, 1972-2 C.B. 340, *modified* by Rev. Rul. 80-123, 1980-1 C.B. 205, Rev. Rul. 82-128, 1982-2 C.B. 71, *clarified* by Rev. Rul. 82-165, 1982-2 C.B. 117; Priv. Ltr. Rul. 9952035 (because trust does not have accounting income under local law until actual receipt of money or other property, amount treated as consent dividend of a corporation that intended to convert to a real estate investment trust (REIT) is not income for purposes of making distributions to

section 643(b) regulations, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property (that is, cannot be determined by a unitrust regime), notwithstanding any contrary provision in state law.⁶³ Also, proceeds for any tax year ending after April 18, 1997, from the sale or exchange of any assets contributed by the grantor must be allocated to corpus at least to the extent of fair market value at the date of contribution, and the proceeds for taxable years ending after January 2, 2004, from a sale or exchange of any assets purchased by the trust, must be allocated to corpus at least to the extent of the purchase price. Otherwise, proceeds from the sale or exchange may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument, but only to the extent that the state statute permits the trustee to make adjustments between income and corpus to treat beneficiaries impartially.⁶⁴

The charitable deduction for income, estate, and gift tax purposes is the same for “net-income” and “make-up” unitrusts as that calculated for the first type of charitable remainder unitrust even though the charity may receive more with the second and third types of unitrusts.^{64.1}

As with the charitable remainder annuity trust, no other payments may be made from a charitable remainder unitrust to or for the use of any person other than an organization described in section 170(c), and on termination of the annual or more frequent unitrust payments, the remainder interest is to be transferred to or for the use of an organization described in section 170(c) or retained by the trust for its use.

unitrust recipients of “income-only” charitable remainder unitrust but is includible in the trust’s gross income as ordinary income and, therefore, forms part of the first tier of income under I.R.C. § 664(b)(1)); Treas. Reg. § 1.664-3(a)(1)(i)(b)(3). The same regulations in effect provide that if, under applicable state law, income of a charitable remainder trust is defined as a unitrust amount, the trust instrument must provide its own definition of income. Also, the regulations authorize the allocation of post-contribution capital gain to the income of a charitable remainder trust provided the trustee is not granted discretionary authority to make that allocation. *See* Priv. Ltr. Rul. 9511007 (suggesting that unpaid “make-up” amounts for an income-only charitable remainder unitrust are a liability for purposes of determining the annual value of the fund, in some cases). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

63. Treas. Reg. § 1.664-3(a)(1)(i)(b)(3). This rule is applicable for taxable years ending after January 2, 2004.

64. *Id.*

64.1. *See* Estate of Schaefer v. Comm’r, 145 T.C. ____ (No. 4) (July 28, 2015).

A charitable remainder trust must be exclusively a charitable remainder annuity trust or exclusively a charitable remainder unitrust and may not contain any other provisions.⁶⁵ For instance, no provision may be made for invasion, regardless of the standard or reason, for a person other than an organization described in section 170(c). The charitable remainder trust may provide that upon the death of a noncharitable recipient or upon the termination of a specific year or number of years, a distribution may be made to an organization described in section 170(c), but the remaining payments after this distribution must continue to qualify the trust as a charitable remainder trust. In the case of the unitrust, it must continue to be at least 5% of the annual value, and in the case of the annuity trust, the total annuity payable must continue to be the same to each recipient or the total amount payable must continue to be the same.⁶⁶

In the case of distributions to charity from a charitable remainder trust, except on termination of a noncharitable beneficiary's interest in the trust, the trust must prohibit the trustee from distributing property in kind or must direct that the adjusted basis of distributed property in kind fairly represent the adjusted basis for the property available for the payment.⁶⁷

The regulations prescribe that a charitable remainder trust is deemed created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under the grantor trust rules⁶⁸ but in no event before the time when the property is first transferred to the trust. The trust will not be treated as a grantor trust for these purposes simply because the grantor or the spouse is named as a recipient of the trust. If the grantor retains a life interest in the charitable remainder trust, a portion of the value of the trust at death may be includible in the grantor's gross estate for federal estate tax purposes.⁶⁹

65. Treas. Reg. § 1.664-1(a)(2).

66. Treas. Reg. §§ 1.664-3(a), 1.664-2(a).

67. Treas. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4).

68. Treas. Reg. § 1.664-1(a)(4); *see* I.R.C. §§ 671–79. In Priv. Ltr. Rul. 200813023, the Service ruled that a Charitable Remainder Unitrust (CRUT) was not a grantor trust and thus qualified, although the trustee had the power to allocate the unitrust payment between charitable and noncharitable beneficiaries and the taxpayer reserved the right to remove and replace the trustee. In the ruling, the taxpayer could not be the trustee nor could anyone who was related or subordinate to the taxpayer be the trustee. *Cf.* Rev. Rul. 95-58, 1995-2 C.B. 191. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

69. I.R.C. § 2036; *see* Rev. Rul. 82-105, 1982-1 C.B. 133; Rev. Rul. 76-273, 1976-2 C.B. 268; Prop. Treas. Reg. § 1.2036-1(c)(2), 72 Fed. Reg. 31,487-1, 2007-28 I.R.B. 74 (June 7, 2007).

If the annuity trust amount or unitrust amount is to be paid to an individual or individuals, all such individuals must be alive when the trust is created, unless the amount is payable to a class and only for a term of years.⁷⁰ The trust may not permit any person to alter the amount payable to any person, other than an organization described in section 170(c), if the power to alter would cause anyone to be treated as the owner of the trust under the grantor trust rules.⁷¹ Corporations, partnerships, and trusts, as well as individuals, may create and be beneficiaries of charitable remainder trusts although the term (if not for an individual or individuals) must be for a fixed number of years, not in excess of twenty.⁷²

The trust must provide for prorating the unitrust amount or annuity amount in the case of a short taxable year or provide that the payments to the noncharitable beneficiary are to terminate with the last regular payment preceding the termination of that person's interest.⁷³ The regulations provide for adjustments to be made for payments resulting from incorrect valuations. Usually, adjustments are made by increasing or decreasing future payments.⁷⁴

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70. Treas. Reg. §§ 1.664-2(a)(3)(i), 1.664-3(a)(3)(i).
 71. Treas. Reg. §§ 1.664-2(a)(3)(ii), 1.664-3(a)(3)(ii).
 72. See, e.g., Priv. Ltr. Rul. 9340043 (S corporation); Priv. Ltr. Rul. 9205031 (C corporation); Priv. Ltr. Rul. 9419021 (partnership); Priv. Ltr. Rul. 9821029 (trust); cf. Priv. Ltr. Rul. 9328041 (trusts are recipients although not grantors); Priv. Ltr. Rul. 9718030, *revoking* Priv. Ltr. Rul. 9107010 and holding that a trust that makes unitrust distributions for the life of a named individual to a second trust whose only function is to receive and administer those distributions for the benefit of the individual cannot qualify as a charitable remainder trust unless the individual is incompetent. *But cf.* Priv. Ltr. Rul. 200203034 (charitable remainder trust to be created by an S corporation for benefit of a shareholder would not be treated as a trust because part of trust contribution will be treated as being provided by the shareholder so corporation and shareholder will be treated as co-grantors and having a joint investment). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. Perhaps, if the recipient is a grantor trust in its entirety under I.R.C. §§ 671-79, with respect to an individual the term could be for individual's life, as the I.R.S. indicates such trusts do not "exist" for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184; Rev. Rul. 85-158, 1985-2 C.B. 175; cf. Rev. Rul. 85-45, 1985-1 C.B. 183.
 73. Treas. Reg. §§ 1.664-3(a)(5)(i), 1.664-2(a)(5)(i).
 74. See Treas. Reg. §§ 1.664-2(a)(1)(iii), 1.664-3(a)(1)(iii). Rev. Rul. 74-403, 1974-2 C.B. 381, indicates that the general rules for valuing property for federal estate tax purposes are to be used for valuing property for charitable remainder trust purposes.

Additional contributions after initial funding are prohibited in the case of a charitable remainder annuity trust⁷⁵ but are permitted with respect to a charitable remainder unitrust.⁷⁶

Under section 170(a)(3), when a future interest in tangible personal property is transferred to a charity, no income charitable deduction is permitted until all intervening interests held by the donor or persons related to the donor within the rules of sections 267(b) or 707(b) have expired. One private letter ruling^{76.1} held that section 170(a)(3) applies to charitable remainder trusts, and another noted that it would to charitable remainder trusts although it was not applicable in the ruling.^{76.2} If correct, this means when a tangible personal property is transferred to a charitable remainder trust, no income tax deduction is permitted until the charitable remainder trust has sold or otherwise disposed of the tangible personal property. Treasury Regulation section 1.170A-5(a) provides several examples of how section 170(a)(3) applies and two of the examples concern the contribution of tangible personal property to a pooled income fund.^{76.3}

The trust itself is exempt from income taxation unless it has any unrelated business income.⁷⁷ The Tax Relief and Health Care Act of 2006 changed the taxation of charitable remainder trusts that have unrelated business income.⁷⁸ Before 2007, charitable remainder trusts were subject to income taxes on unrelated business taxable income (UBTI), as defined in section 512(a)(1).⁷⁹ After 2006, section 664(c)(1) imposes an excise tax on UBTI equal to the amount of the UBTI, that

75. Treas. Reg. § 1.664-2(b).

76. Treas. Reg. § 1.664-3(b), which prescribes the formula to be used for payments attributable to additional contributions.

76.1. Priv. Ltr. Rul. 9452026. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

76.2. Priv. Ltr. Rul. 7501020160A. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

76.3. Treas. Reg. § 1.170A-5(b), exs. 6 & 7.

77. I.R.C. §§ 664(c), 512(b). In certain instances, debt-financial income on encumbered property can produce unrelated business income. *See* I.R.C. § 514. Moreover, many of the restrictions imposed upon private foundations, within the meaning of I.R.C. § 508(e), apply to charitable remainder trusts. I.R.C. § 4947. *Leila G. Newhall Unitrust v. Comm'r*, 104 T.C. 236 (1995) (any amount of unrelated business income causes charitable remainder trust to lose its entire exemption from taxation under I.R.C. § 664(c) for the year); Priv. Ltr. Rul. 9952086 (charitable remainder trust will not have unrelated business taxable income on distributions from a wholly owned corporation that is treated as a corporation for U.S. income tax purposes and that owns interest in a U.S. partnership that uses debt financing).

78. Pub. L. No. 109-432, § 424, 120 Stat. 2922, 2974.

79. *See* Treas. Reg. § 1.512(a)(1)(a).

is, a 100% tax on UBTI. This tax is allocated to corpus and is not deductible by the trust.⁸⁰ Thus, the beneficiary of a charitable remainder trust will pay taxes on UBTI if and when distributed.

In June 2008, the Treasury Department issued final regulations reflecting the changes made to section 664(c) by the 2006 legislation.⁸¹ The regulations provide that the excise tax imposed on a trust with UBTI is treated as paid from corpus and the trust income includes the UBTI for purposes of determining the tax character of distributions made to the beneficiaries.⁸² The regulations contain two examples of the tax effects of UBTI on charitable remainder trusts.⁸³

In Revenue Ruling 2008-41,⁸⁴ the Service held that a pro rata division of a charitable remainder trust into separate trusts, one for each beneficiary, does not disqualify the trust as a charitable remainder trust under section 664. The pro rata division of assets is not a taxable event. Moreover, the Service ruled that the excise tax under section 507 is not applicable, the division is not an act of self-dealing under section 494, and the division is not a taxable expenditure under section 4945. In Private Letter Ruling 201420010, the Service ruled that the consolidation of two identical charitable remainder trusts will not cause the survivor trust to fail to qualify as a charitable remainder unitrust under section 664.^{84.1}

Investment by university-trustee-remainderman in its general endowment fund does not jeopardize a trust's exemption from taxation or a donor's charitable deduction.⁸⁵

In a series of consecutive revenue procedures, the Service has provided a number of examples for drafting charitable remainder annuity trusts and charitable remainder unitrusts, for *inter vivos* documents and testamentary trusts.⁸⁶ The charitable remainder trust revenue procedures annotate the various form choices. The annotations should be studied closely before drafting a charitable remainder trust.

80. Treas. Reg. § 1.664-1(d)(2).

81. See T.D. 9403, 2003-1 C.B. 611.

82. Treas. Reg. § 1.664-1(c).

83. *Id.*

84. Rev. Rul. 2008-41, 2008-2 C.B. 170.

84.1. Priv. Ltr. Rul. 201420010. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

85. Rev. Rul. 83-19, 1983-1 C.B. 115, *amplifying* Rev. Rul. 73-571, 1973-2 C.B. 213.

86. See Rev. Procs. 2005-52 to 2005-59; Rev. Proc. 2005-52, 2005-2 C.B. 326; Rev. Proc. 2005-53, 2005-2 C.B. 339; Rev. Proc. 2005-54, 2005-2 C.B. 353; Rev. Proc. 2005-55, 2005-2 C.B. 367; Rev. Proc. 2005-56, 2005-2 C.B. 383; Rev. Proc. 2005-57, 2005-2 C.B. 392; Rev. Proc. 2005-58, 2005-2 C.B. 402; Rev. Proc. 2005-59, 2005-2 C.B. 412.

In Private Letter Ruling 201249002, a non-charitable beneficiary of a charitable remainder unitrust donated to the charitable remainder beneficiary an undivided portion of the beneficiary's right to the unitrust payments.⁸⁷ The Service ruled that the gift did not disqualify the trust as a charitable remainder trust. In Private Letter Ruling 201340012, the Service approved a judicial reformation of a charitable remainder unitrust that eliminated the interest of a beneficiary that the trust's grantor did not intend to include. The reformation occurred in the same year the trust was created.^{87.1}

Revenue Procedure 83-32⁸⁸ sets forth (in an easy-to-follow chart) the filing requirements for wholly charitable and split-interest funds.

§ 7:4.2 Taxation of Distributions to Beneficiaries

The ordinary rules for the income taxation of distributions to trusts and beneficiaries provided for under subchapter J are not applicable to charitable remainder trusts.⁸⁹ However, for a testamentary charitable remainder trust, until the trust has been funded, the general rules provided for in subchapter J do apply to distributions, although it is problematic whether the estate, upon funding the charitable remainder trust, would be entitled to the usual deduction under section 661 for distributions to the trust.⁹⁰ Presumably it is.⁹¹ If a testamentary charitable remainder trust is created with a pecuniary legacy, the estate may not be entitled to a distribution deduction under section 661 and

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87. Priv. Ltr. Rul. 201249002. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
- 87.1. Priv. Ltr. Rul. 201340012. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
88. Rev. Proc. 83-32, 1983-1 C.B. 723.
89. Treas. Reg. § 1.664-1(d)(1)(ii). For an excellent discussion, see Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Deceaseds' Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1 (1984).
90. *Mott v. United States*, 462 F.2d 512 (Ct. Cl.), *cert. denied*, 409 U.S. 1108 (1972).
91. Treas. Reg. § 1.664-1(d)(1)(ii); *cf.* Treas. Reg. § 1.664-1(a)(5)(iii); Priv. Ltr. Rul. 8341001, indicating allowance of charitable deduction under I.R.C. § 642(c) for amounts earned in estate, with residuary charitable remainder annuity trust, where sufficient income "kept" in estate for annuity and distributions deduction under I.R.C. § 661 for estate distributions to trust that do not qualify under I.R.C. § 642(c). I.R.S. Tech. Adv. Mem. 8810006 holds that the distributions deduction under I.R.C. § 661, but not the charitable deduction under I.R.C. § 642(c), is allowed for distributions from an estate to a residuary charitable remainder trust. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

may recognize gain or loss upon such distribution.⁹² A distribution in kind in satisfaction of the annuity or unitrust amount payable probably constitutes an exchange within the meaning of section 1001, so that gain or loss to the estate may be recognized and the recipient takes the fair market value of the property on the date distributed as the basis.⁹³

The noncharitable beneficiary of a charitable remainder trust includes the annuity trust or unitrust payment in income for the trust tax year that ends with or within his or her tax year. For this purpose, trust corpus is “defined . . . as the net fair market value of the trust assets less the total undistributed income (and not loss).”⁹⁴

The regulations provide special rules for allocating deductions and income.⁹⁵ The noncharitable beneficiaries are required to report income in amounts distributed under a special rule of distribution provided for under section 664.⁹⁶ Up to the limit of the unitrust or annuity payment, the recipient is required to include in gross income the ordinary income of the trust to the extent thereof, then capital gain to the extent of the trust’s undistributed capital gain.⁹⁷ If the payment exceeds those two categories, then to the extent thereof, the distribution is in effect deemed to be from tax-exempt income and lastly from the corpus of the trust. For a beneficiary of a charitable remainder trust to treat income as qualified dividend income (subject to a maximum federal rate of 15% under section 1(h)(11)), the dividends must be received by the trust after 2002.⁹⁸ The regulations contain other transitional rules for long-term capital gain or loss received by the trust before 1997, unrecaptured section 1250 gain and qualified five-year gain defined in section 1(h)(9). Thus, for this purpose, it is the timing of receipt of the income by the trust and not just the timing of the distribution to the beneficiary that determines how it will be taxed in the beneficiary’s hands.

The regulations provide more specific guidance with respect to the tax character of distributions within the same category. Under the current provisions of the Code, different types of income within the “ordinary income” distribution category from a charitable remainder trust, such as qualified dividend income within the meaning of section 1(h)(11) of the Code, may be taxed to an individual taxpayer

92. See I.R.C. §§ 663, 1040.

93. See Treas. Reg. § 1.664-1(d)(5), (e)(2).

94. Treas. Reg. § 1.664-1(d)(1)(i)(a)(1)B(3) (ordinary income, capital gain and other income); Treas. Reg. § 1.664-1(d)(1)(ii)(a)(4).

95. See Treas. Reg. § 1.664-1(d)(2), (3).

96. Treas. Reg. § 1.664-1(d)(4).

97. I.R.C. § 664(b).

98. Treas. Reg. § 1.664-1(d)(1)(vi).

at different rates. The same is true for capital gain within the capital gain category, such as short-term capital gain and unrecaptured section 1250 gain. The determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the charitable remainder trust is made as of the end of that taxable year of the trust.⁹⁹

If the charitable remainder trust has different classes of ordinary income (taxable at different rates), any distribution from the ordinary income category is treated as being made first from the class subject to the highest federal income tax rate, until exhausted, and ending within the class subject to the lowest federal income tax rate.¹⁰⁰ If the trust has different classes of net gain in the capital gain category, distributions are treated as first being made from short-term capital gain, then each class of long-term capital gain, beginning with the gain subject to the highest federal rate and ending with the lowest rate.¹⁰¹ If more than one of the classes within the same category is subject to the same current rate but one or more will be subject to a different rate in a future year (because, for example, a provision for lower rate is scheduled to terminate in a future year), the order is based on future rates (apparently starting with what would be the highest rate in the future and ending with the lowest such rate).¹⁰²

Net ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years assigned to the same class to which the loss is assigned. Any loss remaining after the allocation is then used to reduce current undistributed ordinary income from other classes, beginning with the class subject to the highest federal income tax rate and ending with the lowest.¹⁰³ Any further excess is carried forward indefinitely but retains its class

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99. Treas. Reg. § 1.664-1(d)(1)(ii)(a). Although a commentator to the proposed regulations requested that the final regulations address the treatment of municipal bond interest and the effect of the alternative minimum tax provisions and I.R.C. § 469 (passive activity losses and credit limitations), they provide no guidance on these matters.
100. These “highest” and “lowest” federal income tax rates are determined by the rates applicable to the year the income is deemed distributed and not the rates applicable to the year the income is received by the charitable remainder trust. Treas. Reg. § 1.664-1(d)(1)(ii)(a).
101. Gains and losses of long-term capital gain are netted against each other, then gains and losses of short-term capital gain are netted against each other, and finally the net short-term capital losses are netted against any net long-term capital gain.
102. Treas. Reg. § 1.664-1(d)(1)(ii)(b).
103. Treas. Reg. § 1.664-1(d)(1)(iii)(a). The amount of current income and prior years’ undistributed income is computed without regard to any deduction for net operating loss provided in I.R.C. § 172 (net operating loss deduction) or § 642(d) (net operating loss deduction for an estate or trust).

assignment.¹⁰⁴ A loss in an income category (other than the ordinary income category) for the current year of the trust is used to reduce undistributed income in that category for prior years, and any excess is carried forward indefinitely to reduce income (other than the ordinary income category) for future years.¹⁰⁵

The deductions provided for under sections 642(b) and (c), 661, and 1202, however, are not permitted.¹⁰⁶ The distributions to charitable organizations are deemed to have been carried out in the inverse order of those described above for noncharitable recipients.¹⁰⁷ Thus, the payments are first deemed to be from trust corpus to the extent thereof. The regulations do not prescribe rules for the ordering of the payments of different classes within the same category of income (for example, types of ordinary income) for such purposes as they do for distributions to noncharitable recipients.

If there are two or more recipients, each is treated as having received his or her pro rata portion of the categories of income and corpus.¹⁰⁸ The annuity or unitrust payment is includible in the recipient's gross income for the taxable year in which or with which ends the taxable year of the trust, even though the payment is not distributed until after the close of the taxable year of the trust.¹⁰⁹

In Private Letter Ruling 200739004,¹¹⁰ the Service ruled that the termination of a charitable remainder unitrust by distributing to each income beneficiary an amount equal to the actuarial value of each beneficiary's interest was a sale of the income beneficiary's interest to the charitable remainder beneficiary. The gain realized by each beneficiary is taxable as a capital gain with the beneficiary having a zero adjusted basis. The distributions to the beneficiaries were not deemed acts of self-dealing under section 4941 because the distributions were accelerations of the unitrust interests and within the exception for self-dealing for distributions from a charitable remainder trust.

In Revenue Procedure 2015-3,¹¹¹ the Service announced that it would no longer rule on:

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104. *Id.*
 105. Treas. Reg. § 1.664-1(d)(1)(iii)(b).
 106. Treas. Reg. § 1.664-1(d)(2).
 107. Treas. Reg. § 1.664-1(c)(1).
 108. Treas. Reg. § 1.664-1(d)(3).
 109. Treas. Reg. § 1.664-1(d)(4)(i). Amounts required to be distributed on the recipient's death constitute income in respect of a decedent within the meaning of I.R.C. § 691(a). Treas. Reg. § 1.664-1(d)(4)(iii).
 110. Priv. Ltr. Rul. 200739004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 111. Rev. Proc. 2015-3, 2015-1 I.R.B. 129.

issues pertaining to the tax consequences of the termination of a charitable remainder trust . . . before the end of the trust term as defined in the trust's governing instrument in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets; (a commutation)^{111.1}

whether the commutation of a charitable remainder trust will be "treated as a sale or other disposition by the beneficiaries of their interests in the trust;" ^{111.2}

whether the commutation of a charitable remainder trust will be "treated as the sale or exchange of a capital asset by the beneficiaries;" [and]^{111.3}

[w]hether transactions during the administration of an estate or trust meet the requirements of the exception to § 4941 set forth in § 53.4941(d)-1(b)(3) of the Private Foundation Excise Tax Regulations, in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust.^{111.4}

In 2014, the Treasury Department issued proposed regulations^{111.5} that provide rules for determining the income tax basis of a noncharitable beneficiary's annuity or unitrust interest in a charitable remainder trust (CRT) when the noncharitable beneficiary and charitable remainder beneficiary join together in the sale of their respective interests to a third party.^{111.6} The proposed regulations were issued in response to a transactions designed to allow a taxpayer to contribute substantially appreciated assets to a CRT, have those assets sold by the CRT on an income tax-free basis and reinvested in newly acquired assets with an income tax basis equal to their purchase price, and later sell the annuity or unitrust interest in the CRT at little or no taxable gain. The transaction is structured to avoid the application of section 1001(e)(1), under which the annuity or unitrust interest (referred to in the section as a "term interest") would otherwise have a zero income tax basis if sold alone, and takes advantage of the uniform basis rules applicable to trusts when there is a combined sale of both the term and remainder interests to a third party. The result sought is much more favorable than where only the annuity or unitrust interest is sold by a noncharitable beneficiary, separate and apart from the remainder

111.1. *Id.* § 3.01(68).

111.2. *Id.* § 3.01(82).

111.3. *Id.*

111.4. *Id.* § 3.01(102).

111.5. REG-154890-03 (Jan. 16, 2014), Prop. Treas. Reg. § 1.1014-5.

111.6. This discussion of Prop Treas. Reg. § 1.1014-5 appears in Richard L. Fox & Jonathan G. Blattmachr, *Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust*, 121 J. TAX'N 100 (Sept. 2014), and appears herein with the permission of the authors.

interest. When the noncharitable annuity or unitrust interest is sold separately, any gain recognized on the sale is equal to the total amount of the proceeds because the interest sold has a zero income tax basis under section 1001(e)(1).

The very transaction targeted by the proposed regulations was previously identified as a “transaction of interest” in Notice 2008-99.^{111.7} It stated that the “IRS and the Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets.” The proposed regulations override the uniform basis rules by limiting the amount of income tax basis that may be allocated to an annuity or unitrust interest in a CRT when such interest and the charitable remainder interest are simultaneously sold to a third party. The proposed regulations accomplish this essentially by reducing the uniform tax basis otherwise attributable to the annuity or unitrust interest by the amount of undistributed ordinary income and capital gain income of the CRT that is attributable to such interest. While the proposed regulations significantly limit the amount of uniform basis allocable to an annuity or unitrust interest in a CRT, the result is still better than in the context of an early termination of a CRT, where the Service has consistently ruled that the basis of the annuity or unitrust interest is always equal to zero under section 1001(e)(1).^{111.8}

§ 7:5 Charitable Lead Trusts

A charitable lead trust is the opposite of a charitable remainder trust in that a charity or charities are the current income beneficiary or beneficiaries and the remainder beneficiary or beneficiaries are not a charity or charities. A properly structured charitable lead trust will qualify for either a gift tax charitable deduction,¹¹² an estate tax charitable deduction, or both.¹¹³

Payments to the charity or charities must be guaranteed payments, that is, the payments may not be dependant on the amount of trust income or subject to any other contingency. No net income or net income with make-up variations is permitted.¹¹⁴ A charitable lead interest is not a guaranteed charitable interest if the trustee has the discretion to commute and prepay the charitable interest before the termination of the charitable interest.¹¹⁵ Trust income in excess of the charitable payments may be distributed currently to the charity or

111.7. I.R.S. Notice 2008-99, 2008-2 C.B. 1194.

111.8. REG-154890-03 (Jan. 16, 2014), Prop. Treas. Reg. § 1.1014-5.

112. I.R.C. § 2522(c)(2)(B).

113. I.R.C. § 2055(e)(2)(B).

114. See Treas. Reg. §§ 20.2055-2(e)(2)(vi)(b), 25.2522(c)-3(c)(2)(vi)(b).

115. Rev. Rul. 88-27, 19881 C.B. 331.

retained by the trust. If a nongrantor charitable lead trust, as described below, provides that excess income is paid to the charity, the trust is entitled to a charitable income tax deduction for the amounts of any excess income paid to the charitable beneficiary.¹¹⁶

Like charitable remainder trusts, there are two types of charitable lead trusts: charitable lead annuity trusts and charitable lead unitrusts. The payouts for charitable lead trusts are similar to qualified charitable remainder trusts in that the annuity trust pays a set sum to the charity and the unitrust pays a set percentage of fair market value determined periodically.

There are no set minimum or maximum payment amounts for a charitable lead trust. If, however, the guaranteed charitable interest is an annuity interest (as opposed to a unitrust payment) and if the present value of the charitable interest on the appropriate valuation date exceeds 60% of the value of the trust, the charitable interest is not considered a qualified annuity interest unless the trust document prohibits the acquisition and retention of assets that would result in a tax under section 4943 or 4944 (as modified by sections 4947(a)(2) and 4947(b)(3)).¹¹⁷ The potential 60% problem is solved by good drafting and careful administration.

A charitable lead trust must prorate the charitable payment for any short taxable year, including the last year of the payment period. The taxable year of a charitable lead trust must be a calendar year.¹¹⁸

The trust term may be for a term of years or for the life of an individual.¹¹⁹ The only individuals that may be used as measuring lives are the grantor, for an *inter vivos* charitable lead trust, the grantor's spouse or the decedent's spouse, as the case may be, and an individual who is either a lineal ancestor or the spouse of a lineal ancestor of the noncharitable beneficiaries.¹²⁰ Each person used as a measuring life for the payment period by a charitable lead trust must be alive on the date of the decedent's death for a testamentary trust¹²¹

116. See Situation 2 of Rev. Rul. 88-82, 1988-2 C.B. 336, for the gift tax consequences of the payment of excess income to a noncharitable beneficiary. No additional estate or gift tax charitable deductions are available for the excess amounts distributed to the charitable beneficiary. See Treas. Reg. §§ 20.2055-2(e)(2)(vi)(d), 25.2522(c)-3(c)(2)(vi)(d).

117. Treas. Reg. § 20.2055-2(e)(2)(vi)(e).

118. I.R.C. § 644(a).

119. Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

120. Treas. Reg. § 20.2055-2(e)(2)(vi)(a). The regulation also provides: "A trust will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus." *Id.*

121. *Id.*

or alive on the date assets are transferred to the charitable lead trust in the case of an *inter vivos* charitable lead trust.¹²²

Within each type of charitable lead trust there are two types: grantor and nongrantor. A nongrantor charitable lead trust is taxed as a complex trust under the subchapter J rules (other than the grantor trust rules).¹²³ A nongrantor charitable lead trust is allowed a charitable deduction¹²⁴ in determining taxable income for any gross income paid for qualified charitable purposes.¹²⁵ Generally, the donor of a nongrantor charitable lead trust is not permitted an income tax charitable deduction for the transfer to the trust or during the trust's administration.

For income paid to the charitable beneficiary after the close of the taxable year in which the income was received (but on or before the last day of the next succeeding taxable year), the trustee of a nongrantor charitable lead trust may elect to take the charitable deduction for that payment for the year in which the income was received, rather than for the year in which the payment was made.¹²⁶ The election is made on the income tax return for the taxable year in which the charitable contribution is deemed paid by filing a statement with that return.¹²⁷

Capital gains may be allocated to the income or the principal of the trust. When the trust capital gains are allocated to principal, they will qualify for a charitable deduction if paid to the charitable beneficiary as part of the guaranteed charitable payment of a nongrantor charitable lead trust.¹²⁸

A charitable lead trust is a grantor trust if a U.S. citizen or resident donor is the owner of the entire charitable lead trust under the grantor trust rules of subpart E of part I of subchapter J.¹²⁹ The donor of a grantor charitable lead trust may be entitled to a charitable deduction for the value of the charitable lead interest for the year in which the donor makes a contribution to the charitable lead trust if the requirements of section 170(f)(2)(B) and the applicable regulations are met. During the term of a grantor charitable lead trust, all the income, including the capital gains of the charitable lead trust, are taxed to the donor and the donor is not entitled to any additional income tax charitable deduction for payments made to charitable organizations after the first year.¹³⁰ After the death of the donor of a grantor

122. Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a).

123. See section 3:4, *supra*, for a discussion of complex trusts.

124. I.R.C. § 642(c)(1).

125. I.R.C. § 170(c).

126. I.R.C. § 642(c)(1).

127. See Treas. Reg. § 1.642(c)-1(b); see section 3:2.1[K], *supra*.

128. Rev. Rul. 83-75, 1983-1 C.B. 114.

129. See chapter 5 for a discussion of grantor trusts.

130. I.R.C. § 170(f)(2)(C).

charitable lead trust, the continuing trust will be taxed as a complex trust.¹³¹

The grantor of a charitable lead trust is entitled to a deduction in the year the trust is created if it is a grantor trust. However, section 170(f)(2)(B) (second sentence) provides that all or a portion of the deduction will be recaptured if the trust's grantor trust status terminates, essentially, before the charitable annuity or unitrust term ends. Grantor trust status, of course, will end not later than when the grantor dies as the income, deductions and credits against tax can no longer be attributed to the grantor as his or her life as a taxpayer has ended. Unfortunately, the Code and regulatory provisions with respect to the recapture are quite disparate. For a thorough discussion of recapture see section 7:7.7, below

The payments to charity may be made in cash, in property, or a combination of cash and property. If the trustee distributes appreciated property in satisfaction of the required charitable payment, the trust will recognize taxable gain on the assets distributed¹³² and the trust may be allowed a charitable deduction for the gains realized.¹³³

The Treasury Department issued final regulations in the spring of 2012 for section 642(c) concerning provisions in trusts or wills or local law that provide the tax character of the amounts paid to a charitable beneficiary of the trust or estate by designating the source of the income distributed.¹³⁴ Such a so-called ordering provision might, for example, provide that income distributions to a charity are deemed to be paid first out of ordinary income of a trust before being deemed paid out of other types of income, such as long-term capital gains or tax-exempt income. The purpose of such a provision is to reduce the tax liability of an estate or a trust, or its beneficiaries, by leaving the estate or the trust, or its beneficiaries, taxable on classes of income that are taxed at lower rates or that are not taxable.

The regulations provide that a specific ordering provision must have "economic effect" independent of the income tax consequences. If the ordering in the governing instrument or local law does not have an independent economic effect, the types of income distributed to a charity will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes.¹³⁵ Examples 1 and 2 of regulations sections 1.662(b)-2 and 1.662(c)-4(e)

131. See section 3:4, *supra*, for a discussion of complex trusts.

132. See Priv. Ltr. Rul. 200920031. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

133. See section 3:4, *supra*, for a discussion of complex trusts.

134. T.D. 9582, Treas. Reg. §§ 1.642(c)-3, 1.643(a)-5.

135. Treas. Reg. § 1.642(c)-3(b)(2).

illustrate how the character of an amount paid to a charity, deductible under section 642(c), is determined when the ordering provision is ignored.¹³⁶

The import of the regulation is obvious when applied to charitable lead trusts (CLTs). The regulations contain the following example:

Example 1: A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of \$10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the \$10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.¹³⁷

The regulations provide also an example of when an ordering provision will have an independent economic effect.

Example 2: A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to *B*, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.¹³⁸

136. Treas. Reg. § 1.643(a)-5(b).

137. Treas. Reg. § 1.642(c)-3(b)(2), ex. 1.

138. Treas. Reg. § 1.642(c)-3(b)(2), ex. 2.

A provision of a trust providing that a charity is to receive the greater of a specified amount of the trust's ordinary income might satisfy the regulation, but this is likely only when the trust's ordinary income is the higher amount, or at least has the potential to be higher. A "higher of" type of payment is permitted by the guidance for CLTs.¹³⁹

Section 681 disallows a charitable lead trust's charitable deduction in a tax year to the extent that a deduction is allowed against the trust's section 512 unrelated business taxable income for that year.¹⁴⁰ A partial deduction is allowed for amounts allocable to unrelated business taxable income.¹⁴¹

Prohibitions against retaining any excess business holdings within the meaning of section 4943 (as modified by sections 4947(a)(2) and 4947(b)(3)) and against investments that jeopardize the exempt purpose of the trust within the meaning of section 4944 (as modified by sections 4947(a)(2) and 4947(b)(3)) are generally required.

In 2007, the Service issued two Revenue Procedures that provide sample documents for *inter vivos* charitable lead annuity trusts¹⁴² and testamentary charitable lead annuity trusts.¹⁴³ In 2008, the Service issued two additional Revenue Procedures to provide sample documents for *inter vivos* charitable lead unitrusts¹⁴⁴ and testamentary charitable lead unitrusts.¹⁴⁵ The sample forms are annotated and should be studied closely before drafting a charitable lead trust. Generally, the Service will not issue private letter rulings for charitable lead annuity trusts or charitable lead unitrusts.¹⁴⁶

§ 7:6 Pooled Income Funds

A remainder interest in trust qualifies for a charitable deduction for income, estate, or gift tax purposes if the transfer is in the form of a pooled income fund.¹⁴⁷ A pooled income fund is defined in section 642(c)(5). The fund usually is a trust,¹⁴⁸ but it need not be.¹⁴⁹ Each donor of the trust must transfer property to the fund and

139. See, e.g., Rev. Proc. 2008-45, § 5.02(7), 2008-2 C.B. 224.

140. See I.R.C. § 1.681(a)-2.

141. See § 512(b)(11), (12); Treas. Reg. § 1.681(a)-2(a).

142. Rev. Proc. 2007-45, 2007-2 C.B. 89.

143. Rev. Proc. 2007-46, 2007-2 C.B. 102.

144. Rev. Proc. 2008-45, 2008-2 C.B. 224.

145. Rev. Proc. 2008-46, 2008-2 C.B. 238.

146. Rev. Proc. 2007-45, 2007-2 C.B. 89; Rev. Proc. 2007-46, 2007-2 C.B. 102; Rev. Proc. 2008-45, 2008-2 C.B. 224, and Rev. Proc. 2008-46, 2008-2 C.B. 238.

147. I.R.C. § 170(f)(2)(A).

148. I.R.C. § 642(c)(5)(A).

149. Treas. Reg. § 1.642(c)-5(a)(2).

contribute an irrevocable remainder interest in the property to or for the use of an organization described in section 170(b)(1)(A), other than clauses (vii) or (viii) of section 170(b)(1)(A). Note that examples (6) and (7) of Treasury Regulations section 1.170A-5(b) indicate that no income tax deduction will be allowed for a transfer of tangible personal property to a pooled income fund if the donor or someone in a relationship to the donor under section 267 is an income beneficiary under the fund.¹⁵⁰ A donor to a pooled income fund may be a person other than an individual.¹⁵¹ The provisions of section 683 causing recognition for transfers to a trust that act as an exchange fund are inapplicable to pooled income funds.¹⁵²

To determine the amount of any charitable contribution allowed by a transfer of property to a pooled income fund, the value of the income interest is determined on the basis of the highest yearly rate of return earned by the fund for the three taxable years immediately preceding the taxable year of the pooled income fund in which the transfer is made.¹⁵³ In the case of a pooled income fund that has had less than three years of existence, the rate of return is calculated in accordance with the regulations.¹⁵⁴

An income interest in the property transferred must be retained by the donor for life or for the life or lives of one or more beneficiaries, each of whom is living at the time of the transfer to the fund.¹⁵⁵ For this purpose, income means trust accounting income.¹⁵⁶ When a donor or the donor's spouse retains an income interest, no part of the fund is treated as a grantor trust because the provisions of subpart E of part I of subchapter J do not apply to pooled income funds.¹⁵⁷

Although one person cannot be used as the measuring life for another beneficiary,¹⁵⁸ the income beneficiaries can be members of a specified class provided they are alive and ascertainable at the time of

150. See I.R.C. § 170(a)(3).

151. Rev. Rul. 85-69, 1985-1 C.B. 183; Rev. Rul. 92-108, 1992-2 C.B. 121 (holding fund maintained by community foundation would not be valid pooled income fund where donor permitted to specify ultimate charitable taker), *revoked by* Rev. Rul. 93-8, 1993-1 C.B. 125.

152. I.R.C. § 683(b); Treas. Reg. § 1.642(c)-5(a)(3).

153. I.R.C. § 642(c)(5); Treas. Reg. § 1.642(c)-6T(e).

154. Treas. Reg. § 1.642-6(e); *see* Rev. Rul. 85-20, 1985-1 C.B. 183 (first tax year of fund is year it first receives assets).

155. I.R.C. § 642(c)(5)(A); Rev. Rul. 76-196, 1976-1 C.B. 178 (pooled income fund was not qualified because severance of remainder based on regular valuation date following death of life income beneficiary whose interest in fund ends with regular payment date before death).

156. Treas. Reg. § 1.642(c)-5(a)(5)(i).

157. Treas. Reg. § 1.642(c)-5(a)(2).

158. Rev. Rul. 79-61, 1979-1 C.B. 220.

the transfer to the pooled income fund.¹⁵⁹ Income interests may run concurrently, consecutively, or both. The charity named as remainderman may be an income beneficiary.¹⁶⁰

The property transferred by the donor must be commingled with property transferred by other donors.¹⁶¹ The fund may not make investments in securities whose income is exempt from income taxation¹⁶² and may not hold property other than that transferred by donors.¹⁶³ The trust must be maintained by the charitable organization to which the remainder interest was contributed either by serving as trustee or by otherwise exercising direct or indirect control of the fund, such as by the power to substitute trustees.¹⁶⁴ No donor or income beneficiary (other than the charity) may serve as a trustee.¹⁶⁵

Although the pooled income fund is not exempt from taxation, it is entitled, unlike most post-1969 trusts, to a “set-aside” deduction under section 642(c) for long-term capital gain that is permanently set aside for a charitable purpose. Treasury Regulations section 1.642(c)-2(c) provides that no net long-term capital gain is considered permanently set aside for charitable purposes in a pooled income fund described in section 642(c)(5) if, under the terms of the governing instrument *and* applicable local law,¹⁶⁶ the trustee has the power (whether or not it is

159. Treas. Reg. § 1.642(c)-5(b)(2).

160. *Id.*; cf. Rev. Rul. 85-69, 1985-1 C.B. 183 (corporation can be donor).

161. This requirement for commingling must be set forth in the governing instrument of the fund, as must others. Treas. Reg. § 1.642(c)-5(b)(3). For sample language, see Rev. Rul. 72-196, 1972-1 C.B. 194. *See also* Rev. Rul. 82-38, 1982-1 C.B. 96, *amplified by* Rev. Rul. 85-57, 1985-1 C.B. 182.

162. I.R.C. § 642(c)(5)(C). Rev. Rul. 74-247, 1974-1 C.B. 152, holding that an investment by bank-trustee in common trust fund (not exclusively for pooled income funds) does not cause disqualification (if no tax-exempts in fund). Rev. Rul. 79-387, 1979-2 C.B. 247, holding that that pooled income funds may invest in real estate subject to mortgage. But public charity remainderman must have power to remove a bank-trustee that controls investments. Rev. Rul. 75-116, 1975-1 C.B. 182. *See also* Rev. Rul. 74-132, 1974-1 C.B. 152; Joseph A. Veres, *Using Pooled Income Funds to Pass ITC and Depreciation Through to Life-Income Donors*, 61 J. TAX’N 28 (1984).

163. The fund may invest jointly with certain other assets of the charitable remainderman. Treas. Reg. § 1.642(c)-5(b)(3).

164. Treas. Reg. § 1.642(c)-5(b)(5).

165. Treas. Reg. § 1.642(c)-5(b)(6). The final regulations deleted a provision in the proposed regulations that clearly stated that participation in the maintenance in the fund by an individual donor or beneficiary who does so in the capacity as trustee, officer, director, or other official of the charity will not cause the fund to fail to qualify. The final regulations provide that such participation “ordinarily” will not prevent the fund from qualifying.

166. This suggests that if the payments are made only pursuant to state law or only pursuant to the governing instrument, the denial of the set-aside deduction does not apply. That result, however, seems untenable.

exercised) to satisfy a beneficiary's right to income by the payment of either a unitrust amount or any other amount that takes into account unrealized appreciation in the fund's assets.¹⁶⁷ The other trust rules with respect to amounts paid or set aside for charitable purposes apply in the case of a pooled income fund. This means, in effect, that a pooled income fund will be taxed on short-term capital gains even though these are, in effect, permanently set aside to the charity. The donor does not recognize gain or loss by the donation of assets to the fund except to the extent they are subject to indebtedness. The fund's basis and holding period on donated property are determined under sections 1015(b) and 1223(2), respectively.¹⁶⁸

The income must be distributed currently or, if permitted by the governing instrument of the fund, within sixty-five days of the close of the tax year.

Although the meaning of income of a pooled income fund generally has the same meaning as under section 643(b) and its regulations, income

generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of [Treas. Reg.] § 1.643(b)-1.¹⁶⁹

Every income interest in the fund must be assigned a number of "units of participation" in the fund, which is determined by dividing the fair market value of the property transferred to the fund by the fair market value of a unit in the fund at the time of such transfer. The fair

167. Some state statutes may prohibit the allocation of such capital gain to income. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 11-2.3(b)(5)(C)(iv). In any case, a pooled income fund's long-term capital gain may be considered permanently set aside for charity if the governing instrument is amended or reformed to eliminate the conversion to a unitrust payment arrangement, provided payments have not yet been determined in a unitrust manner. To be a sufficient reformation, a judicial reformation proceeding must be commenced, or a nonjudicial one that is valid under local law must be completed, by the date that is nine months after the later of January 2, 2004 (that is, October 2, 2004), or the effective date of a state statute, applicable to the fund, authorizing determining payment by a unitrust method.

168. Treas. Reg. § 1.642(c)-5(a)(3). Note that I.R.C. § 170(a)(3) prohibits a deduction for a future interest in tangible personal property.

169. Treas. Reg. § 1.642(c)-5(a)(5)(i).

market value of a unit at the time of transfer is determined by dividing the fair market value of all property in the fund by the number of units then in the fund. The share of income allocated to each unit of participation is determined by dividing the accounting income for the taxable year by the outstanding number of units at year end, except adjustment is made on account on units outstanding for only part of the year.¹⁷⁰

When an income interest in the fund ends, the trustee must sever from the fund an amount equal to the remainder interest upon which the terminated income interest was based.¹⁷¹

An estate should be entitled to a deduction for its gross income paid to or set aside for the pooled income fund.¹⁷² However, Revenue Ruling 76-445 provides that income earned in an estate that pours into a pooled income fund must be paid directly from the estate to individuals named as fund recipients and not to the fund.¹⁷³

A pooled income fund is taxed as a trust and not as a corporation.¹⁷⁴ It is not treated as a grantor trust even if the donor or the donor's spouse retains an income interest in the trust or retains the power to terminate the interest of any income beneficiary, as is permitted.¹⁷⁵ Unlike a charitable remainder trust, a pooled income fund is not exempt from income taxation. Also unlike a charitable remainder trust, no special rules for determining the character of distributions are provided. Consequently, the amount and the character for tax purposes of the income deemed received by the income beneficiaries are based upon the fund's distributable net income (DNI).¹⁷⁶

It appears that the fund will be treated as a simple trust under subpart B of part I of subchapter J if it receives no long-term capital gains for the tax year, as it will have no charitable deduction under section 642(c), unless the charity is paid some other amount of the income for the year for which a section 642(c) deduction is permitted.¹⁷⁷ If a section 642(c) "set-aside" or "paid" charitable deduction is permitted, the fund will be governed by the complex trust rules under subpart C of part I of subchapter J. In any event, the amounts received by beneficiaries would

170. Treas. Reg. § 1.642(c)-5(c). The governing instrument may provide for another method for assigning units and allocating income if the result is "reasonably consistent" with this regulation.

171. Treas. Reg. § 1.642(c)-5(b)(8).

172. I.R.C. § 642(c); Treas. Reg. §§ 1.642(c)-3(c), 1.642(c)-3(c), ex. (1).

173. Rev. Rul. 76-445, 1976-2 C.B. 193.

174. Treas. Reg. § 1.642(c)-5(a)(2).

175. Treas. Reg. § 1.642(c)-5(a)(2), (b)(2); *cf.* I.R.C. § 677(a).

176. *Id.*

177. Treas. Reg. § 1.651(a)-4. See section 3:4, *supra*, for a discussion of simple trusts.

appear to be tier-one distributions. Note, however, that the governing instrument need not require that all income be distributed currently but may permit delay until sixty-five days after the close of the tax year. But the delayed income is deemed paid as of the last day of the preceding tax year.¹⁷⁸ The noncharitable income beneficiaries of the fund are taxed under the usual rules providing for the inclusion of amounts paid from trusts in gross income.

Pooled income funds are subject to minimum taxes on items of tax preference as are individuals.

General Counsel Memorandum 39709 states that a trustee of a pooled income fund may have to set up a reserve for depreciation in order for donors to receive a charitable income tax deduction for contributions to the fund.¹⁷⁹

A pooled income fund, like a charitable remainder trust, is a type of split-interest trust described in section 4947(a)(2), and, thus, subject to a variety of private foundation rules.¹⁸⁰

Sample language for pooled income funds is contained in Revenue Procedure 88-53.¹⁸¹

178. Treas. Reg. § 1.642(c)-5(b)(7). See section 3:4, *supra*, for a discussion of complex trusts.

179. *Cf.* Rev. Rul. 74-530, 1974-2 C.B. 188 (depreciation deductions may be allocated to beneficiaries even if the deductions exceed income paid). Under I.R.C. § 6110(k)(3), a General Counsel Memorandum may not be cited or used as precedent.

180. It should be noted that under one of the private foundation rules to avoid the potential “termination tax” under I.R.C. § 507(c), all of the fund’s net assets must be paid upon termination of the trust to one or more charities continuously described in section 170(b)(1)(A) (other than clauses (vii) and (viii)) for the sixty calendar months immediately preceding the distribution). It is unclear whether this provision is applicable to pooled income funds and, if so, what the effects would be if the charitable remainderman were in existence for less than five years.

181. Rev. Proc. 88-53, 1988-2 C.B. 712. *See* Rev. Rul. 90-103, 1990-2 C.B. 159 (fund without depreciation reserve will not qualify as pooled income under I.R.C. § 642(c)(5)); Priv. Ltr. Rul. 9311018 (direction in pooled income fund for amortization of bond premium approved where consistent with state law but not for charitable remainderman to pay fund’s administration expenses); Priv. Ltr. Rul. 8830044 (depreciation on pooled income fund’s property apportioned between income beneficiaries and trustee in proportion to income of each); Priv. Ltr. Rul. 8806065 (rental of land and buildings by pooled income fund is passive activity under I.R.C. § 469(c) so gross rental income minus losses on same will be passive income and income beneficiaries report same proportion as net rental income bears to fund’s DNI); Priv. Ltr. Rul. 9642020 (fund merged from two pooled income funds is I.R.C. § 642(c)(5) qualified pooled income fund if otherwise qualified). *See* Priv. Ltr. Rul. 9642037 for an example of approval of provisions not contained in Rev. Proc. 88-53 sample language. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

§ 7:7 Split Interest Trusts Created by Entities¹⁸²

§ 7:7.1 Background

Partnerships and corporations, at least occasionally, create trusts. Trusts also may be created by the trustees of other trusts.¹⁸³ Treasury regulations specify when a partnership or the corporation will be treated, for Federal income tax purposes, as the grantor¹⁸⁴ of the trust or when its partner or shareholder will be treated as the grantor, even though the trust “nominally” was created by the entity.¹⁸⁵ Unfortunately, forecasting whether the entity or an owner of the entity will be treated as the grantor of a trust may be difficult in many situations.¹⁸⁶

182. This section is derived in major part from J. Blattmachr & D. Zeydel, *Split Interest Trusts Created by Entities (and More)*, 49 U. MIAMI, HECKERLING INST. ON EST. PLAN., 1404 (2015).

183. For example, in doing a “decanting” under ALASKA STAT. § 13.36.157–.159, the trustees of one trust (the “invaded trust”) may pay the corpus, pursuant to a power of invasion, to another trust (the “appointed trust”), in certain cases, including, as defined in ALASKA STAT. § 13.36.215, to “a new trust created . . . by the trustees, acting in that capacity, of the invaded trust.”

184. The term “grantor” can have more than one meaning for income tax purposes. A grantor can be the person who creates a trust. A grantor can also be a person treated as the owner of the trust assets for Federal income tax purposes. It is possible to be a grantor without being an owner, and to be an owner without being a grantor. To be a grantor that is also treated as an owner for purposes of section 671 of the Code, as a general matter, the person must have made a gratuitous transfer of property to the trust. A person may also become an owner under section 678, even if that person has not made a gratuitous transfer of property to the trust. Note that in this context, a gratuitous transfer need not have a transfer tax implication. In other words, a gratuitous transfer need not be a gift for gift tax purposes. A gratuitous transfer means only an uncompensated transfer of property.

185. Although this regulation has been promulgated under section 671 of the Code, which section is part of the so-called grantor trust rules, which are contained in subpart E of part 1 of subchapter J of chapter 1 of subtitle A of the Code, the determination under the regulation of which taxpayer is the grantor for Federal income tax purposes seems to be for all purposes of the income taxation of estates, trusts and their beneficiaries, not just for purposes of the grantor trust rules. *See, e.g.*, Treas. Reg. § 1.671-2(e)(1), which provides, in part, “For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person . . .” In other words, this regulation indicates that the determination of the identity of the grantor is not limited to the grantor trust provisions (sections 671–679) but for all purposes of the income taxation of estates, trusts, and their beneficiaries.

186. The regulations do not deal with situations where a doctrine, such as the reciprocal trust doctrine, would cause someone other than the nominal grantor to be treated as the trust’s grantor (or owner). *See* Chapter 5, notes 82–84 and accompanying text.

In contrast, the regulations dealing with the status of a trust as the grantor of another trust are reasonably certain.¹⁸⁷ It does not appear that one trust can be treated for income tax purposes as the grantor (meaning a creator who has made a gratuitous transfer of property to the trust) of another trust although one trust may be treated as the owner, for Federal income tax purposes, of another trust, in some cases.¹⁸⁸ The determination of the identity of the owner for income tax purposes of a trust can be significant, in some cases.

The basic rule is set forth in Treasury Regulations section 1.671-2(e)(1) and provides that for purposes of the grantor trust rules, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of the regulation) of property to a trust. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or section 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or section 679. However, a person may be treated as an owner of a trust without being a grantor under section 678. How this rule applies in the case of an entity or a trust that creates a trust can be difficult to analyze.

There may be important differences to both the grantor of the trust (or its income tax owner) and the trust itself depending upon whether the entity that is stated as the trust's grantor or one or more of the owners of the entity is the grantor. This may be especially important where the trust is a so-called split-interest trust, such as a charitable

187. "If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code." *Treas. Reg. § 1.671-2(e)(5)*. However, as illustrated by Example 8 in *Treas. Reg. § 1.671-2(e)(6)*, one trust may be the owner, for income tax purposes, of another trust it creates.

188. *Id.*

remainder trust described in section 664(d)¹⁸⁹ or a CLT described in section 170(f)(2)(B),¹⁹⁰ where an individual or a trust (or a decedent's estate) is a partner or shareholder. Sections below suggest ways of making it more certain that the partnership or corporation, rather than its partners or shareholders, will be treated as the grantor (owner) of the trust when that is beneficial. Also discussed are certain other matters relating to split-interest trusts, whether created by an entity or by an individual.

§ 7:7.2 Some Basic Charitable Deduction Rules

[A] For Individuals

Individuals are entitled, under section 170(a), to an income tax deduction for certain contributions to charitable organizations that are described in section 170(c), subject to limitations relating to the individual's contribution base,¹⁹¹ the type of organization to which the contribution is made,¹⁹² the nature of the asset donated,¹⁹³ and other factors.¹⁹⁴

[B] For Estates and Trusts

The taxable income of a decedent's estate and of a trust that is not a grantor trust¹⁹⁵ is computed in the same manner as an individual's taxable income, except to the extent otherwise provided in part 1 of Subchapter J of Chapter 1 of Subtitle A of the Code.¹⁹⁶

189. Note that, although a charitable remainder trust is described in section 664, the income tax deduction for the charitable interest in one is allowed under section 170(f)(2)(A) to the individual who creates one. The gift and estate tax deductions for the charitable interest in a charitable remainder trust are provided under sections 2522(c)(2)(A) and 2055(e)(2)(A), respectively.

190. The income tax deduction for a transfer to a charitable lead trust is allowed under section 170(f)(2)(B), but, as discussed later, only if it is a grantor trust. *See* section 7:7.4, note 42 and accompanying text. The gift and estate tax charitable deductions for the creation of a charitable lead trust are under sections 2522(c)(2)(B) and 2055(e)(2)(B), respectively.

191. Contribution base is defined in section 170(b)(1)(G) as adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172).

192. *See* I.R.C. § 170(b)(1)(A), (B).

193. *See* I.R.C. § 170(b)(1)(C).

194. *See, e.g.*, I.R.C. § 170(a)(3), (f).

195. A grantor trust is one the income, deductions and credits against tax of which are, pursuant to section 671, attributed to the trust's grantor (or technically its "owner") or, if the trust is described in section 678(a), to another taxpayer.

196. I.R.C. § 641(b).

One important difference between the manner in which the taxable income of an estate or trust is determined as opposed to that of an individual is the extent of the deduction permitted for gifts or payments to charity. An estate or a non-grantor trust is entitled to a charitable deduction, without limitation, under section 642(c) for its gross income paid (or, for a decedent's estate, paid or set aside) pursuant to the terms of its governing instrument for a charitable purpose described in section 170(c). However, no section 642(c) deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's UBI within the meaning of section 681. UBI, for this purpose, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in section 512(b). These modifications include a deduction for charitable contributions allowed by section 170, subject to the percentage limitations applicable to individuals. UBI, within the meaning of section 681, is essentially the same as unrelated business taxable income or "UBIT"¹⁹⁷ defined in section 512, which includes income attributable to acquisition indebtedness.¹⁹⁸ Capital gain recognized on the sale of an asset is not normally UBIT if there is no

197. Although the initials are "UBTI," it is commonly pronounced as "UBIT" by practitioners.

198. If there is no debt on the asset, there can be no acquisition indebtedness. Acquisition indebtedness is defined in section 514(c)(7). Note that, to the extent section 681 applies, the limitations relating to the taxpayer's contribution base attributable to individuals apply to the trust. Section 681 does not apply to a decedent's estate. It may also be noted that certain formerly revocable trusts may elect, pursuant to section 645, to be treated as part of the decedent's estate for federal income tax purposes, for the time limit specified in the section, which will exempt the trust during that time from section 681. See section 3:8 for a discussion of the section 645 election. That will also permit such a trust to be entitled to an income tax deduction for its gross income set aside for a charitable purpose during the period that the section 645 election is in effect. Note that a decedent's estate will be treated as ceasing to exist for income tax purposes when the administration of the estate is determined to have been unduly prolonged. See *Treas. Reg.* § 1.641(b)-(3)(a); section 3:9. In any case, it may be important, in planning, to determine whether there is acquisition indebtedness. Perhaps, it also should be noted that transferring property subject to debt to a charitable remainder trust or a charitable lead trust may be an act of self-dealing exposing the transferor to tax imposed by section 4941(a). See *I.R.C.* § 4941(d)(2)(A) (an act of self-dealing occurs if property transferred is subject to a mortgage or similar lien which the charitable remainder trust assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the ten-year period ending on the date of the transfer).

indebtedness against the property.¹⁹⁹ To the extent the trust has UBI that is paid to charity, its deduction limitations are the same as those for an individual.²⁰⁰

[C] For C Corporations

Corporations (so-called C corporations) that are not so-called S corporations²⁰¹ are entitled to a deduction under section 170(a) for contributions to charity, but the rules for C corporations are different from those for contributions by individuals, in some ways. For example, as a general matter, a corporation may reduce its taxable income by only 10% for such contributions.²⁰²

[D] For S Corporations

Charitable contributions made by an S corporation pass through to the shareholders, under section 1366(a)(1)(A), in a manner similar to how contributions by a partnership pass through, under section 702(a)(4), to the partners.²⁰³

199. Section 512(b)(5) provides that from UBIT:

There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

200. See Treas. Reg. § 1.681(a)-2(a) (second to last sentence); I.R.C. § 512(b)(11).

201. See I.R.C., subtit. A, ch. 1, subch. S; chapter 8, *infra*.

202. I.R.C. § 170(b)(2).

203. For an electing small business trust (ESBT) defined in section 1361(e)(1), no income or deduction is passed out of the trust that is the shareholder to its beneficiaries. See I.R.C. § 641(c). For more on a comparison of a charitable contribution by an S corporation as opposed to one by its shareholder, see generally, C. Hoyt, *Charitable Gifts By Subchapter S Corporations and by Shareholders of S Corporation Stock*, ALI-ABA ESTATE PLANNING COURSE MATERIALS J., Apr. 2006, http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.

[E] For Partnerships

Charitable contributions made by a partnership pass through, under section 702(a)(4), to the partners. It is important to note that a decedent's estate or a trust that is not a grantor trust, which is a partner, is entitled to a deduction under section 642(c) for a charitable contribution made by the partnership from the partnership's gross income even if the governing instrument of the trust or estate does not provide for the making of charitable contributions.²⁰⁴

§ 7:7.3 More on Non-Grantor Trusts As Partners and S Shareholders

Revenue Ruling 2004-5 states explicitly that a charitable contribution by a partnership was from its gross income although the conclusion (that the trust, as a partner, is entitled to take a deduction under section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from gross income. Nonetheless, it appears to be the position of the IRS that, for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income.²⁰⁵ It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of section 642(c).²⁰⁶ In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income at least as long as the asset can be traced to such gross income.²⁰⁷

204. Rev. Rul. 2004-5, 2004-1 C.B. 295.

205. See Field Serv. Adv. 200140080. Under section 6110(k)(3), a Field Service Advice may not be cited or used as precedent.

206. See, e.g., *Old Colony Trust Co. v. Comm'r*, 301 U.S. 379 (1937), dealing with the predecessor to current section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See also Chief Couns. Adv. 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under section 642(c) when distributed to charity because it was out of gross income). However, the charitable deduction was limited to the trust's adjusted basis in the property. Under section 6110(k)(3), a Chief Counsel Advice may not be cited or used as precedent. Cf. *Crestar Bank v. IRS*, 47 F. Supp. 2d 670 (E.D. Va. 1999); *Estate of Freund v. Comm'r*, 303 F.2d 30 (2d Cir. 1962); *Sid W. Richardson Found. v. United States*, 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Comm'r*, 145 F.2d 411 (1944); *Estate of Esposito v. Comm'r*, 40 T.C. 459 (1963). For a more complete discussion see section 3:2.1[J].

207. Chief Couns. Adv. 201042023, *Id.* Under section 6110(k)(3), a Chief Counsel Advice may not be cited or used as precedent.

Revenue Ruling 2004-5 indicates that section 681 would apply if the partnership makes the charitable contribution from its gross income that would have been UBI if received directly from the trust.²⁰⁸ Although the concept of UBI (or UBIT) does not apply to a partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes.²⁰⁹

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to section 642(c) or otherwise, the gross income should not be treated as UBIT in the hands of the charity even if it would have been UBIT if received directly by the charity.²¹⁰ Of course, as noted above, section 681 does not apply to an estate.

208. The ruling states, in part, "Because none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. Field Serv. Adv. 200140080 dealt with a trust's distributive share of a partnership's charitable contributions. The IRS stated that although the courts in *Lowenstein v. Comm'r*, 12 T.C. 694 (1949), *aff'd sub nom.* *First Nat'l Bank of Mobile v. Comm'r*, 183 F.2d 172 (5th Cir. 1950), and *Estate of Bluestein v. Comm'r*, 15 T.C. 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the *Bluestein* and *Lowenstein* cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions." Under section 6110(k)(3), a Field Service Advice may not be cited or used as precedent.

209. I.R.C. § 513(b).

210. This conclusion is based upon the absence of a provision that would cause the distribution to be treated as UBIT in the hands of the charitable recipient, the several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust, and the fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBIT if it would have been UBIT if earned directly by the charity. For example, in the case of a partnership, UBIT carries out to any partner that is a charity, as provided in section 512(c) and as UBI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBI to the section 170 limitations to individuals. However, payments to charity from an estate or trust even if consisting of UBI should not be treated as UBIT in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under section 651(a) or 661(a) and do not consist of the DNI of the estate or trust under section 652(a) or

In any event, the safer course, in order to allow a non-grantor trust partner to be entitled to the charitable deduction under section 642(c) without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI.²¹¹

Although not addressed in Revenue Ruling 2004-5, it may suggest that tracing of the source of the contribution by the partnership may be permitted—that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, it seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, an amendment to the regulations under section 642(c) provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of “shifting” income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has independent economic effect.²¹² This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a non-grantor trust and an estate under the prior regulation could specify the

662(a) whose tax character is also passed out to the non-charitable recipient of the DNI. See section 663(a)(2), which denies this treatment for amounts paid to charity that are deducted under section 642(c) (and determined without regard to section 681) by an estate or trust. This seems consistent with the private foundation rules where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of section 4940. See I.R.S. Notice 2004-35, 2004-19 I.R.B. 889. So UBI should not be treated as “carried out” from an estate or trust to a charity and treated as UBIT in its hands. But, as previously mentioned, section 681(a) provides that in computing the deduction allowable under section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under section 642(c) shall be allowed as a deduction with respect to income of the taxable year which is allocable to “unrelated business income.” See also I.R.C. § 642(c)(4) (providing that in the case of a trust (but not an estate), the deduction allowed by section 642(c) is subject to section 681 (related to UBI)). Cf., also, J. Blattmachr, *Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration*, 26 U. MIAMI, HECKERLING INST. ON EST. PLAN. ¶ 1004.3 (1992).

211. Note that section 68(a), which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. I.R.C. § 68(e). The two percent “floor” rule of section 67(a) does not apply to section 642(c) deductions. I.R.C. § 67(b)(4). For a discussion of the application of section 67 to estates and trusts, see section 3:2.1[G][3].

212. See Treas. Reg. § 1.642(c)-3(b)(2).

character of the income being distributed to charity and because the amended regulation does not, as just stated, by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid which would be respected for purposes of section 681.

In any event, under Revenue Ruling 2004-5, if a non-grantor trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") of an individual taxpayer.

There is developed law on whether a non-grantor trust that is a shareholder of an S corporation may take a deduction for charitable contributions made by the S corporation.²¹³ The treasury regulations dealing with ESBTs, defined in section 1361(e)(1), which are certain trusts that may qualify by electing to be eligible shareholders of S corporations, provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion."²¹⁴ If the shareholder is a grantor trust for income tax purposes (or another is treated as the owner of the trust for income tax purposes under section 678²¹⁵), the charitable deduction would pass through to the individual who is the income tax owner of the trust. Certain trusts are not grantor trusts but may be eligible shareholders of an S corporation. These consist of voting trusts the beneficial owners of which are treated as the S shareholders (to whom any charitable contribution made by the S corporation would

213. Although section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and the shareholder's basis in any indebtedness the corporation owes the shareholder. For years, 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

214. Treas. Reg. § 1.641(c)-1(d)(2). The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. *See generally* section 8:7.

215. Note that the beneficiary of a Qualified Subchapter S Trust makes an election pursuant to section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to section 678. *See generally* section 8:6.

be attributed); certain testamentary trusts, including certain formerly revocable trusts,²¹⁶ for a limited period, of which the decedent's estate will be treated as the shareholder (and to which any charitable contribution made by the S corporation would be attributed); and certain tax exempt trusts.²¹⁷ In addition, a decedent's estate is an eligible S shareholder.²¹⁸ Thus, in circumstances where the decedent's estate is the shareholder or treated as the shareholder of the S corporation, the principles of Revenue Ruling 2004-5 should apply so the estate will obtain a section 642(c) deduction for contributions by the S corporation (and not limited by section 681 as that section does not apply to a decedent's estate).

§ 7:7.4 More on Contribution Limitations

An individual may be entitled to a deduction of up to 50% of his or her contribution base for donations of cash (or non-appreciated property) to a so-called publicly supported charity and 30% for cash donations to a so-called private foundation.²¹⁹ Although section 170(c) permits a deduction for contributions "to or for the use" of charitable organizations, the treasury regulations impose a 30% (or 20% with respect to any long-term capital gain property) contribution base limit for contributions "for the use" of charity as opposed to a contribution "to" charity.²²⁰ Contributions are limited to

216. See I.R.C. § 645, discussed at section 3:8.

217. For more detail on trusts, see section 8:4.

218. For a more complete discussion of these matters, see section 8:2.

219. See I.R.C. § 170(b). These deduction limitations are reduced, in general, to 30% and 20%, respectively, to the extent the donation consists of property that includes inherent "long term capital gain," that is, gain that would be taxed as long-term capital gain if the contributed asset were sold by the taxpayer. See I.R.C. § 170(e).

220. This conclusion on the limits for contributions to charitable lead trusts seems challenging to reach. Treas. Reg. § 1.170A-8(a)(2) provides that a contribution of an income interest (essentially, the unitrust or annuity interest in a charitable lead trust) is treated as a contribution "for the use" of charity rather than "to" charity. Treas. Reg. § 1.170A-8(b) provides, in part, "To qualify for the 50-percent limitation the contributions must be made 'to,' and not merely 'for the use of,' one of the specified organizations." Thus, if the charitable lead trust is for charities and consists of property that otherwise would entitle the individual taxpayer to a deduction of up to 50% of his or her contribution base, the taxpayer's contribution limit is 30% of the contribution base. See I.R.C. § 170(b)(1)(B)(i). Treas. Reg. § 1.170A-8(c) indicates that the contribution limitation is 20%, not 30%. But the 20% limit was the limit the Code imposed on all contributions to or for the use of charities that were not so-called publicly supported ones (that is, other than the entities described in section 170(b)(1)(A)), such as contributions to or for the use of most private foundations. However, the 20% threshold was increased to 30% by the

30% and 20% if the contribution is made to a CLT.²²¹

As detailed below, not only may trusts make contributions to charity, they also may, in some cases, create and make contributions to charitable remainder and CLTs, and except to the extent such contributions consist of UBI, such a trust would not be subject to the special deduction limitations, computed as a percentage of the contribution base, applicable to individual taxpayers. An income tax deduction is permitted for the value of the remainder committed in a charitable remainder trust described in section 664(d); provided the value of the remainder interest is at least 10% of the value of the property contributed to the trust.²²² An income tax charitable deduction is permitted for value of the annuity or unitrust interest committed to charity in a CLT only if it is a grantor trust under subpart E of part 1 of subchapter J of chapter 1 of subtitle A of the Code.²²³

Deficit Reduction Act of 1984. Treas. Reg. § 1.170A-8 predates the effective date of that Deficit Reduction Act of 1984 change, *see* T.D. 7207, 1972-2 C.B. 106 (Oct. 3, 1972), and has not been amended to reflect that change. However, if the contribution to the charitable lead trust consists of long-term capital gain property for a private non-operating foundation, the limit is 20% on account of section 170(b)(1)(D)(i). Thus, where the contribution to a charitable lead trust is for publicly supported charities the deduction limitation, as a percentage of the contribution base, is 30% whether the contribution is of cash (or other unappreciated property) or of long-term capital gain property. Other limitations on deductions and some elective rules that may raise the contribution level back to 50% or 30%, *see, e.g.*, I.R.C. § 170(b)(1)(C)(iii), (e). Note, as mentioned elsewhere, that an individual is entitled to an income tax deduction for the value of the annuity or unitrust interest committed to charity in a charitable lead trust only if the trust is a grantor trust. *See* I.R.C. § 170(f)(2)(B).

221. *See* Treas. Reg. § 1.170A-8(b) (third sentence), (a)(2) (first sentence), (c)(1)(ii), (d).

For purposes of the income tax charitable deduction, transfers to grantor charitable lead trusts are considered gifts 'for the use of' charity rather than gifts 'to' charity. If the trust makes payments to a public charity, the deduction can be used against up to 30% of the grantor's contribution base with a five year carryover of any excess deduction. If the trust provides income to a private non-operating foundation, the percentage limitation is reduced to 20%. Any deduction exceeding the amount deductible in the year of contribution can be carried forward up to five additional years. Marty McKeever, *Charitable Lead Trust*, PLANNED GIVING DESIGN CTR. (May 3, 2003), www.pgdc.com/pgdc/charitable-lead-trust.

222. Note that a trust can be a charitable remainder trust under section 664 only if it never was or when it is no longer a grantor trust. Treas. Reg. § 1.664-1(a)(4) (second sentence). Note, also, that contributions to a charitable remainder trust will be limited to the percentage of the individual's contribution base for transfers to private foundations if the remainder may pass to such a foundation.

223. *See* I.R.C. § 170(f)(2)(B).

However, if the contribution to a CLT is made to a non-grantor trust, no charitable deduction is allowed to the trust's grantor but the non-grantor trust would be entitled, under section 642(c), to an unlimited deduction for its gross income paid pursuant to its governing instrument to charity (again subject to the limitations imposed by section 681 if made from UBI).

§ 7:7.5 **Split Interest Trusts Created by Non-Grantor Trusts**

The IRS has issued a private letter ruling holding that a non-grantor trust may transfer assets to a charitable remainder trust described in section 664(d).²²⁴ The trust, apparently, was not authorized to create a charitable remainder trust. However, the trust beneficiary held a presently exercisable special (non-general) power of appointment by which, it seems, the beneficiary could create such a trust. Of course, a charitable remainder trust will not be "qualified" until such time that it is not a grantor trust.²²⁵ It is interesting, perhaps, to note that the ruling does not specify whether the trust which formed the charitable remainder trust was entitled to an income tax deduction under section 642(c) for the actuarial value of the remainder to the extent the charitable remainder trust was funded with gross income of the trust.²²⁶ There would not appear to be any reason why it should not be entitled to such a deduction. In fact, it seems that this conclusion is consistent with Revenue Ruling 2005-4, allowing a non-grantor trust that is a partner of a partnership to deduct a charitable contribution made by the partnership (at least if made from the partnership's gross income).

224. Priv. Ltr. Rul. 9821029. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. Treas. Reg. § 1.664-1(a)(4) provides that a charitable remainder trust will be treated as created no earlier than when no one is treated as the trust's owner for income tax purposes under the grantor trust rules.

225. If the trust does not grant a beneficiary such a special power, it may be possible to grant one by "decanting" the trust from the current one to another that permits it. *See generally* D. Zeydel & J. Blattmachr, *Tax Effects of Decanting — Obtaining and Preserving the Benefits*, 111 J. TAX'N 288 (2009). However, it is not certain that any deduction for the payment of gross income from the "new" trust will qualify for a section 642(c) deduction if the original grantor of the property did not "envison" charitable contributions. *Cf. Brownstone v. United States*, 465 F.3d. 525 (2d Cir. 2006), discussed in section 3:2.1[J].

226. The beneficiary might have held a power not just to appoint corpus of the trust but income as well. In fact, it might be that corpus, for state law accounting purposes, would include capital gain for Federal tax purposes.

The reasoning set forth in the private letter ruling supports the view that a non-grantor trust also may create a CLT described in section 170(f)(2)(B).²²⁷ However, an income tax deduction is not permitted for the actuarial value of an interest in a CLT unless the trust is a grantor trust. It seems that a non-grantor trust may create another trust which is a grantor trust (meaning a trust whose assets are treated as owned for income tax purposes by the other) under section 678 as to the non-grantor trust that created it if the non-grantor trust is authorized to do so.²²⁸

A trust may be a grantor trust with respect to the person who made a gratuitous transfer to the trust for many reasons, one of which is that someone holds a power exercisable in a non-fiduciary capacity to substitute property of equivalent value for assets in the trust.²²⁹ In fact, the Service has held that such provision will cause a CLT to be a grantor trust.²³⁰ It seems that if, pursuant to a presently exercisable special (non-general) power of appointment held by a beneficiary of a non-grantor trust or pursuant to a power held by the trustees of such trust to do so, a CLT that is a grantor trust is created from the gross income of the non-grantor trust, the non-grantor trust should be entitled to a deduction pursuant to section 642(c), except to any extent it is limited by section 681.

In any case, if a beneficiary of a non-grantor trust does not hold a presently exercisable special (non-general) power of appointment, which may be exercised to create a CLT, and if the non-grantor trust

227. The IRS has also ruled that a corporation may create a charitable lead trust. *See* Priv. Ltr. Rul. 9512002. Under section 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

228. Treas. Reg. § 1.671-2(e)(6), ex. 8. It may be of interest to note that the example concludes that the trust created by the non-grantor trust is one described in section 678. Thus, the creating trust is not the grantor for Federal income tax purposes under sections 671 through 677 and section 679, but would be the owner of the trust for income tax purposes. Note that section 170(f)(2)(B) allows an income tax deduction to the “grantor” who is the owner of the trust for income tax purposes. As discussed elsewhere, one trust cannot, at least as a general rule, be treated as another trust’s grantor. It seems likely that if a trust described in section 678 creates a charitable lead trust that is treated as a grantor trust with respect to the beneficiary who is treated as the owner, the section 678 owner should be entitled to a deduction for the value in the lead trust committed to charity. However, it may be that having a partnership of which the section 678 trust is a partner create the lead trust that is a grantor trust with respect to the partnership produces a more certain result of the owner of the section 678 trust obtaining the deduction.

229. I.R.C. § 675(4)(C).

230. *See* Rev. Proc. 2007-45, 2007-29 I.R.B. 89, § 8.09(1); Rev. Proc. 2008-45, 2008-30 I.R.B. 224, § 8.09(1).

is not authorized to create one,²³¹ it likely will be preferable for any such grantor CLT to be created by a partnership of which the non-grantor trust is a partner (or a shareholder of an S corporation) as there seems more certainty that a charitable deduction would be available in such a case.

The IRS has also ruled privately that a partnership and a corporation (including an S corporation) may create a charitable remainder trust.²³² Moreover, the Service has issued a private letter ruling on some of the effects of a corporation creating a CLT, indicating that the Service accepts that a corporation may create a CLT.²³³

Thus, it seems that a partnership (that is not a disregarded entity²³⁴) may create a CLT and, if it is a grantor trust with respect to the partnership, an income tax deduction should be passed out to the partners including, under Revenue Ruling 2004-5, to any non-grantor trust that is a partner.²³⁵

However, even if the partnership or corporation is not disregarded for income tax purposes, an issue is whether, under the Treasury

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231. It might be possible, pursuant to a state “decanting” law, to transfer the assets of the non-grantor trust to another non-grantor trust under which a beneficiary holds a presently exercisable special power of appointment, which may be exercised to create a charitable lead trust which would be a grantor trust with respect to the trust over which the special power is held, or under which the trustees may create such a trust. There is, nonetheless, an issue whether a section 642(c) deduction would be allowed because the original trust from which the decanting occurred did not so authorize the creation of the trust by the trustees or a beneficiary. For information about decanting (the exercise of a power of invasion by the trustee in further trust) and some of the tax effects of decanting, see D. Zeydel & J. Blattmachr, *Tax Effects of Decanting-Obtaining and Preserving the Benefits*, 111 J. TAX’N 288 (2009), cited in *Morse v. Kraft*, 466 Mass. 92 (2013).
232. Priv. Ltr. Ruls. 9205031, 8102093 (C corporation); Priv. Ltr. Ruls. 200644013, 9340043 (S corporation); Priv. Ltr. Rul. 9419021 (partnership); Priv. Ltr. Rul. 199952071 (limited liability company, treated as a partnership for Federal tax purposes). Under section 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.
233. Priv. Ltr. Rul. 9512002. Under section 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.
234. If the partnership is disregarded for federal tax purposes, see Treas. Reg. § 301.7701-3; Rev. Rul. 2004-77, 2004-2 C.B. 119 (entity with two partners, one of which is disregarded as to the other), it cannot be classified as a partnership but rather will be treated as a disregarded entity unless it elects to be taxed as a corporation. If the partnership is a disregarded entity, its partners would be treated as creating the trust.
235. If the trust that is a partner is a grantor trust, then the charitable deduction would be attributed (passed out) to the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184.

Regulation,²³⁶ the entity will be treated as creating the trust or whether one or more of its owners will.

§ 7:7.6 Structure of the Partnership and Corporation That Creates the Trust

A partnership may be treated as creating a trust, including a grantor trust, if it is for its benefit as opposed to the personal benefit of a partner. A corporation may be treated as creating a trust, including a grantor trust, if it is for its benefit as opposed to the personal benefit of a shareholder. The regulations provide:

If a gratuitous transfer is made by a partnership or corporation to a trust *and is for a business purpose of the partnership or corporation*, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, *if a partnership or corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders*, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.²³⁷

As reflected by the treasury regulation, partnerships and corporations often create trusts for business reasons and, in such a case, presumably would be treated as the grantor of any such trust for federal income tax purposes. The same would seem true for a charitable remainder trust or CLT created by the entity as reflected by the private letter rulings cited above.

Of course, partnerships (and other business entities, such as S and C corporations) often make contributions to charities. However, there does not seem to be any requirement that the charitable contribution need be for a business purpose to be treated as made by the entity for income tax purposes, as opposed to being treated as made by its owners.

236. Treas. Reg. § 1.671-2(e)(4).

237. Treas. Reg. § 1.671-2(e)(4) (emphasis added).

If the creation of the charitable remainder trust or the CLT will be in fulfillment of one of the entity's business purposes, it certainly would seem to fall under the foregoing regulation that provides that a partnership or corporation may be treated as the grantor of a trust (whether or not it is a grantor trust for income tax purposes).

Thus, if a partnership or corporation creates a CLT and the entity retains the right annually to choose the charitable recipients or commits the payments to a local charities or charities in the same "industry" as the company (for example, educational institutions if the company publishes school books and provides other educational goods) and if the remainder reverts solely to the partnership or corporation, as the case may be, when the charitable term ends, it seems the contribution to the trust is for a business purpose of the partnership or corporation and not for the personal benefit of any partner or shareholder.²³⁸

Similarly, if a partnership or a corporation creates a charitable remainder trust, it may well be treated as created by the entity (as opposed to any owner of the entity) if there is a business purpose for doing so. As mentioned elsewhere, the IRS has ruled that C corporations, S corporations and partnerships may create charitable remainder trusts. One reason the entity may do that is because the entity has an asset which if sold (or distributed to its owners) would cause gain recognition. In at least some cases, an appreciated asset may be contributed to a charitable remainder trust without gain recognition and the charitable remainder trust may sell the asset without paying any income tax because a charitable remainder trust is exempt from income tax except that, to the extent it has UBTI, which may include acquisition indebtedness, an excise tax may be imposed on such income.²³⁹

Even though, ultimately, everything a partnership or an S corporation does is for the benefit of its owners, it seems that creating a CLT as a grantor trust to generate a deduction for the owners or creating a charitable remainder trust to eliminate income tax on the sale of an

238. The IRS has issued private letter rulings, which although they may not be cited or used as precedent, hold that entities, such as partnerships, may create charitable remainder trusts described in section 664. *See, e.g.*, Priv. Ltr. Rul. 9419021. *See generally* BAKER & BATSON, CHARITABLE REMAINDER HANDBOOK, at 1, n. 3 ("A sampling of PLRs that permit non-natural person entities to be a charitable remainder trust donor includes: C-Corporation—9205031 and 8102093; S-Corporation—200644013 and 9340043; LLC—199952071; Partnership—9419021; and Trust—9821029.") Under section 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

239. *See* I.R.C. § 664(c).

appreciated asset should be treated as being done for a business purpose of the entity. However, there seems to be a more assured way of having the creation of a CLT or charitable remainder trust be treated as being for a business purpose of the entity, so the trust is not treated as created by the entity's owners.

Suppose the entity includes in its statement of purposes philanthropic ones. Although it may seem odd that a for-profit entity would be devoted, in part, to philanthropic purposes, this has been done ever since Google created Google.org almost twenty years ago. Google.org's website states that "Google.org develops technologies to help address global challenges and supports innovative partners through grants, investments and in-kind resources." In other words, Google.org is an organization that attempts to accomplish philanthropic goals (although, apparently, its goals are not limited to purely qualified charitable purposes as described in section 501(c)(3)). Google does so without the restrictions on activities that a tax exempt charity must follow, such as the prohibition on carrying on propaganda or otherwise attempting to influence legislation.²⁴⁰ For example, apparently, Google.org may and does make "grants" to other for-profit companies that may develop technologies that may benefit human kind (such as cleaner energy). The following is a description of how Google.org is intended to operate:

By choosing for-profit status, Google will have to pay taxes if company shares [that it owns] are sold at a profit—or if corporate earnings are used—to finance Google.org. Any resulting venture that shows a profit will also have to pay taxes. It could, for example, form a company to sell . . . converted cars [that pollute less], finance that company in partnership with venture capitalists, and even hire a lobbyist to pressure Congress to pass legislation granting a tax credit to consumers who buy the cars.²⁴¹

In a circumstance where the purposes of the partnership or corporation include charitable ones within the meaning of sections 664 or 170(f)(2)(B), it seems that the deduction for the value of the charitable interest committed in a CLT that is a grantor trust or a charitable remainder trust created by the partnership or S corporation should pass out to its partners or shareholders, as the case may be. In fact, the governing documents of the partnership or corporation might explicitly authorize the entity to create charitable remainder trusts and CLTs to carry out its philanthropic purposes. An S corporation or

240. See I.R.C. § 501(c)(3).

241. See Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. TIMES (Sept. 14, 2006), www.nytimes.com/2006/09/14/technology/14google.html?pagewanted=all.

partnership, which has such purposes and powers, creates a charitable remainder trust described in section 664 or a CLT described in section 170(f)(2)(B), which is a grantor trust CLT, the deduction allowed for the charitable component of the trust should be deductible for income tax purposes by the shareholders or partners including any non-grantor trust or a decedent's estate that is a shareholder or partner, pursuant to Revenue Ruling 2004-5, under section 642(c). And unlike C corporations and individuals whose income tax deductions are limited to a percentage of adjusted gross income, a decedent's estate or a non-grantor trust is entitled to an unlimited charitable deduction under section 642(c) (except to the extent section 681 applies).

§ 7:7.7 The Problem of Recapture

As indicated, the grantor of a CLT is entitled to a deduction in the year the trust is created if it is a grantor trust. However, section 170(f)(2)(B) (second sentence) provides that all or a portion of the deduction will be recaptured if the trust's grantor trust status terminates, essentially, before the charitable annuity or unitrust term ends.²⁴²

The tax law provides that the upfront income tax deduction allowed when the taxpayer creates a CLT that is a grantor trust is recaptured, in whole or in part, in some cases when grantor trust status ends.²⁴³ Grantor trust status, of course, will end not later than when the grantor dies. Unfortunately, the Code and regulatory provisions with respect to the recapture are quite disparate.

When a taxpayer creates a CLT that is a grantor trust for income tax purposes, the taxpayer may be viewed as trading an upfront income tax deduction for gross income inclusion during the charitable term of the lead trust of gross income the trust earned and without any further deduction even if such income is paid to charity. The taxpayer cannot obtain both an upfront income tax deduction for the value of the interest committed to charity and essentially avoid income tax on the trust's taxable income that is used to fund the payments to charity.²⁴⁴

In addition, the upfront income tax deduction, in whole or in part, is recaptured (that is, it must be included in the gross income of the taxpayer) when the trust's grantor trust status ends to the extent, if any, determined on a present value basis, that the upfront deduction is

242. A portion of this part is derived from J. Blattmachr, *Some Recapture Considerations and Other Problems Relating to Charitable Lead Trusts*, LISI CHARITABLE PLANNING NEWSLETTER #172 (Feb. 7, 2011), www.leimbergservices.com.

243. See Treas. Reg. § 1.170A-6(c)(4).

244. I.R.C. § 170(f)(2)(C).

greater than the amount of trust income that has been attributed to the grantor under the grantor trust rules.²⁴⁵

For example, assume a taxpayer creates a CLT that is a grantor trust for income tax purposes with \$1 million of cash when the applicable section 7520 rate (used to determine the value of the interests in the trust) is 3.2% providing for charity to receive at the end of each year \$524,137 for two years, after which the charitable interest will end and the remainder will pass outright to the taxpayer's descendants. The present value of the annuity payments for charity is slightly above \$1 million so the taxpayer will be entitled to an income tax deduction (subject to any other limitations imposed by section 170) of \$1 million. If the trust earns exactly 3.2% each year, the entire corpus and income of the trust will be paid to charity. The trust will have earned only about \$48,252 of income during the two-year charitable term. The present value of that \$48,252 (as of the creation of the trust) is only about \$46,368. Because the trust will be exhausted at the end of the two-year charitable term, nothing will pass to the remainder beneficiaries and grantor trust status will have ended. As a consequence, under the provisions of the Code, taken literally, the taxpayer will then have \$953,632 of gross income under the recapture rule of section 170(f)(2)(B) (the amount equal to the difference between the value of the income reported by the grantor as a result of including the trust's income (\$46,368) in the grantor's gross income and the value of the charitable deduction received up front (\$1 million)). That result seems bizarre. The taxpayer could have simply given charity the \$1 million of cash, obtained a \$1 million income tax deduction (to the extent within the grantor's contribution limits) with no recapture at all.

Apparently, to ameliorate that possible draconian result under the Code, the treasury regulations provide, in part:

(4) *Recapture upon termination of treatment as owner.* If for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) *the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest.*²⁴⁶

245. I.R.C. § 170(f)(2)(B) (second and third sentences).

246. Treas. Reg. § 1.170A-6(c)(4) (emphasis added).

In other words, recapture of the upfront deduction occurs under the regulation (1) only if grantor trust status ends *before* the CLT ends, and (2) only to the extent (based upon present value calculations) charity has received less (whether it is income or corpus or both) than the donor's income tax deduction amount, rather than, as under the Code, only to the extent that the grantor had to include trust income in gross income. Thus, under the regulation, in the foregoing example where the taxpayer created a \$1 million two-year CLT paying \$524,137 each year to charity, there would be no recapture because the present value of the payments made to charity during the charitable term would equal the upfront deduction, assuming the grantor did not die or the trust otherwise ceases to be a grantor trust before the end of the two year term. Note that, in fact, no recapture would occur even if the trust's income exceeded 3.2% each year because at least \$ 1 million, on a present value basis, is delivered to charity.

Therefore, the recapture rules under the Code are starkly different than under the regulation. Which rule prevails? It seems appropriate to note that the Congress apparently intended the literal result dictated under the Code. The General Explanation of the Tax Reform Act of 1969 provides, in part, in discussing the recapture rule,

This is accomplished by treating the donor at the time he ceases to be taxable on the trust income as having received income to the extent the deduction he previously was allowed exceeds the value of the income previously earned by the trust and taxable to him.²⁴⁷

It appears that the recapture rule set forth in the regulation, although contrary to the "harsher" provision in the Code, also was intentional.

The Treasury Department Technical Memorandum to the Treasury Decision, by which the regulation was promulgated,²⁴⁸ explains the limited recapture rule the regulation adopts and states, in part:

The amount of the charitable contributions deduction required under section 170(f)(2)(B) to be recaptured is measured by subtracting from the amount of such deduction previously taken the discounted value of all amounts of income earned by the trust and taxable to the donor by reason of section 671 before the time he

247. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 88 (Comm. Print 1970).

248. Technical Memoranda Notice of proposed rulemaking—Amendment of Income Tax Regulations to conform them to section 201 (a) and (f) of the Tax Reform Act of 1969, relating to charitable contributions, 1970 TM LEXIS 26, Dec. 10, 1970, REFERENCE: CC:LR-1699, Br1:NGZ, ACTION DOC: T.D. 7207.

ceases to be treated as the owner of the interest. The amounts of income earned by the trust in each taxable year and taxable to the donor are discounted to their value as of the date of contribution. The statutory formula raises the question as to whether only those [*32] amounts of income earned by the trust, paid to the charity, and taxable to the donor are taken into account or whether all amounts of income earned by the trust and taxable to the donor, whether or not paid to charity, are to be considered. *The argument was made that a recapture rule conforming to a literal reading of the statute would be illogical because there is no necessary correlation between the charitable contributions deduction previously allowed to the donor and the amount paid to the charity.* Thus, for example, the trust might earn \$10,000 annually (all taxable to the donor) and pay \$1,000 annually to the charity.

Notwithstanding the foregoing language, the preamble continues as stated below, and confusingly, seems to restate the rule set forth in the Code.

Accordingly, the proposed regulation adopts the position that the amount recapturable is to be measured by subtracting from the amount of the charitable contributions deduction previously allowed to the donor the discounted value of only those amounts which were taxable to the donor and paid by the trust to the charity. It is recognized that this approach is not clearly supportable under the language of section 170(f)(2)(B). Paragraph (c)(4) also adopts the position that, for purposes of applying this recapture rule, trust income of which the donor is treated as the owner shall be treated as income taxable to him even though it is excluded from his gross income by reason of an exclusion provision of the Code. This appears consistent with the allowance of a charitable contributions deduction to a donor for amounts paid to a charitable organization from amounts received as a gift or as exempt income. (Emphasis added.)²⁴⁹

The regulation is so explicit that one might conclude that the IRS would accept it as the recapture rule. However, Revenue Procedure 2007-45, promulgated by the Treasury Department to provide sample CLT provisions, essentially recites the same recapture rule contained in the Code. Specifically, it provides,

If at any time the donor ceases to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code, the donor shall be considered to have received an amount of income equal to the amount of any deduction the

249. Note that the Technical Memorandum provides that it may not be cited or used as precedent.

donor received under § 170(a) for the contribution to the trust, reduced by the discounted value (as of the date of the contribution to the trust) of all amounts of income earned by the trust and taxable to the donor before the time that the donor ceased to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Section 170(f)(2)(B).²⁵⁰

Whether the Service would be bound by the regulation is uncertain. Indeed, it is questionable whether a government agency may ignore the law.²⁵¹ Therefore, in the absence of clarification by the Service, a taxpayer must consider that recapture might occur under the harsher provisions of the Code. Fortunately, if the corporation or the partnership (or a non-grantor trust) is the grantor (or, for a non-grantor trust, the income tax owner) of the CLT as it likely can be kept from “dying” before the charitable term of the grantor lead trust ends and the trust otherwise does lose its grantor trust status, recapture of the income tax deduction generated by the creation of the charitable lead annuity trust (CLAT) should not occur assuming the contributor to the CLAT is treated as being the entity itself and not its owners.

There is no indication even where the deduction is “passed out” from the partnership or the S corporation to the partners or the shareholders, as the case may be, that the partnership or shareholders should be treated as the grantors for recapture purposes rather than the entity. Indeed, the premise is that the partnership or corporation is the grantor under the regulation. Even if the partners or shareholders are treated as the grantors for recapture purposes, it is likely that any non-grantor trust that is a partner or shareholder also could be structured not to “die” before the charitable term of the lead trust ends.²⁵²

This problem for a term-of-years CLAT might be ameliorated by providing language in the trust document so that grantor trust status cannot end (other than by the grantor’s death) before all unitrust or annuity payments, in fact, are made to charity. For example, the trust could be drafted so that any power of substitution (which, if described in section 675(4)(C), causes the trust to be a grantor trust during the time the power is outstanding) would not expire until sometime after the final payment to charity is made. But there is a risk that the grantor will die prior to the end of the term of years and, of course,

250. Rev. Proc. 2007-45, § 8.01(5).

251. For a discussion related to this issue, see Mitchell Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731, 795–800 (Winter 2002); Mitchell Gans, *Deference and Family Limited Partnerships: A Case Study*, 39 U. MIAMI, HECKERLING INST. ON EST. PLAN. ch. 5.

252. Many states now permit trusts to last for very long fixed or even perpetual terms. See H. ZARITSKY, *THE RULE AGAINST PERPETUITIES: A SURVEY OF STATE (AND D.C. LAW)* (2012), www.actec.org/public/documents/studies/zaritsky_rap_survey_03_2012.pdf.

grantor trust status automatically will end when the grantor dies. Moreover, although this might be a solution for CLATs in general, it cannot be a solution for a CLAT funded with insurance.

When the final payment to charity arises by reason of the grantor's death, there is no opportunity to extend grantor trust status—the grantor's death ends that status as to the grantor no matter what. The status will end no later than when the grantor dies even if it is a term-of-years lead trust as opposed to one for life.

This result would be quite severe if the trust were a so-called shark fin CLAT—a CLT that provides small payments until the very end of the charitable term when a very large payment to charity arises. Again, the chance of being able to pay charity with cash simultaneously with the grantor's death likely cannot occur. Thus, if charity's interest is not deemed to have ended before the final payment to charity is actually made, there may be significant recapture.²⁵³

§ 7:7.8 Summary and Conclusions

In some cases, a better result may be obtained if a partnership or a corporation creates a charitable split interest trust, such as a charitable remainder trust or CLT, than if the trust is created by the partners or shareholders. No income tax deduction for a creation and funding of a CLT is permitted unless the trust is a grantor trust. That means that all income earned during the charitable term of the trust will be taxed to the grantor without any further deduction. In addition, the amount by which an individual may reduce his or her taxable income by the deduction allowed is limited to 30% or 20% of the contribution base. Also, the deduction allowed may be recaptured when grantor trust status ends (which will be no later than the death of the grantor). However, a non-grantor trust that is allowed by deduction for creation of a CLT created by a partnership of which the trust is a partner may be unlimited (that is, not limited by a percentage of any contribution base) as a general rule. Furthermore, properly structured, it seems that recapture that may occur when the lead trust is a grantor trust likely can be avoided if an entity creates the trust.

253. For a discussion of a possible way to avoid recapture, see J. Blattmachr & D. Zeydel, *Split Interest Trusts Created by Entities (and More)*, 12 U. MIAMI, HECKERLING INST. ON EST. PLAN. ¶ 1206 (2015).

Chapter 8

Trusts As S Corporation Shareholders

- § 8:1 S Corporation Eligibility
- § 8:2 Trust Ownership of S Stock
- § 8:3 Subpart E Trusts (Grantor Trusts)
- § 8:4 Two-Year Trusts, Testamentary Trusts and Section 645 Trusts
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 - § 8:7.1 Eligibility
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- § 8:9 Section 1362(f) Relief

§ 8:1 S Corporation Eligibility

Generally, a corporation is taxed on its taxable income.¹ In addition, the shareholders of the corporation usually must include in gross income, and may pay a tax on, dividends paid out of a corporation's earnings and profits.²

However, in 1958, Congress added provisions to the Code that permit certain electing corporations to be taxed more like partnerships.³ These corporations, commonly known as "S corporations" or as "Subchapter S corporations," and their shareholders are taxed under the provisions of Subchapter S of chapter 1 of the Code.⁴ Under these special rules, corporations and their shareholders that qualify and make an "S election" are taxed like partners in a partnership (on a "conduit" basis) rather than like shareholders of a regular corporation.⁵ The income of the corporation is attributed directly to the shareholders, and is not taxed to the corporation.⁶

The 1958 qualification rules permitted only ten shareholders, and a trust was not allowed to own stock in a qualified Subchapter S corporation.⁷ The subchapter S corporation rules were substantially revised in 1982, and the reference to electing entities changed from qualified "subchapter S corporations" to "S corporations."⁸

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1. See I.R.C. § 11.
 2. See I.R.C. §§ 301, 316.
 3. The Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1650.
 4. I.R.C. §§ 1361-79. These provisions were substantially modified by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). See Steven L. Gleitman & Anatole Klebenow, *Designing Trusts That Will Preserve the S Election*, 67 J. TAX'N 146 (1987); Bernard L. Karr, *Grantor Trusts with Withdrawal Powers Add Flexibility in S Corp. Owner's Estate Planning*, 15 EST. PLAN. 266 (1988). See generally W. Birch Douglas, III & T. Randolph Harris, *The Estate Separate Share Rule and S Corporation Stock*, 15 PROB. & PROP. June 2001, at 28.
 5. Generally, the character of S corporation items of income, deductions and credits remains the same in the hands of each shareholder. I.R.C. § 1366(b). Shareholders report these items in their tax year in which the tax year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year). I.R.C. § 1366(a). Generally, S corporations must use a "permitted" tax year. I.R.C. § 1378.
 6. An S corporation may be taxed only on certain capital gains or when it has "subchapter C" earnings and profits in situations where a former C corporation has elected S corporation status. I.R.C. §§ 1374, 1375.
 7. The Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1650.
 8. The Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669.

The statutory rules permit only domestic “small” business corporations that are not ineligible to make the S corporation election under section 1362(a).⁹

Although the statutory limits on who may own S corporation stock have been greatly relaxed over the years, ownership is still restricted. To qualify, the corporation may not have more than 100 shareholders,¹⁰ more than one class of stock¹¹ (although voting differences among shares are permitted),¹² or ineligible shareholders. Ineligible shareholders include nonresident aliens¹³ of the United States and those who are not individuals (other than decedents’ estates, certain “parent” corporations, and certain trusts).¹⁴ Partnerships are not permitted to be S corporation shareholders.¹⁵

Determining the number of shareholders is not as simple as counting the number of shareholders of record. Instead, statutory rules may combine certain family members to count as only one shareholder.¹⁶ For example, a husband and wife (and their estates) are treated as one S corporation shareholder.¹⁷

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9. I.R.C. § 1361(a), (b). Corporations that are not eligible to elect S status (known as “ineligible corporations”) include (a) financial institutions which use the reserve method of accounting for bad debts, (b) most insurance companies, (c) corporations to which an election under I.R.C. § 936 applies, and (d) a current or former domestic international sales corporation (DISC). I.R.C. § 1361(b)(2).
 10. I.R.C. § 1361(b)(1)(A).
 11. I.R.C. § 1361(b)(1)(D).
 12. I.R.C. § 1361(c)(4).
 13. I.R.C. § 1361(b)(1)(C). I.R.C. § 7701(b) defines nonresident alien.
 14. I.R.C. § 1361(b)(1)(B). Effective for tax years after 1997, entities described in I.R.C. § 401(a) (qualified “retirement” plans) or I.R.C. § 501(c)(3) (charitable organizations), which are exempt from income tax under I.R.C. § 501(a), may be eligible shareholders. I.R.C. § 1361(c)(6). “Estate” includes the estate of an individual in bankruptcy under title 11 of the U.S. Code. I.R.C. § 1361(c)(5); Treas. Reg. § 1.1361-1(b)(2).
 15. *See, e.g.*, Priv. Ltr. Rul. 200550031, in which S stock was held by partnerships that were intended to be nominees of eligible shareholders. The IRS granted relief under I.R.C. § 1362(f) for the inadvertent termination of the S election as a result of the partnerships distributing all of the S stock to qualified shareholders. However, the ruling made no mention of the possibility that the partnership could have been deemed a voting trust. *See* the discussion at section 8:5 for voting trusts that qualify as permissible S shareholders. *See* section 8:9 for a discussion of I.R.C. § 1362(f) relief. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 16. *See* I.R.C. § 1361(c)(1).
 17. I.R.C. § 1361(c)(1)(i).

Legislation in 2004 amended the rules to treat all members of the same family as one shareholder,¹⁸ although an affirmative election was required for family members (and their estates) other than a husband and wife.¹⁹ Late in 2005, legislation²⁰ deleted the requirement for an election. Now, the statute combines family members to count as one shareholder without an election.²¹ The effect of the new legislation is to make an S election potentially available to many closely held corporations that have hundreds of actual shareholders if many of them are related. This may be common for closely held businesses that have passed through and have been disbursed among several generations of several families.

A “family” is defined by statute as all lineal descendants of a common ancestor (and their spouses and former spouses) not more than six generations removed from the generation of the youngest family member on the later of the date that (i) the S election is made, (ii) any family member acquires any S corporation stock, or (iii) October 22, 2004.²² Estates of family members are considered to be family members, as well.²³

In response to the 2004 legislation, the IRS issued I.R.S. Notice 2005-91²⁴ to provide guidance on combining family members for purposes of counting the number of shareholders, but much of the guidance was mooted by the 2005 legislation’s repeal of the affirmative election requirement.²⁵ Nevertheless, some portions of the I.R.S. Notice are still valid. For example, the Notice provides that a spouse or former spouse of the common ancestor is treated as being in the same generation as the common ancestor when the identity of the common ancestor is determined. Moreover, the common ancestor does not have to be alive. Similarly, a spouse or former spouse of a lineal descendant of the common ancestor is treated as being in the

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18. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231, 118 Stat. 1418.
 19. I.R.C. § 1361(c)(1)(A)(ii) and (D) before amendments made by the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § 403, 119 Stat. 2577.
 20. The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § 403, 119 Stat. 2577.
 21. I.R.C. § 1361(c)(1)(A)(ii).
 22. I.R.C. § 1361(c)(1)(B). *See also* Treas. Reg. § 1.1361-1(e)(3), effective August 14, 2008.
 23. I.R.C. § 1361(c)(1)(A)(i)–(ii).
 24. I.R.S. Notice 2005-91, 2005-2 C.B. 1164.
 25. The Notice included information about making the election that was repealed by the 2005 legislation. The Notice indicates that it may be relied on until further guidance is issued.

same generation of that lineal descendant. Finally, the estate of a deceased family member is considered a family member when the estate, or a testamentary trust described in section 1361(c)(2)(A)(iii),²⁶ owns stock in the S corporation. The Notice provides that “family members” include:

- (1) Each potential current beneficiary of an electing small business trust (ESBT) who is a member of the family,
- (2) The income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a member of the family,²⁷
- (3) Each beneficiary of a trust who is a member of the family, if the trust was created primarily to exercise the voting power of stock transferred to it,
- (4) The member of the family for whose benefit a trust described in section 1361(c)(2)(A)(vi) was created,²⁸
- (5) The deemed owner of a trust treated as wholly owned under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code, if that deemed owner is a member of the family, and
- (6) The owner of an entity disregarded as an entity separate from its owner under section 301.7701-3 of the Procedure and Administration Regulations, if that owner is a member of the family.²⁹

Finally, the Notice requires that the S corporation keep records as provided in section 6001 and the applicable regulations thereunder.

26. I.R.C. § 1361(c)(2)(A)(iii) permits a trust to be a qualified S corporation shareholder for up to two years if it receives the S corporation stock in a distribution from an estate “pursuant to the terms of a will.”

27. *But see* Priv. Ltr. Rul. 9410035 (the fourteen beneficiaries of thirty-four qualified subchapter S trusts treated as fourteen shareholders and trusts themselves apparently not treated as one for number of shareholder purposes). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

28. I.R.C. § 1361(c)(2)(A)(vi) permits an IRA to hold bank and bank holding company stock if the stock were held by the IRA before October 23, 2004. *See also* Treas. Reg. § 1.1361-1(h), effective August 14, 2008.

29. I.R.S. Notice 2005-91, 2005-2 C.B. 1164. Single-member LLCs are disregarded as a separate entity under Treas. Reg. § 301.7701-3. *See also* Treas. Reg. § 1.1361-1(e)(3)(ii)(F), effective August 14, 2008.

§ 8:2 Trust Ownership of S Stock

The 1958 prohibition on trust ownership of S corporation stock was finally relaxed by legislation in 1982³⁰ and 1996³¹ to allow certain trusts to own S corporation stock; in addition, a decedent's estate may own S corporation stock. Today, many types of trusts may own S corporation stock, and a decedent's estate also may qualify as an S corporation shareholder, unless and until its administration is unduly prolonged.³² Moreover, the IRS has ruled that a life estate may be the equivalent of a trust and thus an eligible ownership arrangement for S corporation stock.³³

The types of trusts that may own S corporation stock are:

1. Subpart E Trust (Grantor Trust). A trust, all of which is treated as owned by an individual (who would be a permitted shareholder) under the "grantor" trust rules, is a permitted shareholder.³⁴ This includes both trusts where the creator of the trust is treated as the grantor under sections 671–77 or another person is deemed the grantor for tax purposes under section 678. This type of trust may continue to be a permitted shareholder for two years immediately following the grantor's death.³⁵

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30. The Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669.
 31. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1302, 110 Stat. 1755.
 32. *Old Va. Brick Co. v. Comm'r*, 367 F.2d 276 (4th Cir. 1966), *aff'g* 44 T.C. 724 (1965). Note that for income tax purposes, specifically bequeathed shares of stock in a corporation may be treated as being held by the legatee (rather than the executor or administrator) as of the moment of the decedent's death. If the legatee is not a permitted shareholder of an S corporation, death of the decedent may terminate the corporation's S election or prevent its S election from being effective. *Cf. Hibernia Nat'l Bank v. Donnelly*, 121 F. Supp. 179 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954). As to the permissible period for administration, see Treas. Reg. § 1.641(b)-3(a). If upon the death of the owner a trust that is an ineligible S shareholder owns the stock, it appears that for the two-year period following the owner's death, the owner's estate is treated as the shareholder of the S corporation for eligibility purposes, but the income, deductions and credits are attributed to the trust. Treas. Reg. § 1.1361-1(k)(1), ex. 4(iii).
 33. *See* Priv. Ltr. Ruls. 200247030, 200404037 (IRS rules that the life tenants could make QSST elections). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.
 34. I.R.C. § 1361(c)(2)(A)(i).
 35. I.R.C. § 1361(c)(2)(A)(ii). For tax years before 1997, a grantor trust, not all of the corpus of which was includible in the gross estate of its grantor was an eligible shareholder only for sixty days. I.R.C. § 1361(c)(2)(A)(ii) before amendments made by the Small Business Job Protection Act of 1997, Pub. L. No. 104-188, § 1303(1)–(2), 110 Stat. 1755. Note that if the election

2. Testamentary Trust. Any trust that receives S stock pursuant to the terms of a decedent's will may qualify for a two-year term immediately following receipt of the S stock, even if the trust does not otherwise qualify as a permitted S corporation shareholder.³⁶
3. Voting Trust. A trust created primarily to exercise the voting power of the stock transferred to it.³⁷
4. Qualified Subchapter S Trust (QSST). A Qualified Subchapter S Trust is one that owns stock in an S corporation, and all of the accounting income³⁸ is distributed or is required to be distributed currently³⁹ to one individual who is a citizen or resident of the United States.
5. Electing Small Business Trust (ESBT). Any trust that satisfies the ESBT rules can make an affirmative election to be a qualified S corporation shareholder. All beneficiaries of an ESBT must be estates, individuals, or certain charitable organizations, and the trustee must make an affirmative election.⁴⁰

under I.R.C. § 645 to treat a formerly revocable trust as part of the estate is made, the trust presumably can be an eligible shareholder as long as the election applies even if it extends beyond two years after the decedent's death. *See* Priv. Ltr. Rul. 9642003 (corporation treated as continuing as S corporation where trust held shares for more than two years after death because termination of S status was inadvertent). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

36. I.R.C. § 1361(c)(2)(A)(iii). For tax years before 1997, these trusts were eligible shareholders only for sixty days. I.R.C. § 1361(c)(2)(A)(iii) before amendments made by the Small Business Job Protection Act of 1997, Pub. L. No. 104-188, § 1303(1)-(2), 110 Stat. 1755.
37. I.R.C. § 1361(c)(2)(A)(iv). *See* Treas. Reg. § 1.1361-1(h)(1)(v).
38. This has the same meaning as under Treas. Reg. § 1.643(b)-1. Treas. Reg. § 1.1361-1(j)(1)(i). Unless otherwise provided under local law (including governing instrument provisions which are effective under local law), income includes distributions from the S corporation but not amounts merely imputed under I.R.C. § 1366. *Id.*
39. Treas. Reg. §§ 1.651(a)-2(a) and 1.663(b)-1(a) determine whether all income is distributed or is required to be distributed currently. Treas. Reg. § 1.1361-1(j)(1)(i).
40. I.R.C. § 1361(e)(1)(A)(i), (iii). The permissible charities are those described in paragraphs (2), (3), (4), and (5) of I.R.C. § 170(c). An organization described in I.R.C. § 170(c)(1) may hold a contingent interest in an ESBT if it is not a potential current beneficiary. Treas. Reg. § 1.1361-1(m)(1)(i). *See generally* F.G. Corneel, *The Election Small Business Trust: Subchapter S's User-Friendly Estate Planning Tool*, 86 J. TAX'N 215 (Apr. 1997); N.C. Hughes & D.T. Lewis, *Electing Small Business Trust: The Good, the Bad and the*

6. Tax-Exempt Trusts. A trust exempt from taxation under section 501, if it is an organization described in section 401 or 501(c)(3) can own S corporation stock without causing the corporation to lose its S status.⁴¹ But this does not include IRAs,⁴² except for banks and bank holding companies, which are permitted to own stock if the stock were held by the IRA before October 23, 2004,⁴³ or Roth IRA.⁴⁴
7. Estates. A decedent's estate may own S corporation stock. Although an estate is not a trust in the state law sense of a trust, it is a trust for income tax purposes under subchapter J and is taxed as a trust. An estate's ownership is expressly provided for in section 1361(b)(1)(B). Typically, the estate will receive its S stock from a decedent. However, if an estate acquires shares of a C corporation from a decedent or purchases shares of a C corporation, the estate may consent to an S election by a C corporation.⁴⁵ The bankruptcy estate of an individual under Title 11 of the U.S. Code is also an eligible shareholder.⁴⁶

Care must be taken not to unduly prolong the administration of a decedent's estate or it will be deemed terminated under section 641(a)(3) and Treasury Regulations section 1.641(b)-3(a). In Revenue Ruling 76-23,⁴⁷ the IRS ruled that an estate could continue to remain open and own S corporation stock during the period it was paying estate taxes under section 6166.⁴⁸

None of these exceptions that permit a trust to be a shareholder of an S corporation apply to a foreign trust as defined in section 7701(a)(13),

Ugly, 11 PROB. & PROP., Sept.–Oct. 1997, at 50; F.G. Corneel, *ESBTs and Crummey Trusts*, TAX MGMT. WKLY. REP. 962 (July 6, 1998); S. Traum, *New IRS Guidance Provides Fresh Impetus for Using Electing Small Business Trusts*, 94 J. TAX'N 285 (May 2001).

41. I.R.C. § 1361(c)(6).

42. Rev. Rul. 92-73, 1992-2 C.B. 224. *See also* Priv. Ltr. Rul. 199933035. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

43. I.R.C. § 1361(c)(2)(A)(vi).

44. *Taproot Admin. Servs., Inc. v. Comm'r*, 133 T.C. 202 (2009).

45. *See* Priv. Ltr. Rul. 7951131. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

46. I.R.C. § 1361(c)(3).

47. Rev. Rul. 76-23, 1976-1 C.B. 264.

48. If an estate qualifies, it may elect to pay some portion of its federal estate taxes attributable to certain closely held business interests owned by the estate over a term of years following the normal due date.

apparently even if the grantor is a resident or citizen of the United States,⁴⁹ and even if the grantor is regarded as the owner of the entire trust under the grantor trust rules.⁵⁰

§ 8:3 Subpart E Trusts (Grantor Trusts)

A trust that is treated as being owned entirely by an individual who would be an eligible shareholder may own S corporation stock.⁵¹ That individual “owner” (the grantor of the trust, or other person treated as the owner under section 678) is treated as the shareholder.⁵² The deemed-owner individual must be a U.S. citizen or resident.⁵³ Under the grantor trust rules discussed in chapter 5, it is possible for an individual to be the deemed owner of all or part of a trust for income tax purposes. The rule of section 1361(c)(2)(A)(i) is satisfied only if the individual is the owner of “all” of the trust. The regulations provide an example of a qualified subpart E trust (a “qualified grantor trust” that may own S corporation stock):

In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require

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49. Under I.R.C. § 679, a foreign trust created by an American for Americans is treated as owned by the creator during the creator's lifetime. *See* chapter 6, *supra*; I.R.C. § 1361(c)(2) (last sentence). In fact, if S corporation stock is held by a foreign trust, the corporation cannot be an S corporation even if the trust is a grantor trust in its entirety. Treas. Reg. § 1.1361-1(h)(2).
50. This seems to be the result, even though it is the position of the IRS that a grantor trust, apparently even a foreign grantor trust, is entirely ignored for all federal income tax purposes. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
51. I.R.C. § 1361(c)(2)(A)(i).
52. I.R.C. § 1361(c)(2)(B)(i). *See* Priv. Ltr. Rul. 200147044 (each trust, apparently under the same trust agreement, is an eligible S shareholder where each beneficiary of the trust has unilateral right to withdraw all contributions to the trust, making each beneficiary an owner of the trust assets under I.R.C. § 678). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
53. I.R.C. § 1361(c)(2)(A)(i); Treas. Reg. § 1.1361-1(h)(1)(i). *See* I.R.S. Tech. Adv. Mem. 9707005 as an example. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. *Compare* Estate of O'Connor v. Comm'r, 69 T.C. 165 (1977) (trust's existence ignored where I.R.C. § 678 grantor trust rule applies), *with* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) (trust's existence not ignored). The IRS will not follow *Rothstein*. Rev. Rul. 85-13, 1985-1 C.B. 184. The deemed owner of the trust under the grantor trust rules is treated as the shareholder. Treas. Reg. § 1.1361-1(h)(3)(i)(A).

that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.⁵⁴

Moreover, the regulation example continues to provide an example of a deemed owner under section 678:

[T]he terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.⁵⁵

If the grantor of the trust, under sections 671–77, is treated as the entire owner of a trust under the grantor trust rules or the owner of the S stock portion of a trust, a current income beneficiary of a trust may not make the QSST election discussed below.⁵⁶ When, however, the beneficiary of a trust, or beneficiaries who are husband and wife, are the deemed grantors under section 678, a QSST election is permitted.⁵⁷

The IRS has ruled that a “Crummey trust” is a section 678 grantor trust because of the noncumulative right of withdrawal held by the beneficiary.⁵⁸ In the S corporation stock context, the IRS ruled in

54. Treas. Reg. § 1.1361-1(k)(1), ex. 2(i). I.R.C. § 1361(b)(1) limits who may own S corporation stock. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

55. Treas. Reg. § 1.1361-1(k)(1), ex. 2(iii). I.R.C. § 1361(b)(1) limits who may own S corporation stock. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

56. Treas. Reg. § 1.1361-1(j)(6)(iv).

57. *Id.*

58. Priv. Ltr. Rul. 200147044. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. For a discussion of the topic, see Charles E. Early, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status*, 62 J. TAX'N, 198 (Apr. 1985).

Private Letter Ruling 200147044⁵⁹ that a series of trusts created by a grantor were section 678 trusts because of the beneficiaries, rights of withdrawal, and, as a consequence, the trusts could own S corporation stock as grantor trusts. Not all Crummey trusts necessarily qualify because it's possible that a donor to the trust may contribute more to the trust than the beneficiary may withdraw. For example, it is not uncommon for the trust to limit Crummey withdrawal powers to the maximum amount that qualifies for the gift tax annual exclusion (currently \$12,000 or \$24,000 for a married donor whose spouse agrees to "split gift" under section 2513), but the gift to the trust exceeds the amount that may be withdrawn.

Similarly, the IRS has ruled that a grantor's retained interest in a so-called "grantor retained annuity trust" or "GRAT" described in section 2702(b) may result in the grantor being deemed the owner of the entire trust for income tax purposes. In a private letter ruling, the grantor retained an annual annuity payment and a general testamentary power of appointment if the grantor did not survive the GRAT term.⁶⁰ Because the GRAT was a grantor trust based on these terms of the trust, it could own S corporation stock.

Similarly, the IRS has ruled that a charitable lead annuity trust may qualify as an S corporation shareholder as a section 674 grantor trust.⁶¹

In Private Letter Ruling 200841007, the grantor created several grantor trusts and transferred to the trusts interests in a wholly-owned LLC that owned S corporation stock. Later that year, the grantor died, and, as a result, the trusts were no longer grantor trusts. The Service ruled that the LLC became a partnership for tax purposes on the date of the decedent's death and the S election terminated immediately although the LLC was terminated later that same year by distributing the S corporation stock to the trusts. The letter ruling concluded that the termination was inadvertent and granted section 1362(f) relief so S status was not lost.

59. Priv. Ltr. Rul. 200147044. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

60. See Priv. Ltr. Rul. 200227022. *But see* Priv. Ltr. Rul. 199916047, in which a trust intended to qualify as a GRAT and a grantor trust, but qualified as neither. Because the trust failed to be a grantor trust, it was not a qualified S corporation shareholder. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

61. See Priv. Ltr. Rul. 19993603. A charitable lead trust is not defined by the Code but is described in I.R.C. § 170(f)(2) as a trust from which an annuity or unitrust amount is paid to a charity for a specific period of time. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

§ 8:4 Two-Year Trusts, Testamentary Trusts and Section 645 Trusts

Upon the death of the deemed owner of a grantor trust, the trust no longer qualifies as an S shareholder by reason of being a qualified subpart E trust (or grantor trust) because the grantor trust status automatically terminates upon the grantor's death. Nevertheless, after the grantor's death the trust may continue in existence. If it does, it may continue to own the S stock for up to two years, during which time the estate is deemed a qualified shareholder.⁶² An exception to this rule exists if the trust continues to be a subpart E trust (or grantor trust) after the grantor's death. The regulations provide an example of continuing subpart E status as a result of section 678:

[T]he terms of the trust also provide that if *A* does not exercise the power to revoke before *A*'s death, *B* will have the sole power to withdraw all trust property at any time after *A*'s death. The trust continues to qualify as a qualified subpart E trust after *A*'s death because, upon *A*'s death, *B* is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon *A*'s death, *B* (and not *A*'s estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.⁶³

The continuing qualification of a grantor trust to own S corporation stock terminates upon the second anniversary of the deemed owner's death or upon the distribution of the S corporation stock by the trust, whichever is earlier.⁶⁴ Of course, the trust may thereafter qualify to own S corporation stock if it is another type of qualifying trust such as an electing QSST or ESBT. If the stock is community property, this rule applies only to the extent that the decedent's community property interest is included in the decedent's estate. The surviving spouse remains the shareholder of the remaining applicable state law community property interest.⁶⁵

The regulations provide an example of the continuing qualification of a trust after the death of the deemed owner:

62. Treas. Reg. § 1.1361-1(h)(3)(i)(B).

63. Treas. Reg. § 1.1361-1(k)(1), ex. 2(iii). I.R.C. § 1361(b)(1) limits who may own S corporation stock. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

64. *Id.*

65. *Id.* See Priv. Ltr. Ruls. 200031038, 200027032, discussing the treatment of community property stock after the death of one spouse. See also Priv. Ltr. Rul. 19993603. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

In 1997, *A*, an individual established a trust and transferred to the trust *A*'s shares of stock of Corporation *M*, an S corporation. *A* has the power to revoke the entire trust. The terms of the trust require that all income be paid to *B* and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after *A*'s death. *A* dies without having exercised *A*'s power to revoke. Upon *A*'s death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). *A*'s estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1).⁶⁶ *A*'s estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation *M* stock by the trust (other than to *A*'s estate), the expiration of the 2-year period beginning on the day of *A*'s death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT. However, until that time, because the trust continues in existence after *A*'s death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368.⁶⁷ If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.⁶⁸

The effect of this example is the estate is considered the shareholder for purposes of a qualified owner of the S corporation stock, that is, for purposes of section 1361(b)(1), but the trust is taxable on its share of S corporation income under section 1366 and the basis rules of section 1367 and the distribution rules of section 1368 apply to the trust. This treatment is the same as when the trust is a qualified S corporation shareholder because of a QSST election, that is, the estate of the qualifying QSST beneficiary is the deemed shareholder and the trust reports its share of S corporation income.⁶⁹

Care must be taken to avoid an unintended termination of an S election when the two-year period has expired. For example, in Private Letter Ruling 200602015,⁷⁰ S stock was held in a revocable

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66. I.R.C. § 1361(b)(1) limits who may own S corporation stock.
67. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).
68. Treas. Reg. § 1.1361-1(k)(1), ex. 2. If the qualified subpart E trust makes an I.R.C. § 645 election, the time period it qualifies to own S corporation stock is potentially extended by the I.R.C. § 645 election. See the discussion of the I.R.C. § 645 election at notes 79–83, *infra*, and accompanying text.
69. See notes 176–80, *infra*, and accompanying text.
70. Priv. Ltr. Rul. 200602025. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

trust that was a permitted S shareholder as a grantor trust. When the grantor died, the S stock remained in the trust, which continued to qualify as an S shareholder under the two-year rule. Before the expiration of the two-year period, the trust (Trust 1) transferred the stock to a second trust (Trust 2) that was not an eligible shareholder. Pursuant to the provisions of a buy-sell agreement, the transfer to Trust 2 was null and void, and Trust 1 continued as the shareholder and no other attempt was made to transfer the S stock out of the grantor trust within the two-year time limit. Thus, the S election terminated upon the second anniversary of the grantor's death.⁷¹

Similar to a grantor trust, any trust that receives stock from a decedent's estate pursuant to the terms of a decedent's will is an eligible shareholder for the two-year period beginning on the date that the S corporation stock is transferred to the trust, although the estate of the testator is still the deemed shareholder.⁷² If thereafter the trust makes either a QSST election or an ESBT election, both of which are discussed below, the estate is no longer treated as the shareholder, but rather the QSST or ESBT rules control as to whom the shareholder is for S corporation purposes.⁷³ The regulations provide an example of a trust receiving stock from a decedent's estate and include a second example of a grantor trust owned by a decedent at death:

F owns stock of Corporation *P*, an S corporation. In addition, *F* is the deemed owner of a qualified subpart E trust that holds stock in Corporation *O*, an S corporation. *F* dies on July 1, 2003. The trust continues in existence after *F*'s death but is no longer a qualified subpart E trust. On August 1, 2003, *F*'s shares of stock in Corporation *P* are transferred to the trust pursuant to the terms of *F*'s will. Because the stock of Corporation *P* was not held by the trust when *F* died, section 1361(c)(2)(A)(ii)⁷⁴ does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii),⁷⁵ the last day on which the trust could be treated as a permitted shareholder of Corporation *P* is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation *O* held by

71. See also Priv. Ltr. Rul. 200542031 (grantor trust failed to distribute the S stock to another qualifying trust within two years of the grantor's death). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

72. Treas. Reg. § 1.1361-1(h)(3)(i)(B). For purposes of I.R.C. §§ 1366-68, the trust is the deemed shareholder. See Treas. Reg. § 1.1361-1(h)(3)(ii)(B).

73. Treas. Reg. § 1.1361-1(h)(3)(i)(D).

74. I.R.C. § 1361(c)(2)(A)(ii) permits a former subpart E trust to own S corporation stock for up to two years.

75. I.R.C. § 1361(c)(2)(A)(iii) permits a trust that receives S corporation stock pursuant to a will to own it for up to two years.

the trust at the time of *F*'s death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation *O* is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of *F*'s death).⁷⁶

Even when S corporation stock is transferred by a testamentary trust to a trust that may qualify as an S corporation shareholder as either a QSST or an ESBT, an affirmative election is required to prevent termination of the corporation's S election. In Private Letter Ruling 200305021,⁷⁷ S stock was transferred within two years to a trust that could qualify to own S corporation stock, but the beneficiary did not make the required QSST election, which resulted in termination of the corporation's S election.⁷⁸

A section 645 electing trust (a trust that elects to be treated as part of the decedent's estate for income tax purposes pursuant to section 645) continues to be a qualified shareholder during the period for which the section 645 election applies or until the stock is distributed, whichever is earlier; if the S stock is distributed to a successor trust, this trust is a qualified shareholder for an additional two years commencing on the date of the distribution.⁷⁹ Thus, a garden variety revocable trust that makes a section 645 election can hold the S stock for the duration of its section 645 election period.⁸⁰ When the section 645 electing trust distributes the S stock to a non-qualifying trust, the second trust can continue to qualify as an S shareholder for an additional two years from the date of the stock distribution. The regulations provide the following example:

F is the deemed owner of a qualified subpart E trust that holds stock in Corporation *O*, an S corporation. *F* dies on July 1, 2003.

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76. Treas. Reg. § 1.1361-1(k)(1), ex. 3(i).
77. Priv. Ltr. Rul. 200305021. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
78. In the private letter ruling, relief was granted under I.R.C. § 1362(f) for an inadvertent termination when the beneficiary agreed to execute the correct form. See section 8:9 for a discussion of I.R.C. § 1362(f) relief. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
79. Treas. Reg. § 1.1361-1(k)(1), ex. 3(ii).
80. If made, the election is effective as of the decedent's death, and it expires:
- (i) the day preceding the date two years after the decedent's death, if a federal estate tax return (Form 706) is not required to be filed, or
 - (ii) if an estate tax return is filed, the day that is six months after the "final determination of liability for estate tax. See I.R.C. § 645(b)(2).
- Upon termination of the election, there is a deemed distribution of all the assets of the electing trust to a new trust. Treas. Reg. § 1.645-1(h)(1). See also the discussion of I.R.C. § 645 in section 3:8.

The trust continues in existence after *F*'s death but is no longer a qualified subpart E trust. . . . *F*'s trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of *F*'s estate, the trust may continue to hold the *O* stock pursuant to section 1361(b)(1)(B), without causing the termination of Corporation *O*'s S election, for the duration of the section 645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation *O* are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.⁸¹

In Private Letter Ruling 200529006,⁸² the IRS ruled that a trust that makes a section 645 election is a qualified shareholder from the time the election is made, and the same trust may hold S corporation stock for an additional two-year period. The particular trust in question had elected to defer payment of estate taxes under section 6166 and sought a ruling that the trust could hold the S corporation stock for the section 6166 election period without terminating the S election. The IRS did rule, however, that the trust could make an ESBT election at the end of the two-year period that followed the section 645 election period. The result in the private letter ruling should be compared with Revenue Ruling 76-23,⁸³ in which the IRS ruled that an estate could continue to remain open and own S corporation stock during the period it was paying estate taxes under section 6166. To extend the time an estate is deemed open for section 6166 purposes, the personal representative might file a protective claim for refund of estate taxes to deduct additional estate administration expenses that are likely to arise after the original estate tax return is filed. So long as the IRS leaves the claim for refund open, the "final determination of estate tax liability" has not occurred, and, as a result, the section 645 election should still be in effect.

81. Treas. Reg. § 1.1361-1(k)(1), ex. 3.

82. Priv. Ltr. Rul. 200529006. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

83. Rev. Rul. 76-23, 1976-1 C.B. 264.

§ 8:5 Voting Trusts

A voting trust is a qualified S corporation shareholder if the trust is created pursuant to a written trust instrument and the beneficial owners are the deemed owners under the grantor trust rules.⁸⁴ For purposes of the S corporation ownership rules, a voting trust is a trust established “primarily to exercise the voting power of S corporation stock transferred to it.”⁸⁵ The writing must delegate the right to vote to the trustee(s), require all distributions with respect to the stock to be made to or for the benefit of the beneficial owners, and terminate under the terms of the agreement or state law by delivering title or possession of the stock to the beneficial owners.⁸⁶ For ownership purposes, the stock held in the voting trust is deemed to be owned proportionately by the beneficial owners.⁸⁷ The regulations do not require that distributions be made currently. In Private Letter Ruling 201226019, the Service approved a voting trust to hold title to stock of an S corporation.⁸⁸

§ 8:6 Qualified Subchapter S Trusts (QSSTs)

A “Qualified Subchapter S Trust,” commonly known as a QSST, is a permitted S corporation shareholder. A QSST is a trust that owns stock in an S corporation, and that distributes or is required to distribute currently⁸⁹ all of its accounting income⁹⁰ to one individual who is a citizen or resident of the United States and who makes the required election.⁹¹

§ 8:6.1 One Current Income Beneficiary per QSST

Section 1361(d)(3)(A) provides that the terms of the trust must require that there be only one income beneficiary during the life of the

84. Treas. Reg. § 1.1361-1(h)(1)(v).

85. *Id.*

86. *Id.*

87. Treas. Reg. § 1.1361-1(h)(3)(i)(D).

88. *See* Priv. Ltr. Rul. 201226019. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

89. Treas. Reg. §§ 1.651(a)-2(a) and 1.663(b)-1(a) determine whether all income is distributed or is required to be distributed currently. Treas. Reg. § 1.1361-1(j)(1)(i).

90. This has the same meaning as under Treas. Reg. § 1.643(b)-1. Treas. Reg. § 1.1361-1(j)(1)(i). Unless otherwise provided under local law (including governing instrument provisions which are effective under local law), income includes distributions from the S corporation but not amounts merely imputed under I.R.C. § 1366. *Id.*

91. I.R.C. § 1361(d)(3)(B).

current income beneficiary,⁹² and that if corpus may be distributed during the life of the current income beneficiary, it is distributable only to that beneficiary.⁹³ Further, the income interest of the current beneficiary must terminate on the death of the beneficiary, or, if the trust terminates before the beneficiary's death, all of the trust assets must be distributable to that beneficiary.⁹⁴ The rules of section 1361(d)(3)(A) must be satisfied as of the earlier of the date the QSST election is made or when it is effective, and must be satisfied at all times thereafter.⁹⁵

Compliance with the one beneficiary rule is dependent on both the trust document and state law not permitting a second beneficiary to receive either income or principal.⁹⁶ If there is a possibility that a second person may be a beneficiary under either the document or state law, the trust will not qualify as a QSST.⁹⁷

The limitation on income beneficiaries is illustrated in two examples. The regulations provide that "a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust."⁹⁸ However, the second regulation example illustrates that it is not mandatory that a qualifying trust prohibit distributions to someone other than the current beneficiary during the current beneficiary's lifetime. This example provides that:

A contributes S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A)(ii) or (iv).⁹⁹

92. I.R.C. § 1361(d)(3)(A)(i).

93. I.R.C. § 1361(d)(3)(A)(ii).

94. I.R.C. § 1361(d)(3)(iii)-(iv).

95. Treas. Reg. § 1.1361-1(j)(1)(iii).

96. Treas. Reg. § 1.1361-1(j)(2)(ii)(A).

97. Treas. Reg. § 1.1361-1(j)(1)(iii); Treas. Reg. § 1.1361-1(j)(2)(ii)(A). The regulations do not seem to permit anyone, not even the beneficiary, to have a power to appoint income or principal of the trust to anyone other than the current beneficiary.

98. Treas. Reg. § 1.1361-1(j)(2)(ii)(A). The regulation does not provide an example of state law that might provide this result, however.

99. Treas. Reg. § 1.1361-1(k)(1), ex. 6. I.R.C. § 1361(d)(3)(A)(ii) requires that any distributions of trust principal may only be made to the current income

As discussed below, one consequence of a QSST election is that the beneficiary is deemed a section 678 owner of the portion of the trust consisting of S corporation stock.¹⁰⁰ If state law alters the section 678 grantor trust status of the QSST, the trust is not a qualified QSST. Thus, “if under local law a distribution to the income beneficiary is in satisfaction of the grantor’s legal obligation of support to that beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor is treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor is treated as a beneficiary under section 662.”¹⁰¹ The regulation provides an example:

F creates a trust for the benefit of *F*’s minor child, *G*. Under the terms of the trust, all income is payable to *G* until the trust terminates on the earlier of *G*’s attaining age 35 or *G*’s death. Upon the termination of the trust, all corpus must be distributed to *G* or *G*’s estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to *G* that will be in satisfaction of *F*’s legal obligation to support *G*. Under the applicable local law, distributions of trust income to *G* will satisfy *F*’s legal obligation to support *G*. If the trustee distributes income to *G* in satisfaction of *F*’s legal obligation to support *G*, the trust will not qualify as a QSST because *F* will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.¹⁰²

Notwithstanding the rule that grantor trust status prevents a QSST election, the regulations permit a trust to qualify as a QSST even though someone other than the current income beneficiary is the deemed grantor so long as the deemed ownership relates only to a

beneficiary and I.R.C. § 1361(d)(3)(A)(iv) requires that if the trust terminates during the current income beneficiary’s lifetime, the trust principal must be distributed to the current income beneficiary.

100. See section 8:6.4.

101. Treas. Reg. § 1.1361-1(j)(2)(ii)(B). The regulation references “§ 1.677(b)-1 for rules on the treatment of trusts for support and § 1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.” Under I.R.C. § 677(b), a trust is not an I.R.C. § 677 grantor trust until the trustee (other than the grantor) actually makes a distribution of income in discharge of the grantor’s obligation to support or maintenance the beneficiary. If the distribution is made from principal, the grantor is a deemed beneficiary under I.R.C. §§ 661(a)(2) and 662 instead.

102. Treas. Reg. § 1.1361-1(j)(2)(ii)(C).

portion of the trust which does not consist of the S corporation stock.¹⁰³ Moreover, the trust must still satisfy the requirements of Treasury Regulations section 1.1361-1(j)(1)(i)-(ii), that is, the income distribution rule discussed in section 8:6.2 and the one current income beneficiary rule discussed in section 8:6.1.

A trust with separate and independent shares within the meaning of section 663(c) may qualify as a QSST, but only if the terms of the trust satisfy the QSST rules for each share.¹⁰⁴ Also, the trust must satisfy the requirements of Treasury Regulations section 1.1361-1(j)(1)(i)-(ii), that is, the income distribution rule discussed in section 8:6.2 and the one current income beneficiary rule discussed in section 8:6.1. Nevertheless, if there is any possibility that trust principal might be distributed to someone other than the beneficiary of each share during the beneficiary's lifetime, the trust does not qualify as a QSST. In Revenue Ruling 93-31,¹⁰⁵ there was a remote possibility that a beneficiary of one share would receive property from another's share. This was not sufficient to deny "separate share" treatment under section 663(c), but it was sufficient to prevent the trust from qualifying as a QSST. In addition, a trust being managed with sub-trusts, but not qualifying for separate share treatment under section 663(c), is not a permissible S corporation shareholder.¹⁰⁶

An income beneficiary's power to transfer or assign the income interest pursuant to state law or the trust instrument does not prevent the trust from qualifying as a QSST.¹⁰⁷ The same is true if it is possible for someone to be considered a beneficiary under Treasury Regulations section 1.643(c)-1.¹⁰⁸ Nevertheless, if the beneficiary assigns all or part of the income interest, or if a second person is deemed a beneficiary under Treasury Regulations section 1.643(c)-1, the trust may no longer qualify as a QSST, "depending on the facts and circumstances." The regulations do not explain what "facts and circumstances" will

103. Treas. Reg. § 1.1361-1(j)(2)(vi).

104. I.R.C. § 1361(d)(3); Treas. Reg. § 1.1361-1(j)(3). The separate-share rules at Treas. Reg. § 1.663(c)-2(b)(4) provide rules for allocating S corporation income when the income is not accompanied by an equal cash distribution. See the discussion in section 3:5.3.

105. Rev. Rul. 93-31, 1993-1 C.B. 186.

106. See Priv. Ltr. Rul. 9950018. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

107. Treas. Reg. § 1.1361-1(j)(2)(iv).

108. *Id.* Treas. Reg. § 1.643(c)-1 provides that a beneficiary includes (1) a person whose legal obligation is discharged or satisfied by a payment from the trust, (2) a person treated as a grantor of a trust under I.R.C. § 677 because payments are made for the support of a dependent, or (3) a trustee who is a deemed grantor under I.R.C. § 678 because the trustee makes support payments for a dependent.

determine whether the qualified status is lost. The regulations provide an example of how an assignment will disqualify a QSST:

On January 1, 1996, stock of Corporation *R*, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, *K*, from assigning *K*'s income interest in the trust. *K* files a timely QSST election that is effective January 1, 1996. On July 1, 1996, *K* assigns the income interest in the trust to *N*. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to *N*. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii)¹⁰⁹ because *N*'s interest will terminate on *K*'s death (rather than on *N*'s death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation *R* ceases to be an S corporation.¹¹⁰

It is not mandatory for the trust to prohibit a court from transferring an interest in a qualifying trust.¹¹¹ However, if a court-ordered transfer occurs, the trust must continue to meet the QSST trust rules after the assignment, or the S election will terminate. For example, a family court might award one spouse's trust income interest to the other spouse in a divorce proceeding. If the first spouse's interest terminates on that spouse's death, the trust will not qualify as a QSST after the court-ordered transfer, because the new income beneficiary's interest will not terminate on the death of the second spouse.

A special power of appointment, even in the current income beneficiary, to appoint income or principal to anyone other than the current income beneficiary is not permitted, unless the power is held by the grantor and the grantor is the deemed owner of the entire trust.¹¹² In that event, the trust may qualify as a grantor trust under the grantor trust rules discussed above.

A special exception to the "one income beneficiary" rule permits a husband and wife to be joint income beneficiaries of a single trust.¹¹³ For this exception to apply, the spouses must file a joint return and be citizens or residents of the United States at all times that the election is effective. In addition, they must join in all actions related to the

109. I.R.C. § 1361(d)(3)(A)(iii) requires the income interest of the current beneficiary to terminate on the death of the current beneficiary or the termination of the trust.

110. Treas. Reg. § 1.1361-1(k)(1), ex. 5.

111. Treas. Reg. § 1.1361-1(j)(2)(v). The regulation's concession on this issue seems necessary; it does not seem possible that a document could always prevent a court from issuing an order that might disqualify a trust.

112. Treas. Reg. § 1.1361-1(j)(2)(iii).

113. Treas. Reg. § 1.1361-1(j)(2)(i), (6)(iv).

trust, such as providing a joint signature on the QSST election form or statement.

Besides a strict rule limiting current income distributions to one beneficiary, the regulations similarly take a strict position on distributions of principal to anyone other than the current income beneficiary. The regulations provide an example of the document failing to limit the number of principal beneficiaries:

[I]f the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.¹¹⁴

In Revenue Ruling 89-45,¹¹⁵ a trust permitted the distribution of principal to a new trust for after-born grandchildren of the grantor. This provision was deemed to be a violation of a QSST requirement. In addition, in Revenue Ruling 93-79,¹¹⁶ a trust that owned stock of a corporation permitted the distribution of principal to someone other than the current income beneficiary. Nevertheless, the corporation made an S election. The IRS ruled that the trust was not a qualified QSST and that a post-election reformation of the trust in state court to eliminate retroactively the disqualifying power to distribute principal back to the effective date of the S election was not retroactively effective for tax purposes. However, the IRS ruled that the reformation would be recognized prospectively and that the corporation could make a new election. Finally, in Revenue Ruling 89-55,¹¹⁷ a trust permitted distribution of principal to someone other than the current income beneficiary if the trust did not own S stock. The IRS ruled that the possibility of principal being distributed to a disqualifying person prevented the trust from satisfying the requirements of section 1361(d)(3)(A). Revenue Ruling 89-55 should be compared with Revenue Ruling 92-20,¹¹⁸ discussed below in section 8:6.2, in which the IRS ruled that a trust could qualify as a QSST even though the trust authorized the trustee to accumulate income when the trust did not own S corporation stock. In Revenue Ruling 89-55 the trust does not qualify as a QSST because there is possibility of distributions to more than one beneficiary, but in Revenue Ruling 92-20 the

114. Treas. Reg. § 1.1361-1(j)(1)(iii).

115. Rev. Rul. 89-45, 1989-1 C.B. 267.

116. Rev. Rul. 93-79, 1993-2 C.B. 269.

117. Rev. Rul. 89-55, 1989-1 C.B. 268.

118. Rev. Rul. 92-20, 1992-1 C.B. 301.

possibility of income accumulations does not disqualify the trust.¹¹⁹ The difference in the two rulings lies in the different code requirements being illustrated by the rulings. Revenue Ruling 89-55 is concerned with the rule that no distributions may be made to anyone other than the current beneficiary while Revenue Ruling 92-20 concerns the income distribution rule that may be satisfied even when the document does not require it so long as the trustee in fact distributes all income.

A qualifying QSST may have multiple beneficiaries after the death of the current income beneficiary, but it would no longer qualify as a QSST when the current income beneficiary dies. The regulations provide an example:

Corporation *Q*, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, *G*, a shareholder of Corporation *Q*, transfers *G*'s shares of Corporation *Q* stock to a trust with *H* as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, *H* makes a QSST election with respect to Corporation *Q* that is effective as of July 1, 1996. . . . *H* dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after *H*'s death, *L* is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to *L* as well as to *J*. The trust ceases to be a QSST as of November 1, [2003], because corpus distributions may be made to someone other than *L*, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), *H*'s estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after *H*'s death and will receive any distributions from the corporation, the trust (and not *H*'s estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period.¹²⁰ After the 2-year period, the S election terminates and the trust continues as a shareholder of a

119. A trust does not fail the QSST rules if it does not required the distribution of all accounting income, but all income must in fact be distributed or the trust will fail to qualify as a QSST. See the discussion of income distribution below at section 8:6.2.

120. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f).¹²¹ However, the S election would not terminate if the trustee distributed all Corporation Q shares to *L*, *J*, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither *L* nor *J* becomes the [101st] shareholder of Corporation Q as a result of the distribution.¹²²

Trusts may be reformed to qualify as QSSTs, notwithstanding Revenue Ruling 93-79.¹²³ The regulations provide an example:

On January 10, 1996, *M* transfers to a trust shares of stock in corporation *X*, an S corporation. *D*, who is 13 years old and not a lineal descendant of *M*, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the *X* shares) is to revert to *M*. The trust instrument provides that the trust will terminate upon the earlier of *D*'s death or *D*'s 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, *M* makes a gift of *M*'s reversionary interest to *D*. Until *M* assigns *M*'s reversion in the trust to *D*, *M* is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368,¹²⁴ *M* is the shareholder of *X*. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to *D* of *M*'s reversionary interest, *D* (upon his 21st birthday) or *D*'s estate (in the case of *D*'s death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A)(ii) and (iv)¹²⁵ even though the terms of the trust do not explicitly so provide. *D* must make a QSST election by no later than April 25, 1996 (the end of

121. See section 8:9 for a discussion of I.R.C. § 1362(f) relief.

122. Treas. Reg. § 1.1361-1(k)(1), ex. 4.

123. Rev. Rul. 93-79, 1993-2 C.B. 269.

124. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

125. I.R.C. § 1361(d)(3)(A)(ii) requires that any distributions of trust principal may only be made to the current income beneficiary and I.R.C. § 1361(d)(3)(A)(iv) requires that if the trust terminates during the current income beneficiary's lifetime, the trust principal must be distributed to the current income beneficiary.

the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M].¹²⁶

A non-qualifying QSST also may be reformed by a qualified disclaimer. In Private Letter Ruling 93-02-025,¹²⁷ a trust was able to meet the qualifications rules of a QSST as the result of a disclaimer.¹²⁸ In the ruling, after the death of a qualifying shareholder, S corporation stock was transferred to a family trust that benefited more than one person and thus did not qualify as a QSST. Thereafter, all but one beneficiary disclaimed their interest in the trust, and the trust then qualified after the IRS granted a waiver under section 1362(f) for the inadvertent termination.¹²⁹ Similarly the IRS has allowed a court-ordered reformation to qualify a trust as a QSST.¹³⁰

§ 8:6.2 Income Distribution Requirement

Besides the one current income beneficiary rule of section 1361(d)(3)(A) discussed above, a QSST under section 1361(d)(3)(B) must distribute or be required to distribute currently¹³¹ all of the accounting income¹³² to one individual who is a citizen or resident of the United

126. Treas. Reg. § 1.1361-1(k)(1), ex. 7.

127. Priv. Ltr. Rul. 9302025. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

128. A qualified disclaimer, described in I.R.C. § 2518, is a refusal to accept a gift or devise. It is notable that I.R.C. § 2518 applies generally for estate tax, gift tax, and generation-skipping transfer tax purposes, but in the private letter ruling the IRS is allowing it to have an income tax effect.

129. For other examples of disclaimers altering trusts to allow a QSST election, see Priv. Ltr. Rul. 9025086 and Priv. Ltr. Rul. 9640010. See section 8:9 for a discussion of I.R.C. § 1362(f) relief. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

130. See Priv. Ltr. Ruls. 200026017, 199930035. The private letter rulings should be compared with Rev. Rul. 93-79, 1993-2 C.B. 269, discussed in note 116 and accompanying text, in which the IRS ruled that a court-ordered reformation was not effective retroactively. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

131. Treas. Reg. §§ 1.651(a)-2(a) and 1.663(b)-1(a) determine whether all income is distributed or is required to be distributed currently. Treas. Reg. § 1.1361-1(j)(1)(i).

132. This has the same meaning as under Treas. Reg. § 1.643(b)-1. Treas. Reg. § 1.1361-1(j)(1)(i). Unless otherwise provided under local law (including governing instrument provisions which are effective under local law), income includes distributions from the S corporation but not amounts merely imputed under I.R.C. § 1366. *Id.* In January 2004, amendments to

States.¹³³ When a trust is an S corporation shareholder for only part of a year, this rule is applicable only for that portion of the year in which the trust owns S stock.¹³⁴

The regulations provide an example of a trust that is not required to distribute all fiduciary accounting income:

Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.¹³⁵

When a trust does not require the distribution of all fiduciary accounting income, it is easy for the trustee to terminate the S corporation election. The regulations provide an example:

Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. . . . [F]or the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an

the I.R.C. § 643 regulations revised the definition of accounting income to follow changes in state law definitions of accounting income. See Treas. Reg. § 1.643(b)(1), permitting unitrust income interests and equitable adjustments to classify principal as fiduciary accounting income.

133. I.R.C. § 1361(d)(3)(B).

134. Treas. Reg. § 1.1361-1(j)(1)(i).

135. Treas. Reg. § 1.1361-1(k)(1), ex. 4. I.R.C. § 1361(b)(1) limits who may own S corporation stock. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

S corporation as of January 1, 1998, because the trust is not a permitted shareholder.¹³⁶

The requirement to distribute all accounting income includes any income distribution of the S corporation (that is, cash-flow) but does not include “the trust’s pro rata share of the S corporation’s items of income, loss, deduction, or credit determined under section 1366.”¹³⁷ The regulations reference Treasury Regulations sections 1.651(a)-2(a) and 1.663(b)-1(a) to determine whether a trust requires all income to be distributed. If a trust does not require all income to be distributed, the section 663(b) sixty-five-day election discussed in section 3:5.5 is available to a QSST to insure that all trust accounting income is in fact distributed.

If a trust is not required to distribute all of its income currently and fails actually to do so, the trust no longer qualifies a QSST as of the first day of the tax year that follows the taxable year in which the distribution was supposed to occur, but did not.¹³⁸ Private Letter Ruling 200550012 illustrates the rule.¹³⁹

Over the years, the IRS has provided guidance as to the income distribution rule. In Revenue Ruling 92-20,¹⁴⁰ the IRS ruled that a trust authorizing the trustee to accumulate income if it no longer held S shares can be a QSST, because the statute does not mandate distributions of income, but rather only that the accounting income is actually distributed. In Revenue Ruling 92-64,¹⁴¹ the IRS ruled that accounting income received by a trust between the date of the last distribution and the date of the current income beneficiary’s death may be distributed in accordance with state law to either the estate of the income beneficiary or to the next income beneficiary of the trust.¹⁴²

136. *Id.* See also Priv. Ltr. Ruls. 200006042, 200002021. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

137. Treas. Reg. § 1.1361-1(j)(1)(i).

138. Treas. Reg. § 1.1361-1(j)(5).

139. See Priv. Ltr. Rul. 200550012, in which S corporation stock was owned by a QSST that did not distribute all of its income. The IRS granted relief under I.R.C. § 1362(f) for the inadvertent termination of the S election as a result of the trust not distributing all of its income. See section 8:9 for a discussion of I.R.C. § 1362(f) relief. See also Priv. Ltr. Rul. 201047018. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

140. Rev. Rul. 92-20, 1992-1 C.B. 301.

141. Rev. Rul. 92-64, 1992-2 C.B. 94.

142. *Id.* The ruling does not answer the question if the document, rather than state law, provides either result. Presumably, the answer would be the same if the document provided either. In Priv. Ltr. Rul. 8509043, the IRS held that a trust is a QSST when, on its termination, “any income not distributed at the . . . wife’s death shall be paid to her estate [or

QSSTs and charitable remainder trusts (CRTs) are mutually exclusive according to the IRS. In Revenue Ruling 92-48,¹⁴³ the IRS noted the differing tax schemes are incompatible. The income of a QSST is taxable to the income beneficiary because of the election to be a section 678 grantor trust, while the income of a CRT is taxable to the beneficiary only to the extent it is required to be distributed, and any excess is exempt from current income taxes because the CRT is a tax-exempt entity under section 664.¹⁴⁴

§ 8:6.3 The QSST Election

For a trust to be a permitted S corporation shareholder as a QSST, the income beneficiary must affirmatively elect to be treated under section 678 as the owner of the portion of the trust that consists of qualifying S stock, and thus be the deemed shareholder.¹⁴⁵ The QSST election does not, however, make the income beneficiary the deemed owner of the balance of the trust income and assets.¹⁴⁶ Care must be taken when the beneficiary is also the trustee that the election is made by the individual in the capacity as beneficiary and not as trustee.¹⁴⁷

[A] Making the Election

The regulations require detailed information for a QSST election, and provide that an effective statement:

- (A) Contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;
- (B) Identifies the election as an election made under section 1361(d)(2);

undistributed income [and corpus] shall be distributed to such persons . . . as decedent's wife shall appoint by will." Priv. Ltr. Rul. 8509043. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

143. Rev. Rul. 92-48, 1992-1 C.B. 301.

144. *Id.*; I.R.C. §§ 678, 671, 664.

145. Treas. Reg. § 1.1361-1(j)(8), (7)(i).

146. I.R.C. § 1361(d)(1)(B), (c)(2) (last sentence). In Priv. Ltr. Rul. 200352014, the trustee of a trust signed the QSST election as trustee instead of as the income beneficiary. In the ruling, the IRS granted I.R.C. § 1362(f) relief for an inadvertent termination of the corporation's S election when trust beneficiary executed the proper form. See section 8:9 for a discussion of I.R.C. § 1362(f) relief. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

147. See Priv. Ltr. Rul. 9917058. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

- (C) Specifies the date on which the election is to become effective (not earlier than fifteen days and two months before the date on which the election is filed);
- (D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and
- (E) Provides all information and representations necessary to show that:
 - (1) Under the terms of the trust and applicable local law—
 - (i) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);
 - (ii) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;
 - (iii) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and
 - (iv) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.
 - (2) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.
 - (3) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.¹⁴⁸

To be timely, the QSST election must be made within two months and sixteen days after S stock is transferred to a trust.¹⁴⁹ The regulations provide an example:

On January 1, 1996, *F* transfers stock of an S corporation to an irrevocable trust whose income beneficiary is *F*'s son, *C*. Under the terms of the trust, *C* is given the noncumulative power to withdraw from the corpus of the trust the greater of \$5,000 or

148. Treas. Reg. § 1.1361-1(j)(6)(ii).

149. Treas. Reg. § 1.1361-1(j)(6)(iii)(A).

5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of *F*'s legal obligation to support *C*, the trust qualifies as a QSST. *C* (or, if *C* is a minor, *C*'s legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).¹⁵⁰

The two-months-and-sixteen-days rule also applies if a C corporation makes an S election, and then stock is transferred to a trust before the S election is effective.¹⁵¹ When a trust owns C corporation stock and an S election is made for the year of the election, the QSST election must be made within two months and sixteen days of the time that the S election is effective. In addition, even if the S election is effective for the year after it is made, the QSST election must still be made within two months and sixteen days of when the S election is made.¹⁵² Finally, if an S election is made for the current year and the QSST election is similarly made, but if under Treasury Regulation section 1.1362-6(a)(2), the S election is not effective until the next year, the QSST election is effective although it indicated that it was to apply for the current year.¹⁵³ For example, an S election made on February 1 of a calendar tax year is not effective for that tax year if one or more of the shareholders who owned stock on January 1, but who do not own stock on February 1, do not consent to the S election. In this circumstance, the S election is effective for the next tax year. A QSST election made on February 1 is effective for the next year, although the election indicated that it was effective for the first year.

The regulations provide an example of a corporation making an S election after C corporation stock has been transferred to a trust:

On January 1, 1996, stock of Corporation *T*, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation *T* files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).¹⁵⁴

150. Treas. Reg. § 1.1361-1(k)(1), ex. 8.

151. *Id.*

152. Treas. Reg. § 1.1361-1(j)(6)(iii)(B).

153. *Id.*

154. Treas. Reg. § 1.1361-1(k)(1), ex. 9(i).

The regulation also provides an example as to when the QSST election must be made if the corporation's S election is late:

On January 1, 1996, stock of Corporation *T*, a calendar year C Corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. . . . Corporation *T*'s election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.¹⁵⁵

Other fact patterns are not covered by the regulation examples, but the rules should work as follows:

1. S corporation stock is transferred to a trust on July 1. The QSST election must be made by September 16.
2. A calendar-year C corporation makes an election on October 1 of year one to be an S corporation for the next calendar year. On November 1 of year one, stock of the C corporation is transferred to trust. The QSST election must be made by January 16 of year two.
3. C corporation stock is held by a trust. On February 1, the C corporation files an S election. The QSST election must be made by March 16.

It should be noted that the S election must be made during the first two months and fifteen days of the tax year for the corporation, but the QSST election gets an extra day, as the regulations require it to be made within two months and sixteen days. The two-months-and-sixteen-days rule initially appears out of sync with the requirement that the election cannot be effective for more than two months and fifteen days before it is made. This is correct, however, as an election made on the sixteenth day of the third month can be effective for two months and fifteen days before it is made, which takes it back to the first day of the tax year.¹⁵⁶

Note also that the QSST election provided for in section 1361(d)(2) made by the beneficiary does not constitute an election for the

155. Treas. Reg. § 1.1361-1(k)(1), ex. 9(ii).

156. See Treas. Reg. § 1.1361-1(j)(6)(iii)(A).

corporation. The corporation must make the election provided for under section 1362(a) to be treated as an S corporation.¹⁵⁷

Once made, a QSST election may be revoked only with the consent of the IRS.¹⁵⁸ Permission will not be granted for a closed year or if the purpose is one of tax avoidance.¹⁵⁹ The private letter ruling format must be used to request permission.¹⁶⁰ A QSST may convert to an ESBT without the Commissioner's permission pursuant to the process described below in section 8:8.1.

A separate QSST election must be made for the stock of each S corporation held by a trust.¹⁶¹ The QSST elections must be made in addition to the qualifying corporations making timely and valid S elections.¹⁶²

The QSST election can either be made at the same time as the corporation's S election on Form 2553, or can be filed separately as a statement containing the required information outlined above.¹⁶³ For a person who is under a legal disability by reason of age, a QSST election may be made by legal or personal representative, or, if none exists, by a natural or adoptive parent.¹⁶⁴

For trusts that lose their grantor trust (qualified subpart E trust) status, a QSST election may be made within two months and sixteen days after the grantor trust status terminates, if the trust otherwise meets the QSST requirements.¹⁶⁵

157. Treas. Reg. § 1.1361-1(j)(6)(i).

158. Treas. Reg. § 1.1361-1(j)(11). Of course, a trustee might "void" the QSST election by exercising a prohibited power such as accumulating income, if the trust permits it, or a court-ordered reformation might void an S election by adding a prohibited power, such as a power to make distributions to a second beneficiary.

159. *Id.*

160. *Id.* The regulation provides:

The application must be signed by the current income beneficiary and must—

- (i) Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;
- (ii) Identify the election being revoked as an election made under I.R.C. § 1361(d)(2); and
- (iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

161. Treas. Reg. § 1.1361-1(j)(6)(i).

162. *Id.*

163. Treas. Reg. § 1.1361-1(j)(6)(ii). See note 144 and accompanying text.

164. Treas. Reg. § 1.1361-1(j)(6)(i). It should be noted that the regulation does not approve action by a natural guardian in the event that a natural guardian is not a natural or adoptive parent.

165. Treas. Reg. § 1.1361-1(j)(6)(iii)(C).

If a subpart E trust (a qualified grantor trust) continues after the grantor's death, upon the expiration of the permitted post-death holding period, the continuing trust must qualify as a QSST or some other type of qualifying S shareholder trust to continue to own the stock. Otherwise, the corporation's S election will terminate. If the trust meets the QSST rules, an affirmative QSST election is required to avoid a termination of the S election. The regulations provide an example:

In 1996, *A* and *A*'s spouse, *B*, created an *inter vivos* trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, *A* and *B* designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon *A*'s death, the trust is to be divided into two separate parts; one part attributable to the assets *A* contributed to the trust and one part attributable to *B*'s contributions. Before the trust is divided, and during the administration of *A*'s estate, all trust income is payable to *B*. . . . The part attributable to *A*'s contributions is to be divided into two separate trusts both of which have *B* as the sole income beneficiary for life. One trust, the Credit Shelter Trust, is to be funded with an amount that can pass free of estate tax by reason of *A*'s available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under section 20.2056(b)-7(b)(3) is directed to make an election under section 2056(b)(7).

On February 3, 1997, *A* dies and the portion of the trust assets attributable to *A*'s contributions including the S stock contributed by *A*, is includible in *A*'s gross estate under sections 2036 and 2038. During the administration of *A*'s estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), *A*'s estate is treated as the shareholder of the S corporation stock that was included in *A*'s gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder.¹⁶⁶ . . . On May 13, 1997, during the continuing administration of *A*'s estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in *A*'s gross

166. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

estate is distributed to the Marital Trust and to the Credit Shelter Trust. *A*'s estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). *B*, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust¹⁶⁷

When the estate of a deceased grantor qualifies as the shareholder, the trust can make a QSST election at any time, if it otherwise qualifies as a QSST, but must make the QSST election within two months and sixteen days after the estate of the deemed owner of the S stock is no longer considered a shareholder.¹⁶⁸ Finally, a testamentary trust that otherwise qualifies as a QSST may make a QSST election at any time, but the QSST election must be made within two months and sixteen days after the permitted two-year ownership expires.¹⁶⁹ In all of these instances, the failure to make a timely QSST election will terminate the corporation's S election.

[B] Death of a QSST Beneficiary

When the income beneficiary of a trust that has made a QSST election dies, the next beneficiary is deemed to consent to the QSST election unless the new beneficiary affirmatively disavows the election.¹⁷⁰ Of course, the QSST must otherwise continue to

167. Treas. Reg. § 1.1361-1(k)(1), ex. 1.

168. *Id.* See also section 8:2 for discussion of estate ownership of S corporation stock.

169. Treas. Reg. § 1.1361-1(j)(6)(iii)(D). See also section 8:4 for discussion of testamentary trust ownership of S corporation stock.

170. Treas. Reg. § 1.1361-1(j)(9)(i). The procedure for an affirmative refusal to consent is contained in Treas. Reg. § 1.1361-1(j)(10). The regulation provides:

- (i) Required statement. A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—
 - (A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;
 - (B) Identifies the refusal as an affirmative refusal to consent under I.R.C. § 1361(d)(2); and
 - (C) Sets forth the date on which the successive income beneficiary became the income beneficiary.
- (ii) Filing date and effectiveness. The affirmative refusal to consent must be filed within 15 days and 2 months after the date on

qualify.¹⁷¹ This rule applies to qualifying separate shares created at the time the income beneficiary changes.¹⁷² The deemed consent rule does not apply if the S stock held in the QSST is distributed to a trust that is considered a new trust under state law.¹⁷³ The regulations provide two examples:

Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.¹⁷⁴

Assume the same facts as in [the above] Example . . . , except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of trust A.¹⁷⁵

If the QSST requirements are no longer satisfied after the death of the current income beneficiary, but the trust continues to own S corporation stock, the estate of the income beneficiary is treated as the shareholder of the S corporation, unless the trust is a qualified grantor trust or the trust qualifies as an ESBT.¹⁷⁶ The estate will cease to be the deemed shareholder for section 1361(b)(1) purposes upon the transfer of the S stock by the trust or the second anniversary of the income beneficiary's death, whichever occurs first.¹⁷⁷ When the

which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

171. Treas. Reg. § 1.1361-1(j)(6).

172. See discussion of I.R.C. § 663 separate-share rules at note 104 and accompanying text.

173. Treas. Reg. § 1.1361-1(j)(9)(i).

174. Treas. Reg. § 1.1361-1(j)(9)(ii), ex. 1.

175. Treas. Reg. § 1.1361-1(j)(9)(ii), ex. 2.

176. I.R.C. § 1361(d)(1)(A), (c)(2)(A)(ii); Treas. Reg. § 1.1361-1(j)(7)(ii).

177. Treas. Reg. § 1.1361-1(j)(7)(ii).

estate is treated as the shareholder for section 1361(b)(1) purposes, the trust is the shareholder for sections 1366, 1367, and 1368 purposes as well.¹⁷⁸ This treatment is the same as when the beneficiary of a qualified subpart E trust (a grantor trust) dies, that is, the grantor's estate is the deemed shareholder and the trust reports its share of S corporation income.¹⁷⁹ If the trust continues to own the S corporation stock after two years, the corporation's S election will terminate if the trust does not otherwise qualify as an S shareholder.¹⁸⁰

[C] Disqualification As a QSST

Generally, if a trust ceases to meet the QSST requirements, it is treated as no longer qualifying as of the first day that a violation of the rules has occurred.¹⁸¹ Nevertheless, if the trust fails the income distribution rule, but continues to meet the other requirements, the disqualification occurs "as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement."¹⁸² An inadvertent termination of an S election resulting from the loss of QSST status may be ameliorated by a request to the IRS for inadvertent termination relief under section 1362(f).¹⁸³

If the QSST ceases to qualify on account of the death of an income beneficiary, it will continue to be an eligible shareholder for the two-year period immediately following the death of the current income beneficiary.¹⁸⁴

If an S corporation election is terminated because of a late QSST election, the inadvertent termination relief provisions of section 1362(f) may be used to cure the defect.¹⁸⁵

178. *Id.* I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

179. *See* note 69, *supra*, and accompanying text.

180. *Id.*

181. Treas. Reg. § 1.1361-1(j)(6).

182. *Id.*

183. *Id.* *See* section 8:9 for more discussion of the procedure for relief from an inadvertent termination of S corporation status.

184. I.R.C. § 1361(d)(1)(A), (c)(2)(A)(ii). The estate of the beneficiary is treated as the owner, provided the trust continues in existence. I.R.C. § 1361(d)(2)(A)(ii). The estate ordinarily will cease as the owner upon the earlier transfer of the shares from the trust or two years.

185. Treas. Reg. § 1.1361-1(j)(6)(iii)(E). *See* section 8:9 for a discussion of I.R.C. § 1362(f) relief.

§ 8:6.4 Income Tax Effect of the QSST Election

When a QSST election is made and becomes effective, the trust is considered to be a grantor trust under section 678 with respect to the electing beneficiary to the extent of the S corporation stock.¹⁸⁶ Thus, the beneficiary must be a qualified shareholder under section 1361(c)(2)(A)(i).¹⁸⁷ In addition, the QSST beneficiary is the shareholder for purposes of sections 1366, 1367, and 1368. These sections regulate the pass-through of the S corporation's income items (section 1366), adjustments to basis (section 1367), and taxation of distributions (section 1368). The treatment of the QSST beneficiary as the owner under section 678 does not apply until the corporation's S election is effective.

When a grantor trust converts to a QSST midyear, the regulations provide that the permissive election under Treasury Regulations section 1.1368-1(g) to close the accounting year rather than using as a per-day proration is not available.^{187.1} This exception is important when income of the S corporation is bunched into one side or the other of the same tax year. This election is available when the prior trust was a grantor trust before the grantor's death or a trust that receives stock from a decedent's estate that may hold the S corporation stock for two years.^{187.2}

In Chief Counsel Advice 201327009, the Service concluded that a QSST beneficiary may deduct interest paid by the QSST to acquire stock of an S corporation.¹⁸⁸ Nevertheless, the Service determined that the tracing rules of Treasury Regulation section 1.163-8T are applicable so that the interest expense must follow the debt proceeds and then interest for debt attributable to the S stock must be traced allocated among the assets of the pass-through entity.

The section 678(a) treatment of the income beneficiary does not apply to a sale of the S corporation stock.¹⁸⁹ The regulations explain: "For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be

186. I.R.C. § 1361(d)(1)(B).

187. I.R.C. § 1361(d)(1)(A).

187.1. Treas. Reg. § 1.1377-1(a)(2)(iii).

187.2. *Id.*

188. Chief Couns. Adv. 201327009. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

189. In Revenue Ruling 92-84, 1992-2 C.B. 216, the IRS ruled that a beneficiary who makes a QSST election is taxed on gains from the sale of S corporation stock, even though the gain was allocated to corpus and the beneficiary could not receive corpus. Nevertheless, the final regulations issued in 1995 change this result. See T.D. 8600, 1995-33 I.R.B. 10.

that of the trust, not the income beneficiary.”¹⁹⁰ Moreover, a distribution of the S stock by a QSST to the income beneficiary will terminate the QSST election as to that stock and the tax consequences of the distribution are neither determined under section 1361 nor as a result of the deemed status under section 678(a).¹⁹¹ For example, in Private Letter Ruling 199905011,¹⁹² the sale of the stock by the QSST caused the QSST election to terminate as to the stock sold, and any gain or loss recognized on the sale was attributed to the trust and not to the income beneficiary.¹⁹³

Nevertheless, the American Jobs Creation Act of 2004¹⁹⁴ added subsection (C) to section 1361(d)(1), which provides that “for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.”¹⁹⁵ Apparently this provision permits the beneficiary to use any passive activity/at-risk losses generated by the sale (instead of being limited to the trust’s ability to use the losses).

The rule that gains and losses of an S corporation are generally taxed to the QSST beneficiary, but gains and losses on the disposition of the S stock are taxed to the trust, can be a tax trap. The problem arises when the trust’s basis in the S corporation stock exceeds a pro-rata share of the S corporation’s basis in its assets. This factual pattern is common when the S corporation stock owned by the QSST has passed through a decedent’s estate and the stock received a stepped-up basis as a result of section 1014. If the S corporation sells its assets for a gain, the basis of the S stock increases. If, thereafter, the S corporation liquidates, then an individual shareholder may realize a tax loss because the stock’s basis will likely exceed the net proceeds realized on liquidation. Thus, for an individual shareholder, the loss on liquidation will partially or fully offset the pass-through gain if both the sale and liquidation occur in the same tax year. However, for the QSST beneficiary, the gain realized on the sale of the S corporation assets will be taxed to the beneficiary, but the loss realized on liquidation is deductible by the trust and not the beneficiary. This is

190. Treas. Reg. § 1.1361-1(j)(8).

191. *Id.*

192. Priv. Ltr. Rul. 199905011. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

193. *See also* Priv. Ltr. Rul. 9721020 (similar). Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.

194. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 236(a)(1)–(3), added subsection (C) to I.R.C. § 1361(d)(1). *See also* Treas. Reg. § 1.1361-1(j)(8), effective August 14, 2008.

195. I.R.C. § 1361(d)(1)(C).

not the result, however, if the trust has an ESBT election in place, as both gains and losses are taxed to the trust.¹⁹⁶

The negative tax result for the QSST beneficiary might be altered by switching the QSST election for an ESBT election. As discussed in section 8:8.1 below, the regulations permit the conversion of a QSST to an ESBT with the automatic consent of the Commissioner if certain conditions are met and the appropriate form is filed.¹⁹⁷ In the alternative, section 506(a)(3) of the 1997 Uniform Principal and Income Act permits the trustee to make an equitable adjustment to reimburse the beneficiary for the tax cost, but the adjustment is discretionary.¹⁹⁸

If a trust is a qualified shareholder of S corporation stock because of a QSST election, the charitable deduction may pass through. The QSST election makes the trust beneficiary a section 678 deemed grantor of the trust, and as a result, the income and deductions of the trust are reportable on the beneficiary's personal return. If this analysis is correct, a QSST (and its beneficiary) might be able to obtain a charitable deduction for a gift of principal by transferring property to an S corporation and then the S corporation makes a charitable gift. Of course, a trustee who considers this strategy must evaluate the fiduciary issues surrounding a gift of principal as the gift may be inconsistent with the settlor's intent. In a footnote in *Goldsby v. Commissioner*, the Tax Court entertained the idea that if the trust was a grantor trust as to both income and principal, the beneficiary might have been entitled to the pass-through charitable deduction but did not rule on the question.¹⁹⁹

§ 8:6.5 Marital Trusts As QSSTs

Most, but not all, trusts qualifying for the estate tax marital deduction could be QSSTs.²⁰⁰ The section 2056(b)(8) trust is the most common type that will not qualify because it is a charitable remainder trust. The so-called estate trust may or may not qualify depending on its terms.²⁰¹ It is common for estate trusts to permit the distribution of accounting income in the trustee's discretion, but the mandated accumulation of income is permissible for an estate trust

196. Treas. Reg. § 1.641(c)-1(d)(3).

197. Treas. Reg. § 1.1361-1(j)(12).

198. See UNIFORM PRINCIPAL AND INCOME ACT, § 506(a)(3) (1997). See also UNIFORM PRINCIPAL AND INCOME ACT, § 506 cmt., 7A U.L.A. 541 (2000).

199. *Goldsby v. Comm'r*, T.C. Memo. 2006-274, n.3. *Goldsby* is discussed in note 329 and accompanying text.

200. See I.R.C. § 2056(b)(5), (b)(7). Cf. I.R.C. § 2056(b)(8).

201. An estate trust is a trust that may benefit only the surviving spouse during the spouse's lifetime and, at the spouse's death, terminates in favor of the spouse's estate. See Treas. Reg. § 20.2056(c)-2(b)(1)(iii). Because the

but not for a QSST. There is no direct authority on whether a section 2056A QDOT may be a QSST. Certainly, if the surviving spouse is a non-resident alien, it will not.²⁰² However, when the surviving spouse is a resident alien and if the QDOT otherwise satisfies the requirements of a QSST, there appears to be no reason why a QDOT could not qualify if the spouse-beneficiary is willing to make the election.²⁰³

There are many variations of the standard power of appointment (section 2056(b)(5)) trusts and QTIP (section 2056(b)(7)) trusts, most of which qualify as QSSTs. For example, in a private letter ruling, the IRS ruled that a trust could constitute a QSST if the individual income beneficiary not only was entitled to all of the accounting income currently but also had a noncumulative annual right to withdraw the greater of \$5,000 or 5% from the corpus of the trust. This annual right of withdrawal caused the beneficiary to be treated as the owner of a portion of the trust under section 678, even without making the special S corporation election under section 1361(d)(2) to be treated as the owner of the entire trust under section 678.²⁰⁴ The regulations seem to confirm this result.²⁰⁵

A notable exception exists for power of appointment marital trusts. Under section 2056(b)(5), no person other than the surviving spouse may have the power to appoint any of the trust corpus to anyone other than the surviving spouse. This means, however, that for marital deduction purposes, the surviving spouse may have the *inter vivos* power to appoint trust principal to someone other than himself or herself and the trust will still qualify for the estate tax marital deduction. Such a power will prevent a trust from qualifying as a QSST, however, as the power violates the “one current income beneficiary” rule of section 1361(d)(3)(A)(ii).

spouse’s interest in this type of trust is not a terminal interest under I.R.C. § 2056(b)(3), it qualifies for the estate tax marital deduction. Nevertheless, the trust may not provide for the distribution of income in which event it would not qualify as a QSST. For more discussion of estate trusts, see RICHARD COVEY, *MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS* (4th ed. 1997). The estate trust might qualify as an S shareholder under the ESBT rules discussed below in section 8:7.

202. Under I.R.C. § 1361(b)(1)(C), an S corporation may not have a non-resident alien as a shareholder. I.R.C. § 7701(b) defines non-resident alien.

203. I.R.C. § 7701(b) defines resident alien. Treas. Reg. § 1.1361-1(j)(6)(ii) provides that the current income beneficiary of a trust must consent to the QSST election.

204. Priv. Ltr. Rul. 8424096. Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110(k)(3).

205. Treas. Reg. § 1.1361-1(k)(1), ex. 8.

Testamentary QTIP trusts, that is, trusts qualifying under section 2056(b)(7), are permissive S corporation shareholders if the trust otherwise satisfies the QSST rules.²⁰⁶ *Inter vivos* QTIP trusts, that is, trusts qualifying under section 2523(f), are not qualified QSSTs and are not permissive S corporation shareholders as such.²⁰⁷ If, however, the grantor-spouse is deemed to be the owner of the entire trust under the grantor trust rules of sections 671–77, the QTIP trust may be a qualified shareholder because of its grantor trust status.²⁰⁸ The regulations provide an example:

On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.²⁰⁹

For the *inter vivos* QTIP trust in the example above to qualify as an S corporation shareholder as a grantor trust, A must be the deemed owner of the entire trust. Otherwise, it does not qualify. The regulations provide an example of a QTIP trust that does not qualify:

On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the

206. Treas. Reg. § 1.1361-1(j)(4).

207. *Id.* It appears that the *inter vivos* trust fails as a QSST because the donor-spouse is the owner of the income portion of the trust under I.R.C. § 677 rather than the spouse-beneficiary under I.R.C. § 678 as a result of a QSST election, *i.e.*, the grantor trust rule trumps the QSST rules. This split between the grantor trust rules and the QSST rules will occur, for example, when the *inter vivos* QTIP trust does not permit the trustee to invade principal for the benefit of the spouse-beneficiary.

208. Treas. Reg. § 1.1361-1(j)(4). See Priv. Ltr. Rul. 200147043 for an example of a QTIP that is partially, but not entirely, a grantor trust. In the ruling, the grantor petitioned a local court to modify the trust to permit the grantor to substitute assets of equivalent value for the trust assets thus making the trust a grantor trust under I.R.C. § 675(4)(c). With the modification, the trust qualified as an S shareholder because of its grantor trust status. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

209. Treas. Reg. § 1.1361-1(k)(1), ex. 10(i). I.R.C. § 1361(b)(1) limits who may own S corporation stock. I.R.C. §§ 1366, 1367, and 1368 regulate the pass-through of the S corporation's income items (I.R.C. § 1366), adjustments to basis (I.R.C. § 1367), and taxation of distributions (I.R.C. § 1368).

requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, *B* is the sole income beneficiary for life. . . . [T]he terms of the trust do not permit corpus to be distributed to *B* and require its retention by the trust for distribution to *A* and *B*'s surviving children after the death of *B*. Under section 677, *A* is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.²¹⁰

Nevertheless, if a couple divorces after an *inter vivos* QTIP trust that owns S corporation stock is created, a QSST election is possible. The regulations provide an example:

On June 1, 1996, *A* transferred S corporation stock to a trust for the benefit of *A*'s spouse *B*, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, *B* is the sole income beneficiary for life. In addition, corpus may be distributed to *B*, at the trustee's discretion, during *B*'s lifetime. . . . *A* and *B* divorce on May 2, 1997. Under section 682, *A* ceases to be treated as the owner of the trust under section 677(a) because *A* and *B* are no longer husband and wife. Under section 682, after the divorce, *B* is the income beneficiary of the trust and corpus of the trust may only be distributed to *B*. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), *B* must make the QSST election within 2 months and 15 days after the date of the divorce.²¹¹

§ 8:7 Electing Small Business Trusts (ESBTs)

A sixth type of trust, known as an "electing small business trust" or ESBT, was added to the list of permitted S corporation shareholders by 1996 legislation.²¹² ESBTs differ from other types of qualified trusts in that the trust, rather than the beneficiary, is taxed on the S corporation income.²¹³ ESBTs specifically differ from QSSTs in that an ESBT can have multiple beneficiaries, and is not required to distribute all of its income annually.

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210. Treas. Reg. § 1.1361-1(k)(1), ex. 10(iii). The trust does not qualify as a QSST because the grantor is deemed the owner of some but all of the trust and thus has two beneficiaries in violation of Treas. Reg. § 1.1361-1(j)(2)(ii)(B).
211. Treas. Reg. § 1.1361-1(k)(1), ex. 10(ii).
212. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1302, 110 Stat. 1755.
213. See I.R.C. § 641(c); Treas. Reg. § 1.641(c)-1 (taxation of ESBTs).

§ 8:7.1 Eligibility

For a trust to qualify as an ESBT, all beneficiaries of the trust must be estates, individuals, or certain charitable organizations, and the trustee must make an affirmative election.²¹⁴ Permissible “beneficiaries” of an ESBT include persons with present, remainder, and reversionary interests.²¹⁵ Another trust that may receive distributions from an ESBT is permitted to be the beneficiary of an ESBT, but only if it is “an organization described in section 170(c)(2) or (3).”²¹⁶ Under the regulations,²¹⁷ other trusts may be beneficiaries of an ESBT, but the beneficiaries of the distributee trust are the deemed beneficiaries of the ESBT and must be qualified beneficiaries.²¹⁸ A trust’s right to receive distributions from the ESBT may be “fixed or contingent, or immediate or deferred.”²¹⁹ The regulations provide an example of an ESBT with a trust as a beneficiary:

Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv)²²⁰ of this section [Treas. Reg. § 1.1361-1], Trust-2’s potential current beneficiaries are treated as the potential current beneficiaries of Trust-1²²¹

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214. I.R.C. § 1361(e)(1)(A)(i), (iii). The permissible charities are those described in paragraphs (2), (3), (4), and (5) of I.R.C. § 170(c). An organization described in I.R.C. § 170(c)(1) may hold a contingent interest in an ESBT if it is not a potential current beneficiary. Treas. Reg. § 1.1361-1(m)(1)(i). *See generally* F.G. Corneel, *The Election Small Business Trust: Subchapter S’s User-Friendly Estate Planning Tool*, 86 J. TAX’N 215 (Apr. 1997); N.C. Hughes & D.T. Lewis, *Electing Small Business Trust: The Good, the Bad and the Ugly*, 11 PROB. & PROP., Sept.–Oct. 1997, at 50; F.G. Corneel, *ESBTs and Crummey Trusts*, TAX MGM’T WKLY. REP. 962 (July 6, 1998); S. Traum, *New IRS Guidance Provides Fresh Impetus for Using Electing Small Business Trusts*, 94 J. TAX’N 285 (May 2001).
215. Treas. Reg. § 1.1361-1(m)(1)(ii)(A).
216. Treas. Reg. § 1.1361-1(m)(1)(ii)(B).
217. *Id.*
218. *Id.* *See also* Priv. Ltr. Rul. 200912005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
219. *Id.*
220. Paragraph (m)(4)(iv) provides rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to or may receive a distribution from income or principal of the ESBT.
221. Treas. Reg. § 1.1361-1(m)(8), ex. 6(i). Under the “counting beneficiaries” rules discussed below in section 8:7.3, Trust-2’s potential current beneficiaries are counted for purposes of the 100-shareholder limitation.

A trust that is entitled to income or principal from an ESBT is referred to as a “distributee trust” under the regulations.²²² Neither a trust that is not in existence nor a trust that is not funded, even if it is to be funded in the future, is a distributee trust, however, unless it has some item of income, deduction, loss or credit.²²³ Distributee trusts must otherwise qualify as a permissible S corporation shareholders under section 1361(c)(2)(A).²²⁴ The regulations provide an example:

The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1.²²⁵

For purposes of determining the qualified beneficiaries of an ESBT, a permissive appointee of a power of appointment is not considered to be a beneficiary until the actual exercise of the power in favor of the appointee.²²⁶

Before a 2000 amendment to section 1361(e)(1) to permit a section 170(c)(1) organization²²⁷ to have a contingent interest in an ESBT,²²⁸ proposed regulations excluded the interest of a non-qualified beneficiary whose interest was so remote as to be negligible.²²⁹ The remote beneficiary rule was dropped in the final regulations.²³⁰

222. Treas. Reg. § 1.1361-1(m)(4)(iv).

223. Treas. Reg. § 1.1361-1(m)(4)(iv)(A).

224. Treas. Reg. § 1.1361-1(m)(4)(iv)(B).

225. Treas. Reg. § 1.1361-1(m)(8), ex. 5.

226. Treas. Reg. § 1.1361-1(m)(1)(ii)(C). *But see* note 232, *infra*.

227. An I.R.C. § 170(c)(1) organization is a governmental entity and could be a potential beneficiary of a trust under state escheat laws.

228. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554.

229. *See* Preamble T.D. 8994, 67 Fed. Reg. 34,388. The “remote beneficiary rule” provided that remote, contingent interests were ignored when determining whether a trust had an impermissible shareholder for S purposes.

230. In Priv. Ltr. Rul. 200104014, the trust benefited the grantor’s children and grandchildren. If none of them survived the termination date of the trust, the trustee was directed to pay the trust assets over to a charity of the trustee’s choice. The IRS ruled that the interest of the charities did not prevent an ESBT election. This ruling was based on I.R.C. § 1361(e)(1) before it was amended by the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

No interest in an ESBT can be acquired by purchase.²³¹ In effect, the beneficial interest in the trust must be acquired by gift, bequest, or inheritance.²³² The regulations provide that if any portion of the beneficiary's basis in the trust interest is determined under section 1012, the interest is considered to be acquired by purchase.²³³ Within this rule is a net gift of a trust interest, where the purchaser pays the seller's gift tax.²³⁴ However, the trust's interest in the S corporation stock may be acquired by gift, in a part-gift, part-sale transaction, or by purchase.²³⁵

A trust with a QSST election in place is not eligible to be an ESBT.²³⁶ In addition, a trust exempt from tax is not an eligible ESBT.²³⁷ Moreover, the regulations specifically provide that charitable remainder annuity trusts and charitable remainder unitrusts may not be ESBTs.²³⁸ Nevertheless, the regulation provides that a charitable lead trust may qualify as a ESBT.²³⁹

A trust may be reformed by a qualified disclaimer to qualify as an ESBT under section 1361(e). For example, in Private Letter Ruling 200401011,²⁴⁰ the trustees of two trusts disclaimed the power to make distributions to charities that could not be qualified beneficiaries of the ESBT, and the trust then qualified as an ESBT.

§ 8:7.2 Permissive Current Beneficiaries

The regulations distinguish permissive current beneficiaries from beneficiaries who are not and who would prevent the trust from being an ESBT or who would be counted towards the 100-shareholder

231. I.R.C. § 1361(e)(1)(A)(ii).

232. I.R.C. § 1361(e)(1)(A)(ii), (C); Treas. Reg. § 1.1361-1(m)(i), (iii).

233. Treas. Reg. § 1.1361-1(m)(1)(iii).

234. *Id.*

235. *Id.*

236. Treas. Reg. § 1.1361-1(m)(1)(iv)(A). See Treas. Reg. § 1.1361-1(j)(12) and section 8:8 for procedure for converting a QSST to an ESBT.

237. I.R.C. § 1361(e)(1)(B)(ii); Treas. Reg. § 1.1361-1(m)(1)(iv)(B).

238. I.R.C. § 1361(e)(1)(B)(iii); Treas. Reg. § 1.1361-1(m)(1)(iv)(C). A charitable remainder trust is exempt from income taxes under I.R.C. § 664 other than years in which it has unrelated business income. Thus, permitting a charitable remainder trust to own S corporation stock would be inconsistent with an ESBT being taxed in its share of the S corporation's taxable income.

239. Treas. Reg. § 1.641(c)-1(f), ex. 5; Priv. Ltr. Rul. 9908002. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

240. Priv. Ltr. Rul. 200401011. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

maximum for the corporation's S election.²⁴¹ A "potential current beneficiary" is a person who is entitled to, or, in the discretion of any person, may receive, a distribution from the income or principal of the trust.²⁴² Persons who hold only future interests in a trust are not treated as potential current beneficiaries.²⁴³

This distinction in beneficiaries is particularly important when a nonresident alien may be a beneficiary of a trust, because having a nonresident alien as a trust beneficiary does not disqualify an ESBT until the nonresident alien is a potential current beneficiary.²⁴⁴ The regulations provide an example of a nonresident alien disqualifying an ESBT election and the S corporation election:

Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. . . . Under paragraph (m)(4)(iv) of this section [Treas. Reg. § 1.1361-1],²⁴⁵ Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).²⁴⁶ Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1). . . . *D* is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.²⁴⁷

Persons whose interests are contingent upon the passage of time or the occurrence of an event are not considered to be potential current beneficiaries.²⁴⁸ For example, persons who are takers in default of a power of appointment would not be considered potential current

241. See section 8:7.3 below for a discussion of "counting shareholders" for purposes of the 100-shareholder limit.

242. Treas. Reg. § 1.1361-1(m)(4)(i).

243. *Id.*

244. Treas. Reg. § 1.1361-1(m)(1)(ii)(D). I.R.C. § 7701(b) defines non-resident alien.

245. Treas. Reg. § 1.1361-1(m)(1)(iv) provides that QSSTs, tax-exempt trusts, and charitable remainder trusts are not eligible to be ESBTs.

246. I.R.C. § 1361(b)(1) defines a "small business corporation" and includes the 100-shareholder limit.

247. Treas. Reg. § 1.1361-1(m)(8), ex. 6(i)-(ii).

248. Treas. Reg. § 1.1361-1(m)(4)(v).

beneficiaries. Similarly, in Private Letter Ruling 200522004²⁴⁹ the IRS ruled that a non-resident alien who was not entitled to distributions from the ESBT until a specific date in the future was not deemed to be a potential current beneficiary, and thus the fact that the non-resident alien would become a current beneficiary in the future did not terminate the trust's ESBT status.

When all or part of the ESBT is treated as owned by a person under the grantor trust rules, that person (the grantor) is a potential current beneficiary in addition to any others who may be treated as beneficiaries because of their potential current beneficiary status.²⁵⁰ The regulations provide an example of a section 678 grantor trust that qualifies to make an ESBT election:

M transfers stock in *X*, an S corporation, and other assets to Trust for the benefit of *B* and *B*'s siblings. *M* retains no powers or interest in Trust. Under section 678(a), *B* is treated as the owner of a portion of Trust that includes a portion of the *X* stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section [Treas. Reg. § 1.1361-1].²⁵¹ Trust is eligible to make an ESBT election.²⁵²

§ 8:7.3 Counting Shareholders

When determining who counts as a shareholder for the 100-shareholder limitation, the ESBT regulations use the more restrictive term—"potential current beneficiary"—rather than the broader definition of who may be a beneficiary of an ESBT that qualifies under section 1361(e)(1).²⁵³ Persons who hold only future interests in a trust do not enter into the computation of the number of shareholders.²⁵⁴ If there is no potential current beneficiary of an ESBT, the trust itself is treated as a shareholder and counts as one shareholder.²⁵⁵ In calculating the maximum number of shareholders, permissible appointees of a currently exercisable power of appointment

249. Priv. Ltr. Rul. 200522004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

250. Treas. Reg. § 1.1361-1(m)(4)(ii).

251. Treas. Reg. § 1.1361-1(m)(1)(iv) provides that QSSTs, tax-exempt trusts, and charitable remainder trusts are not eligible to be ESBTs.

252. Treas. Reg. § 1.1361-1(m)(8), ex. 3.

253. Treas. Reg. § 1.1361-1(m)(4).

254. Treas. Reg. § 1.1361-1(m)(4)(i).

255. Treas. Reg. § 1.1361-1(m)(4)(vii).

are not counted as shareholders until the power is exercised.²⁵⁶ This is a change from the law that existed before 2005.²⁵⁷

Regulations issued in August of 2008 for the 2005 statutory changes provide three examples of how to count shareholders when a power of appointment or other power of distribution exists.

Example 7: Potential current beneficiaries and powers of appointment. *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust for any period will be *A* and each person who receives a distribution from Trust pursuant to *A*'s exercise of *A*'s power of appointment during that period.

Example 8: Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment. *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, each then-living descendant of *M*, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

Example 9: Power to distribute to a class of named charitable organizations not pursuant to a power of appointment. *M* creates

256. I.R.C. § 1361(e)(2), amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231, 118 Stat. 1418 (effective Jan. 1, 2005). Now-obsolete Treas. Reg. § 1.1361-1(m)(4)(vi) provides the opposite rule, and Treas. Reg. § 1.1361-1(m)(8), ex. 7, illustrates the old rule:

M creates Trust for the benefit of *A*. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust will be *A* and all other persons except for *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. This number will exceed the 75-shareholder limit of I.R.C. § 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

(Under current law, the maximum number of shareholders is 100. See I.R.C. § 1361(b)(1)(A), as amended by The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, § 231.)

257. I.R.C. § 1362(e)(2) before amendments in The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, § 231.

Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.²⁵⁸

The right or power of a beneficiary to assign a beneficial interest in a trust does not make the assignee a potential current beneficiary, and thus a shareholder, unless and until the assignment is made.²⁵⁹ Furthermore, payments to a third party on behalf of a beneficiary will not make the third party a beneficiary.²⁶⁰

When a distributee trust qualifies as a permissive shareholder as either a grantor trust under section 1361(c)(2)(A)(i) or as a voting trust under section 1361(c)(2)(A)(iv), the potential current beneficiaries of the distributee trust are the deemed current beneficiaries of the ESBT,²⁶¹ as is the grantor of a grantor trust.²⁶² If, however, the distributee trust qualifies as a permissive shareholder under section 1361(c)(2)(A)(ii) as a trust that formerly qualified as a grantor trust during the grantor's lifetime or under section 1361(c)(2)(A)(iii) as a trust receiving S stock from an estate, the decedent's estate is the deemed current beneficiary of the ESBT for the qualifying two-year period.²⁶³ The regulations provide an example:

Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. . . . Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(c) of this section [Treas. Reg. § 1.1361-1],²⁶⁴ Trust-2's

258. Treas. Reg. § 1.1361-1(m)(8), effective August 14, 2008.

259. Treas. Reg. § 1.1361-1(m)(4)(viii).

260. *Id.*

261. Treas. Reg. § 1.1361-1(m)(4)(iv)(C).

262. Treas. Reg. § 1.1361-1(m)(4)(ii).

263. Treas. Reg. § 1.1361-1(m)(4)(iv)(C).

264. Treas. Reg. § 1.1361-1(m)(4)(iv)(C) provides that upon the death of a grantor of a subpart E trust (a grantor trust), the estate of the grantor is the deemed shareholder and the "potential current beneficiary."

only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).²⁶⁵

Note in the example that *C*, *D*, and *E* are not counted as shareholders of the S corporation when *A*'s estate is counted as a shareholder because *A*'s estate is the qualified shareholder during the first two years following *A*'s death.

For purposes of determining the number of shareholders, a person is counted only once as a shareholder even though that person may be treated as a shareholder by direct ownership and indirectly through one or more trusts.²⁶⁶ The regulations provide an example: "if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation."²⁶⁷ This rule applies to husbands and wives. The regulation provides an example: "if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation."²⁶⁸ The regulations contain another example of not counting the same individual as more than one shareholder:

Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the [100]-shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.²⁶⁹

265. Treas. Reg. § 1.1361-1(m)(8), exs. 6(i) & (iii).

266. Treas. Reg. § 1.1361-1(m)(4)(vii).

267. *Id.*

268. *Id.*

269. Treas. Reg. § 1.1361-1(m)(8), ex. 5.

§ 8:7.4 The ESBT Election

The trustee of the trust must sign the ESBT election statement. This varies from the QSSElection, which requires the signature of the beneficiary.²⁷⁰ If there is more than one trustee, the regulations require the signature or signatures of “the trustee or trustees with the legal authority to bind the trust.”²⁷¹ If the electing ESBT is also a grantor trust, both the trustee(s) and the grantor must sign the ESBT election.²⁷² If the same trustee serves as trustee of multiple trusts for the same beneficiary, the trustee must sign the consent on behalf of each trust.²⁷³

Only one ESBT election is needed for a qualifying trust, even if the trust owns stock of more than one S corporation. If, however, the trust owns stock of more than one S corporation at the time of the election and if the S corporations file their tax returns at different IRS service centers, the trustee must file the ESBT election with each service center.²⁷⁴ For a trust that has an ESBT election in effect and then subsequently acquires S corporation stock in a different S corporation, no further filing is required.²⁷⁵ The regulations provide an example:

On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. . . . On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. . . . On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.²⁷⁶

The regulations require that the election statement contain the following information:

- (A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently owns stock;
- (B) An identification of the election as an ESBT election made under section 1361(e)(3);

270. Treas. Reg. § 1.1362-6(b)(2)(iv).

271. *Id.* Under the laws of many states, a majority of trustees may bind the trust unless the governing instrument provides otherwise.

272. *Id.*

273. *See* Priv. Ltr. Rul. 200148031. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

274. Treas. Reg. § 1.1361-1(m)(2)(i).

275. *Id.*

276. Treas. Reg. § 1.1361-1(m)(8), ex. 1(i)-(ii).

- (C) The first date on which the trust owned stock in each S corporation;
- (D) The date on which the election is to become effective (not earlier than fifteen days and two months before the date on which the election is filed); and
- (E) Representations signed by the trustee stating that—
 - (1) The trust meets the definitional requirements of section 1361(e)(1); and
 - (2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).²⁷⁷

Regulations finalized in 2008 provide that if the trust contains a power to distribute to an unlimited number of charities and the power is not a power of appointment within the meaning of Treasury Regulations sections 20.2041-1(b) and 25.2514-1(b), the ESBT election must include a statement to that effect, but it does not need to include any information concerning the charities.²⁷⁸

Generally, the ESBT election is due within the same time as the due date of a QSST election:²⁷⁹ two months and sixteen days following the corporation's S election.²⁸⁰ The two-months-and-sixteen-days rule initially appears out of sync with the requirement that the election can not be effective for more than two months and fifteen days before it is made. This is correct, however, as an election made on the sixteenth day of the third month can be effective for two months and fifteen days before it is made, which takes it back to the first day of the tax year.²⁸¹

For a trust that qualifies to own S stock for two years upon the death of a grantor of a qualified subpart E trust (a qualified grantor trust)²⁸² or a trust that receives stock from a decedent's estate,²⁸³ the ESBT election may be made at any time during the period that the trust continues to be an eligible shareholder because of its status as a former grantor trust or as a testamentary trust, or during the two-month-and-sixteen-day

277. Treas. Reg. § 1.1361-1(m)(2)(ii).

278. Treas. Reg. § 1.1361-1(m)(2)(ii)(A).

279. Treas. Reg. § 1.1361-1(m)(2)(iii).

280. See section 8:6.3[A], *supra*, for detailed discussion of when QSST elections are due.

281. See Treas. Reg. § 1.1361-1(j)(6)(iii)(A).

282. I.R.C. § 1361(c)(2)(A)(ii) discussed above in section 8:4.

283. I.R.C. § 1361(c)(2)(A)(iii) discussed above in section 8:4.

period following the termination of the permitted two-year period.²⁸⁴ The ESBT election will be effective as of the time provided in the election.²⁸⁵

Protective elections are not permitted.²⁸⁶ For example, a trust might want to make a protective ESBT election because there is doubt whether a trust qualifies as an S shareholder under sections 1361(c)(2)(A)(i)–(iv) (as a grantor trust, a two-year trust, or a voting trust). The regulations provide that a protective election in this circumstance is not effective, and if the trust is not otherwise an eligible S corporation shareholder, the corporation's S election will terminate.²⁸⁷ The regulations state, however, that an otherwise wholly-owned grantor trust may make an ESBT election.²⁸⁸ Thus, an unqualified ESBT election can be made when doubt exists if a trust is a qualified subpart E trust (a grantor trust) and the ESBT election will be effective only to the extent the trust is not a grantor trust as to some portion or all. Moreover, the regulations provide that for income tax reporting, the ESBT election effects only the tax reporting of the non-grantor portion of the trust.²⁸⁹

The ESBT status of a grantor trust with an ESBT election in effect is not terminated upon the death of the grantor. Instead, the ESBT status of the trust continues. The regulations provide an example:

On January 1, 2003, *M* transfers stock in *X*, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to *M* during *M*'s lifetime and to *M*'s children upon *M*'s death. During *M*'s life, *M* is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, *M* dies. Under applicable local law, Trust does not terminate on *M*'s death. Trust continues to be an ESBT after *M*'s death, and no additional ESBT election needs to be filed for Trust after *M*'s death.²⁹⁰

284. Treas. Reg. § 1.1361-1(m)(2)(iv). In Priv. Ltr. Rul. 200908007, the Service granted relief from the failure to timely file an ESBT election following a grantor's death. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

285. Treas. Reg. § 1.1361-1(m)(3)(i).

286. Treas. Reg. § 1.1361-1(m)(2)(v).

287. *Id.*

288. *Id.* (last sentence).

289. See section 8:7.5, *infra*; Treas. Reg. § 1.641(c)-1(a).

290. Treas. Reg. § 1.1361-1(m)(8), ex. 4.

By making an ESBT election at a time when the trust is a qualified subpart E trust (a grantor trust), it is possible to make sure the ESBT election is made and will be effective when it is necessary or desired.

§ 8:7.5 Loss of the Election

If an ESBT disposes of all of its S stock, it will no longer qualify as an ESBT.²⁹¹ An exception exists if the trust disposes of the S stock in an installment sale, in which case the trust remains an ESBT until it receives the final installment payment or disposes of the installment obligation.²⁹²

A trust will fail to qualify as an ESBT if a non-qualifying person becomes a potential current beneficiary of the trust.²⁹³ The regulations explain: “the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date.”²⁹⁴ The regulations also provide an example:

Effective January 1, 2003, Trust makes a valid ESBT election. On January 1, [2005] . . . A, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within [one-year] . . . after January 1, [2005] . . . As of January 1, [2005] . . . A is a potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because A is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, [2005] . . . Relief may be available under section 1362(f).²⁹⁵

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- 291. Treas. Reg. § 1.1361-1(m)(5)(ii). The loss of ESBT status means that the trust is no longer taxed on its share of the S corporation’s income and the regular rules concerning the distribution deduction under I.R.C. §§ 651 and 661 apply and the beneficiaries must report income under the rules of I.R.C. §§ 652 and 662.
 - 292. *Id.* The interest paid on the installment obligation is not taxed to S portion of the trust, however. *See* section 8:7.6, *infra*, and Treas. Reg. § 1.641(c)-1(g)(3).
 - 293. *See* Treas. Reg. § 1.1361-1(m)(v)(iii); *see also* Priv. Ltr. Rul. 200522004. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
 - 294. Treas. Reg. § 1.1361-1(m)(5)(iii).
 - 295. Treas. Reg. § 1.1361-1(m)(8), ex. 2(i). When the regulation was promulgated, the statute permitted only a sixty-day grace period. I.R.C. § 1361(e)(2)

Like a QSST, the ESBT status of a trust terminates on the first day that it fails to meet the definition of an ESBT.²⁹⁶ The day before it fails to meet that definition is the last day it is an ESBT.²⁹⁷

Treasury Regulations section 1.1361-1(m)(4)(iii) provides an exception to the disqualification rule: “if a trust disposes of all of its S corporation stock, any person who first met the definition of a potential current beneficiary during the [one-year]²⁹⁸ period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.”²⁹⁹ This means that an ESBT has one year to dispose of its S corporation stock after it becomes ineligible to own the S stock because a non-qualifying beneficiary, such as a non-resident alien, becomes a potential current beneficiary. The regulations provide an example:

Effective January 1, 2003, Trust makes a valid ESBT election. On January 1, [2005] . . . A, a nonresident alien, becomes a potential current beneficiary of Trust. . . . [W]ithin [one-year]³⁰⁰ after January 1, [2005], trustee of Trust disposes of all Trust’s S corporation stock. A is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.³⁰¹

The one-year rule of the regulation was limited to sixty days before 2005. Legislation in 2004 changed the grace period to one year.³⁰²

before amendments by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, § 231. The 2004 legislation expanded the grace period to one year. See section 8:9 for a discussion of I.R.C. § 1362(f) relief.

296. Treas. Reg. § 1.1361-1(m)(5)(i).

297. *Id.*

298. When the regulation was promulgated, the statute permitted only a sixty-day grace period. I.R.C. § 1361(e)(2) before amendments by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231, 118 Stat. 1418. The 2004 legislation expanded the grace period to one year.

299. Treas. Reg. § 1.1361-1(m)(4)(iii). Also, I.R.C. § 1362(f) relief may be available if the S election is terminated inadvertently. Treas. Reg. § 1.1361-1(m)(4)(iii). See section 8:9 for a discussion of I.R.C. § 1362(f) relief.

300. Treas. Reg. § 1.1361-1(m)(8), ex. 2(ii). When the regulation was promulgated, the statute permitted only a sixty-day grace period. I.R.C. § 1361(e)(2) before amendments by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231, 118 Stat. 1418. The 2004 legislation expanded the grace period to one year.

301. Treas. Reg. § 1.1361-1(m)(8), ex. 2(i)–(ii).

302. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 231, 118 Stat. 1418.

A voluntary termination of the ESBT election may occur only with the consent of the Commissioner,³⁰³ and an application for consent to revoke the election must be submitted in the form of a request for a private letter ruling.³⁰⁴ An ESBT may convert to a QSST without the Commissioner's permission pursuant to the process described below in section 8:8.2.

§ 8:7.6 Tax Ramification of an ESBT Election

An ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and one tax return.³⁰⁵ An ESBT election made midyear or revoked midyear does not close the trust's tax reporting year,³⁰⁶ and the trust is still considered one trust for estimated tax purposes.³⁰⁷

Even though an ESBT is administratively treated as one trust, the ESBT may be considered to have as many as three separate portions: a grantor trust portion, the S corporation stock portion, and the non-S stock portion.³⁰⁸ The S corporation stock portion and the non-S stock portion are deemed to be separate trusts for purposes of chapter 1 of the Internal Revenue Code.³⁰⁹

Any portion of the ESBT that is treated as owned by the grantor or another person under the grantor trust rules is called the "grantor trust portion."³¹⁰ The "owner" includes in income those items of income, deductions and credits against tax attributable to the grantor trust

303. I.R.C. § 1361(e)(3) (last sentence).

304. Treas. Reg. § 1.1361-1(m)(6).

305. Treas. Reg. § 1.641(c)-1(a).

306. Treas. Reg. § 1.1361-1(m)(3)(ii), (iii).

307. Treas. Reg. § 1.1361-1(m)(3)(v).

308. Treas. Reg. § 1.641(c)-1(b). The regulation initially provides that an ESBT may have two portions, but it goes on to describe three: the S corporation stock portion, a portion for all non-S stock held by the trust, and a grantor trust portion. From an administrative perspective, it may be easiest if the grantor trust portion, the S portion and the non-S portion are held in separate trusts—by way of example, the S portion trust would consist only of the S corporation shares owned by the trust. It does not seem that the multiple trust rule of I.R.C. § 643(f) would normally cause the S portion trust and the other consisting of the non-S portion to be considered as one trust. However, it may not be practicable to attempt to separate the grantor trust portion from the other portion or portions of the trust. For example, if the ordinary (accounting) income portion is attributed to the grantor but the corpus portion is not, it does not seem that it would be practicable to separate the ordinary (accounting) portion into one trust and the S portion into another trust.

309. Treas. Reg. § 1.641(c)-1(a). Chapter 1 of the Internal Revenue Code is sections 1 to 1563.

310. Treas. Reg. § 1.641(c)-1(b)(1).

portion under the principles of section 671.³¹¹ Only the non-grantor portion of the ESBT is potentially divided between an S portion and a non-S portion.³¹²

When a grantor trust converts to a ESBT midyear, the regulations provide that the election under Treasury Regulations section 1.1368-1(g) to close the accounting year, rather than using a per-day proration is not available.^{312.1} This exception is important when income of the S corporation is bunched into one side or the other of the same tax year. This rule is applicable when the prior trust was a grantor trust prior to the grantor's death or a trust that receives stock from a decedent's estate that may hold the S corporation stock for two years.^{312.2}

The S portion of the trust is taxable on its share of the S corporation's income at the highest trust income tax rate, except to the extent the income consists of net capital gains, in which case it is taxed at the capital gain rates under section 1(h).³¹³ This portion takes into account the items of income, loss, deductions or credit under the S corporation shareholder rules set forth in section 1366.³¹⁴ The S portion includes also the gain or loss on the disposition of the S corporation stock.³¹⁵ State and local taxes and administrative expenses attributable to the S portion are deductible.³¹⁶ The S portion computes its income without the distribution deduction provided for in section 651 or 661.³¹⁷

For tax years beginning after 2006, section 641(c)(2)(C) was amended to permit a deduction.³¹⁸ Thus, interest paid by the ESBT to purchase S corporation stock is deductible, although section 1361(e)(1)(A)(ii) prohibits an interest in an ESBT from being acquired by purchase.

The non-S portion of an ESBT consists of all trust assets other than the S corporation stock and the portion that is not treated as owned by

311. Treas. Reg. § 1.641(c)-1(c).

312. Treas. Reg. § 1.641(c)-1(a).

312.1. Treas. Reg. § 1.1377-1(a)(2)(iii).

312.2. *Id.*

313. I.R.C. § 641(c)(2)(A); Treas. Reg. § 1.641(c)-1(e).

314. I.R.C. § 641(c)(2)(C)(i); Treas. Reg. § 1.641(c)-1(d)(2).

315. I.R.C. § 641(c)(2)(C)(ii); Treas. Reg. § 1.641(c)-1(d)(3).

316. I.R.C. § 641(c)(2)(C)(iii); Treas. Reg. § 1.641(c)-1(d)(4).

317. The list of deductions available to S portion that are itemized in Treas. Reg. § 1.641(c)-1(d) does not include a distribution deduction under I.R.C. § 651 or I.R.C. § 661. Moreover, Treas. Reg. § 1.641(c)-1(i) provides that a distribution deduction is available to the non-S portion of the trust for distributions from either the S portion or the non-S portion, but the income, deductions, or credits of the S portion are not used to compute the DNI of the non-S portion. Thus, by implication, distributions by the S portion do not generate a distribution deduction for the S portion.

318. I.R.C. § 641(c)(2)(C)(iv), added by Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, § 8236, 121 Stat. 112.

the grantor or another person under the grantor trust rules.³¹⁹ This portion reports all income not reportable by either the grantor portion or the S portion and computes its taxable income using the regular rules applicable to trusts³²⁰ and includes taxable dividends under section 1368(c)(2) paid by the S corporation attributable to earning and profits while it was a C corporation.³²¹

The portion of the regulations concerning the non-S portion of the ESBT provide that state or local income taxes and administration expenses of the trust must be allocated between the various shares.³²² Specifically, it states that:

These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.³²³

Thus, to the extent provided for in the regulations, any state or local income taxes and administration expenses of the trust properly allocable to the S corporation stock are allowed in determining taxable income.³²⁴ The exemption for alternative minimum tax purposes under section 55(d) is treated as zero for the S portion of an ESBT.³²⁵

The regulations for the S portion of an ESBT provide that if an S corporation makes a charitable gift from gross income, the contribution will be deemed to satisfy the rules of section 642(c). This may mean that the charitable deduction may be lost if the charitable gift is not from gross income. In any case, the limitation of section 681 regarding unrelated business income still applies, meaning that the section 170 limitations on charitable deductions apply.³²⁶

In Revenue Ruling 2004-5,³²⁷ the Service ruled that a trust was allowed a deduction under section 642(c) for the trust's "distributive share of a charitable contribution made by a partnership from the

319. Treas. Reg. § 1.641(c)-1(b)(3).

320. Treas. Reg. § 1.641(c)-1(g)(1).

321. Treas. Reg. § 1.641(c)-1(g)(2).

322. Treas. Reg. § 1.641(c)-1(h).

323. *Id.*

324. Treas. Reg. § 1.641(c)-1(d)(4).

325. Treas. Reg. § 1.641(c)-1(e)(2).

326. Treas. Reg. § 1.641(c)-1(d)(2)(ii).

327. Rev. Rul. 2004-5, 2004-1 C.B. 295. *See also* Chief Couns. Adv. 200928029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

partnership's gross income" even though the governing instrument of the trust neither authorized nor directed the trustee to make distributions to charity. In the ruling, it seemed important that the partnership made the charitable contribution from its gross income.

In Revenue Ruling 2003-123,³²⁸ a trust was not allowed an income tax deduction under section 642(c) for the transfer of a qualified conservation easement described in section 170(h). The trust instrument permitted the grant of the easement to charity, but it was not made from the trust's gross income. This result was confirmed in *Goldsby v. Commissioner*,³²⁹ in which the Tax Court held that a conservation easement was not deductible when it was not made from income.

The regulations provide that a charitable lead annuity trust may qualify as an ESBT. An example in the section 641 regulations provides that:

Trust is a charitable lead annuity trust, which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in X, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays \$10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.³³⁰

The taxable income of the S portion includes gain (or loss) from the sale of the S corporation stock.³³¹ However, any capital losses in excess of capital gains are not deductible.³³² The taxable income of the S portion also includes distributions by the S corporation in excess of the trust's income tax basis in the S corporation stock.³³³ The regulations provide an example of gain from the sale of S corporation stock:

328. Rev. Rul. 2003-123, 2003-2 C.B. 1200. See also Chief Couns. Adv. 200928029. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

329. *Goldsby v. Comm'r*, T.C. Memo. 2006-274. The Tax Court found that the trust was a grantor trust as to income, but not as to principal. Thus, when the taxpayer did not prove the contribution was from income, then no charitable deduction was allowed. The court, in footnote 3, entertained the idea, but did not rule, that if the trust was a grantor trust as to principal, then the beneficiary might have been entitled to the deduction.

330. Treas. Reg. § 1.641(c)-1(l), ex. 5.

331. Treas. Reg. § 1.641(c)-1(d)(3).

332. *Id.* But see notes 328–30 and accompanying text.

333. Treas. Reg. § 1.641(c)-1(d)(3)(iii).

Trust has a valid ESBT election in effect and owns stock in *X*, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in *X* to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of \$5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).³³⁴

When the S corporation stock is sold on an installment basis, the ESBT is taxable on the installment payments.³³⁵ However, interest on the installment payments is allocated to the non-S portion of the trust.³³⁶ The regulations provide an example:

Trust has a valid ESBT election in effect and owns stock in *X*, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, . . . Trust sells its stock in *X* for a \$400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock. . . . Assume Trust's basis in its *X* stock was \$300,000 and that the \$100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the \$100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.³³⁷

When an ESBT owns stock in more than one S corporation, all of the tax attributes from each S corporation are aggregated in determining the taxable income of the S portion.³³⁸ Nevertheless, the basis adjustment under section 1367 for the stock owned by the ESBT is made separately for each S corporation.³³⁹

Distributions of S corporation income received by the S portion of the trust to a beneficiary of the ESBT are neither deductible by the S portion of the ESBT nor includible in the gross income of the beneficiary. Nevertheless, distributions from the S portion can result in a deemed distribution of DNI attributable to the non-S portion of

334. Treas. Reg. § 1.641(c)-1(l), ex. 2.

335. Treas. Reg. § 1.641(c)-1(d)(3)(ii).

336. Treas. Reg. § 1.641(c)-1(g)(3). The regulation does not distinguish between a sale of all S corporation stock or only a portion. Thus, interest income earned on an installment sale of S corporation stock will be taxed to the non-S portion in both circumstances.

337. Treas. Reg. § 1.641(c)-1(l), ex. 3.

338. Treas. Reg. § 1.641(c)-1(d)(2)(iii).

339. Treas. Reg. § 1.641(c)-1(f).

the trust, and thus result in a distribution deduction for the non-S portion and income for the beneficiary.³⁴⁰

For example, if a discretionary trust with a single beneficiary and both an S portion and a non-S portion distributes a cash dividend received from an S corporation, but makes no distribution of income received on the non-S assets, the trust will receive a distribution deduction under section 661 to the extent of the lesser of DNI attributable to the non-S portion of the trust or the amount required to be distributed and other amounts actually distributed, and the beneficiary will have income under the rules of section 662. The regulations provide an example:

For 2003, Trust has \$5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has \$3,000 of distributable net income (DNI) in the non-S portion. [The trustee of Trust makes a distribution of \$4,000 to Beneficiary during 2003.] The non-S portion of Trust receives a distribution deduction under section 661(a) of \$3,000, which represents the amount distributed to Beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.³⁴¹

If an S corporation distributes a dividend to the trust, that dividend is included in the trust's distributable net income to the extent that it consists of earnings and profits while the corporation was a C corporation, unless it is a distribution of capital gain and is excludible from distributable net income under section 643(a)(3).³⁴² The regulations provide an example:

As of January 1, 2002, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, X makes an \$8,000 distribution to Trust, of which \$3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the X stock under section 1368(b). For 2003, Trust's share of X's section 1366 items is \$5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.³⁴³

340. Treas. Reg. § 1.641(c)-1(i).

341. Treas. Reg. § 1.641(c)-1(l), ex. 5(ii).

342. Treas. Reg. § 1.641(c)-1(j).

343. Treas. Reg. § 1.641(c)-1(l), ex. 5(i)-(ii).

Upon termination of the ESBT, or upon revocation of the ESBT election, the net operating loss carryover under section 172, capital loss carryover under section 1212, and excess deduction are governed by the provisions of section 642(h).³⁴⁴ This means that the deductions are taken into account by the entire trust or the trust beneficiaries if the trust terminates.³⁴⁵ The regulations provide an example:

Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in X to a person who is unrelated to Trust for a \$400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock. Assume Trust's basis in its X stock was \$500,000. Therefore, Trust sustains a capital loss of \$100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).³⁴⁶

The remaining carryovers such as charitable contributions and various tax credits would not seem to pass out of the ESBT.

On the other hand, in Chief Counsel Advice 200734019 a testamentary ESBT trust succeeded to an estate's NOL resulting from S corporation losses. The Service ruled that section 642(h)(1) permitted the non-S portion a deduction for the NOL, but section 642(c)(2)(C) did not permit the S portion of the ESBT to use the NOL because the deduction was not specifically included in the list of permitted deductions for ESBTs.

The separate share rule of section 663 may apply to an ESBT. Each separate share will separately determine distributable net income for the non-S portion purposes of sections 661 and 662, but the trust will be considered as a single ESBT with only one S portion.³⁴⁷ The regulations provide an example:

On January 1, 2003, M contributes S corporation stock to Trust for the benefit of M's three children A, B, and C. Pursuant to section 663(c), each of Trust's separate shares for A, B, and C will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will

344. Treas. Reg. § 1.641(c)-1(j).

345. *Id.*

346. Treas. Reg. § 1.641(c)-1(l), exs. 2 & 3(i)-(ii).

347. Treas. Reg. § 1.641(c)-1(g).

be treated as a single ESBT and will have a single S portion taxable under section 641(c).³⁴⁸

The regulations do not answer the question of how a discretionary distribution of income from the S portion of trust interacts with the separate-share rules. For example, a trust with separate shares might make a discretionary distribution of income from the S portion to only one of several beneficiaries. In this circumstance, the income reportable by the recipient under section 662 should be limited by the amount of DNI attributable to that beneficiary's separate share and the trust's distribution deduction under section 661 similarly limited.

§ 8:7.7 Comprehensive Example

The regulation provides a comprehensive example of how an ESBT is taxed:

(i) Trust has a valid ESBT election in effect. Under section 678, *B* is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in *X*, an S corporation, and in *Y*, a C corporation. During 2000, Trust receives a distribution from *X* of \$5,100, of which \$5,000 is applied against Trust's adjusted basis in the *X* stock in accordance with section 1368(c)(1) and \$100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to <i>X</i> under section 1366	\$5,000
Dividend income from <i>Y</i>	\$900
Dividend from <i>X</i> representing C corporation earnings and profits	\$100
Total trust income	\$6,000
Charitable contributions attributable to <i>X</i> under section 1366	\$300
Trustee fees	\$200
State and local income taxes	\$100

348. Treas. Reg. § 1.1361-1(m)(8), ex. 1(i).

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from <i>X</i>	\$500
Dividend income from <i>Y</i>	\$90
Dividend income from <i>X</i>	\$10
Total grantor portion income	<u>\$600</u>

The total income of the S portion is \$4,500, determined as follows:

Ordinary income from <i>X</i>	\$5,000
Less: Grantor portion	<u>(\$500)</u>
Total S portion income	\$4,500

The total income of the non-S portion is \$900 determined as follows:

Dividend income from <i>Y</i> (less grantor portion)	\$810
Dividend income from <i>X</i> (less grantor portion)	\$90
Total non-S portion income	<u>\$900</u>

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the \$6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) *B* must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from <i>X</i>	\$30
Trustee fees	\$20
State and local income taxes	\$10

(vi) The taxable income of the S portion is \$4,005, determined as follows:

Ordinary income from X	\$4,500
Less: Charitable contributions from X (less grantor portion)	(\$270)
75% of trustee fees	(\$150)
75% of state and local income taxes	(\$75)
Taxable income of S portion	<u>\$4,005</u>

(vii) The taxable income of the non-S portion is \$755, determined as follows:

Dividend income from Y	\$810
Dividend income from X	\$90
Total non-S portion income	<u>\$900</u>
Less: 15% of trustee fees	(\$30)
15% state and local income taxes	(\$15)
Personal exemption	(\$100)
Taxable income of non-S portion	<u>\$755</u>

§ 8:8 Conversion of QSSTs to ESBTs and ESBTs to QSSTs

§ 8:8.1 Conversion of QSSTs to ESBTs

The regulations permit the conversion of a QSST to an ESBT with the automatic consent of the Commissioner if certain conditions are met.³⁴⁹ These are:

- (i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section [Treas. Reg. § 1.1361-1], except for the requirement under paragraph (m)(1)(iv)(A) of this section [Treas. Reg. § 1.1361-1] that the trust not have a QSST election in effect.
- (ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return. This ESBT election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-1(j)" and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section [Treas. Reg. § 1.1361-1]. A separate election must be

349. Treas. Reg. § 1.1361-1(j)(12).

made with respect to the stock of each S corporation held by the trust.

- (iii) The trust has not converted from an ESBT to a QSST within the thirty-six-month period preceding the effective date of the new ESBT election.³⁵⁰

The effective date of the ESBT election cannot be more than two months and fifteen days before the election is filed, and cannot be more than twelve months after the election is filed.³⁵¹ If the effective date for the election is more than two months and fifteen days before the election is filed, the election is effective two months and fifteen days before the date on which the election was filed. Alternatively, if the effective date of the election is more than twelve months after the election is filed, the election is effective on the day that is twelve months after it is filed.³⁵²

Treasury Regulation section 1.1377-1(a)(2)(iii)^{352.1} provides also that when there is a change in ownership the election to close the accounting year rather than using a per-day proration is not available.^{352.2} This rule is applicable when the prior trust was a grantor trust prior to the grantor's death or a trust that receives stock from a decedent's estate that may hold the S corporation stock for two years.^{352.3}

§ 8:8.2 Conversion of ESBTs to QSSTs

Similarly, an ESBT may be converted to a QSST with the automatic consent of the Commissioner if the following conditions are met:

- (i) The trust meets all of the requirements to be a QSST under section 1361(d).
- (ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)" and include all information otherwise required for a QSST election under section 1.1361-1(j)(6). A separate

350. *Id.*

351. *Id.*

352. *Id.*

352.1. This regulation is quoted in full at section 8:8.2, *infra*.

352.2. Treas. Reg. § 1.1377-1(a)(2)(iii).

352.3. *Id.*

QSST election must be made with respect to the stock of each S corporation held by the trust.

- (iii) The trust has not converted from a QSST to an ESBT within the thirty-six-month period preceding the effective date of the new QSST election.³⁵³

The effective date rules for the election to convert to a QSST are similar to the effective date rules for conversions to ESBTs. The effective date of the QSST election cannot be more than two months and fifteen days before the election is filed, and cannot be more than twelve months after the election is filed.³⁵⁴ If the effective date for the election is more than two months and fifteen days before the election is filed, the election is effective two months and fifteen days before the date on which the election was filed. Alternatively, if the effective date of the election is more than twelve months after the election is filed, the election is effective on the day that is twelve months after it is filed.³⁵⁵

The regulations provide an example of a conversion of an ESBT to a QSST:

On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. Pursuant to section 663(c), each of Trust's separate shares for *A*, *B*, and *C* will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c). On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election. Effective January 1, 2004, *A*, *B*, *C*, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section [Treas. Reg. § 1.1361-1]. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.³⁵⁶

The regulations provide that when a trust is an ESBT for part of the year and another qualifying trust for the other part of the year, the rules of section 1377(a) and Treasury Regulations section 1.1377-1(a)(2)(iii) apply.³⁵⁷ This regulation provides that:

353. Treas. Reg. § 1.1361-1(m)(7).

354. *Id.*

355. *Id.*

356. Treas. Reg. § 1.1361-1(m)(8), ex. 1(i)-(iii).

357. Treas. Reg. § 1.1361-1(m)(3)(iv).

If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

This regulation also provides that when there is a change in ownership, the election to close the accounting year rather than using a per-day proration is not available.^{357.1} This rule is applicable when the prior trust was a grantor trust before the grantor's death or a trust that receives stock from a decedent's estate that may hold the S corporation stock for two years.^{357.2}

§ 8:9 Section 1362(f) Relief

A review of the private letter rulings reveals that the IRS has frequently granted relief under section 1362(f) for inadvertent terminations of S corporation elections. Many of these relate to problems with trust ownership of S stock and the failure to make a timely election.³⁵⁸

The procedure for section 1362(f) relief is outlined in Revenue Procedure 2013-30,³⁵⁹ and is generally available if relief is requested within three years and seventy-five days of the effective date of the election.³⁶⁰ A request for relief is filed at the "applicable" IRS Service Center rather than at the National Office. The revenue procedure provides that user fees are not applicable to requests using the procedure.³⁶¹ Private letter ruling relief may be pursued for defective elections that do not fit within the procedure outlined in Revenue Procedure 2013-30.³⁶²

357.1. Treas. Reg. § 1.1377-1(a)(2)(iii).

357.2. *Id.*

358. See many of the Private Letter Rulings cited in this chapter.

359. Rev. Proc. 2013-30, 2013-2 C.B. 173.

360. *Id.* § 4.02(2).

361. *Id.* § 3.01.

362. *Id.* § 3.02.

Appendix A

Internal Revenue Code Sections 641–691

(Subchapter J—Estates, Trusts, Beneficiaries, and Decedents)

- § 641 Imposition of Tax
- § 642 Special Rules for Credits and Deductions
- § 643 Definitions Applicable to Subparts A, B, C and D
- § 644 Taxable Year of Trusts
- § 645 Certain Revocable Trusts Treated as Part of Estate
- § 651 Deduction for Trusts Distributing Current Income Only
- § 652 Inclusion of Amounts in Gross Income of Beneficiaries of Trusts Distributing Current Income Only
- § 661 Deduction for Estates and Trusts Accumulating Income or Distributing Corpus
- § 662 Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus
- § 663 Special Rules Applicable to Sections 661 and 662
- § 664 Charitable Remainder Trusts
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- § 671 Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners
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- § 675 Administrative Powers
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- § 677 Income for Benefit of Grantor
- § 678 Person Other than Grantor Treated as Substantial Owner

- § 679 Foreign Trusts Having One or More United States Beneficiaries
- § 681 Limitation on Charitable Deduction
- § 682 Income of an Estate or Trust in Case of Divorce, etc.
- § 683 Use of Trust as an Exchange Fund
- § 684 Recognition of Gain on Certain Transfers to Certain Foreign Trusts and Estates
- § 685 Treatment of Funeral Trusts
- § 691 Recipients of Income in Respect of Decedents

SEC. 641. IMPOSITION OF TAX

(a) APPLICATION OF TAX.—The tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust, including—

(1) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) COMPUTATION AND PAYMENT.—The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary. For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time.

(c) SPECIAL RULES FOR TAXATION OF ELECTING SMALL BUSINESS TRUSTS.—

(1) IN GENERAL.—For purposes of this chapter—

(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

(2) MODIFICATIONS.—For purposes of paragraph (1), the modifications of this paragraph are the following:

(A) Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e).

(B) The exemption amount under section 55(d) shall be zero.

(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

- (i) The items required to be taken into account under section 1366.
- (ii) Any gain or loss from the disposition of stock in an S corporation.
- (iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).
- (iv) Any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation.

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

- (D) No amount shall be allowed under paragraph (1) or (2) of section 1211(b).

(3) TREATMENT OF REMAINDER OF TRUST AND DISTRIBUTIONS.—For purposes of determining—

- (A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and
- (B) the distributable net income of the entire trust, the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

(4) TREATMENT OF UNUSED DEDUCTIONS WHERE TERMINATION OF SEPARATE TRUST.—If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642(h) shall be taken into account by the entire trust.

(5) ELECTING SMALL BUSINESS TRUST.—For purposes of this subsection, the term “electing small business trust” has the meaning given such term by section 1361(e)(1).

SEC. 642.

SPECIAL RULES FOR CREDITS AND DEDUCTIONS

(a) FOREIGN TAX CREDIT ALLOWED.—An estate or trust shall be allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States, to the extent allowed by section 901, only in respect of so much of the taxes described in such section as is not properly allocable under such section to the beneficiaries.

(b) DEDUCTION FOR PERSONAL EXEMPTION.—

(1) ESTATES.—An estate shall be allowed a deduction of \$600.

(2) TRUSTS.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, a trust shall be allowed a deduction of \$100.

- (B) TRUSTS DISTRIBUTING INCOME CURRENTLY.—A trust which, under its governing instrument, is required to distribute all of its income currently shall be allowed a deduction of \$300.
- (C) DISABILITY TRUSTS.—
- (i) IN GENERAL.—A qualified disability trust shall be allowed a deduction equal to the exemption amount under section 151(d), determined—
- (I) by treating such trust as an individual described in section 68(b)(1)(c), and
- (II) by applying section 67(e) (without the reference to section 642(b)) for purposes of determining the adjusted gross income of the trust.
- (ii) QUALIFIED DISABILITY TRUST.—For purposes of clause (i), the term “qualified disability trust” means any trust if—
- (I) such trust is a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. 1396p), and
- (II) all of the beneficiaries of the trust as of the close of the taxable year are determined by the Commissioner of Social Security to have been disabled (within the meaning of section 1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c(a)(3)) for some portion of such year.

A trust shall not fail to meet the requirements of subclause (II) merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is so disabled.

(3) DEDUCTIONS IN LIEU OF PERSONAL EXEMPTION.—The deductions allowed by this subsection shall be in lieu of the deductions allowed under section 151 (relating to deduction for personal exemption).

(c) DEDUCTION FOR AMOUNTS PAID OR PERMANENTLY SET ASIDE FOR A CHARITABLE PURPOSE.—

(1) GENERAL RULE.—In the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A)). If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such contribution as paid during such taxable year. The election shall be made at such time and in such manner as the Secretary prescribes by regulations.

(2) AMOUNTS PERMANENTLY SET ASIDE.—In the case of an estate, and in the case of a trust (other than a trust meeting the specifications of subpart B) required by the terms of its governing instrument to set aside amounts which was—

- (A) created on or before October 9, 1969, if—

- (i) an irrevocable remainder interest is transferred to or for the use of an organization described in section 170(c), or
 - (ii) the grantor is at all times after October 9, 1969, under a mental disability to change the terms of the trust; or
- (B) established by a will executed on or before October 9, 1969, if—
- (i) the testator dies before October 9, 1972, without having republished the will after October 9, 1969, by codicil or otherwise,
 - (ii) the testator at no time after October 9, 1969, had the right to change the portions of the will which pertain to the trust, or
 - (iii) the will is not republished by codicil or otherwise before October 9, 1972, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit. In the case of a trust, the preceding sentence shall apply only to gross income earned with respect to amounts transferred to the trust before October 9, 1969, or transferred under a will to which subparagraph (B) applies.

(3) POOLED INCOME FUNDS.—In the case of a pooled income fund (as defined in paragraph (5)), there shall also be allowed as a deduction in computing its taxable income any amount of the gross income attributable to gain from the sale of a capital asset held for more than 1 year, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c).

(4) ADJUSTMENTS.—To the extent that the amount otherwise allowable as a deduction under this subsection consists of gain described in section 1202(a), proper adjustment shall be made for any exclusion allowable to the estate or trust under section 1202. In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income).

(5) DEFINITION OF POOLED INCOME FUND.—For purposes of paragraph (3), a pooled income fund is a trust—

- (A) to which each donor transfers property, contributing an irrevocable remainder interest in such property to or for the use of an organization described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)), and retaining an income interest for the life of one or more beneficiaries (living at the time of such transfer),
- (B) in which the property transferred by each donor is commingled with property transferred by other donors who have made or make similar transfers,

- (C) which cannot have investments in securities which are exempt from the taxes imposed by this subtitle,
- (D) which includes only amounts received from transfers which meet the requirements of this paragraph,
- (E) which is maintained by the organization to which the remainder interest is contributed and of which no donor or beneficiary of an income interest is a trustee, and
- (F) from which each beneficiary of an income interest receives income, for each year for which he is entitled to receive the income interest referred to in subparagraph (A), determined by the rate of return earned by the trust for such year.

For purposes of determining the amount of any charitable contribution allowable by reason of a transfer of property to a pooled fund, the value of the income interest shall be determined on the basis of the highest rate of return earned by the fund for any of the 3 taxable years immediately preceding the taxable year of the fund in which the transfer is made. In the case of funds in existence less than 3 taxable years preceding the taxable year of the fund in which a transfer is made the rate of return shall be deemed to be 6 percent per annum, except that the Secretary may prescribe a different rate of return.

(6) TAXABLE PRIVATE FOUNDATIONS.—In the case of a private foundation which is not exempt from taxation under section 501(a) for the taxable year, the provisions of this subsection shall not apply and the provisions of section 170 shall apply.

(d) NET OPERATING LOSS DEDUCTION.—The benefit of the deduction for net operating losses provided by section 172 shall be allowed to estates and trusts under regulations prescribed by the Secretary.

(e) DEDUCTION FOR DEPRECIATION AND DEPLETION.—An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under section 167(d) and 611(b).

(f) AMORTIZATION DEDUCTIONS.—The benefit of the deductions for amortization provided by sections 169 and 197 shall be allowed to estates and trusts in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Secretary.

(g) DISALLOWANCE OF DOUBLE DEDUCTIONS.—Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. Rules similar to the rules of the preceding sentence shall apply to amounts which may be taken into account under section 2621(a)(2) or 2622(b). This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

(h) UNUSED LOSS CARRYOVERS AND EXCESS DEDUCTIONS ON TERMINATION AVAILABLE TO BENEFICIARIES.—If on the termination of an estate or trust, the estate or trust has—

- (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or

(2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust.

(i) CERTAIN DISTRIBUTIONS BY CEMETERY PERPETUAL CARE FUNDS.—In the case of a cemetery perpetual care fund which—

(1) was created pursuant to local law by a taxable cemetery corporation for the care and maintenance of cemetery property, and

(2) is treated for the taxable year as a trust for purposes of this subchapter, any amount distributed by such fund for the care and maintenance of gravesites which have been purchased from the cemetery corporation before the beginning of the taxable year of the trust and with respect to which there is an obligation to furnish care and maintenance shall be considered to be a distribution solely for purposes of sections 651 and 661, but only to the extent that the aggregate amount so distributed during the taxable year does not exceed \$5 multiplied by the aggregate number of such gravesites.

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D

(a) DISTRIBUTABLE NET INCOME.—For purposes of this part, the term “distributable net income” means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) DEDUCTION FOR DISTRIBUTIONS.—No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) DEDUCTION FOR PERSONAL EXEMPTION.—No deduction shall be taken under section 642(b) (relating to deduction for personal exemptions).

(3) CAPITAL GAINS AND LOSSES.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642 (C). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

(4) EXTRAORDINARY DIVIDENDS AND TAXABLE STOCK DIVIDENDS.—For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) TAX-EXEMPT INTEREST.—There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) INCOME OF FOREIGN TRUST.—In the case of a foreign trust—

- (A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(a)(1) (relating to disallowance of certain deductions).
- (B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).
- (C) Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

(7) ABUSIVE TRANSACTIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent avoidance of such purposes.

If the estate or trust is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

(b) INCOME.—For purposes of this subpart and subparts B, C, and D, the term “income”, when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross”, means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

(c) BENEFICIARY.—For purposes of this part, the term “beneficiary” includes heir, legatee, devisee.

(d) COORDINATION WITH BACK-UP WITHHOLDING.—Except to the extent otherwise provided in regulations, this subchapter shall be applied with respect to payments subject to withholding under section 3406—

(1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31(c) (on the basis of their respective shares of any such payment taken into account under this subchapter),

(2) by treating each beneficiary to whom such credit is allocated as if an amount equal to such credit has been paid to him by the estate or trust, and

(3) by allowing the estate or trust a deduction in an amount equal to the credit so allocated to beneficiaries.

(e) TREATMENT OF PROPERTY DISTRIBUTED IN KIND.—

(1) BASIS OF BENEFICIARY.—The basis of any property received by a beneficiary in a distribution from an estate or trust shall be—

- (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for
 - (B) any gain or loss recognized to the estate or trust on the distribution.
- (2) AMOUNT OF DISTRIBUTION.—In the case of any distribution of property (other than cash), the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the lesser of—
- (A) the basis of such property in the hands of the beneficiary (as determined under paragraph (1)), or
 - (B) the fair market value of such property.
- (3) ELECTION TO RECOGNIZE GAIN.—
- (A) IN GENERAL.—In the case of any distribution of property (other than cash) to which an election under this paragraph applies—
 - (i) paragraph (2) shall not apply,
 - (ii) gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and
 - (iii) the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the fair market value of such property.
 - (B) ELECTION.—Any election under this paragraph shall apply to all distributions made by the estate or trust during a taxable year and shall be made on the return of such estate or trust for such taxable year.

Any such election, once made, may be revoked only with the consent of the Secretary.
- (4) EXCEPTION FOR DISTRIBUTIONS DESCRIBED IN SECTION 663(a).—This subsection shall not apply to any distribution described in section 663(a).
- (f) TREATMENT OF MULTIPLE TRUSTS.—For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—
- (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
 - (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.
- For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.
- (g) CERTAIN PAYMENTS OF ESTIMATED TAX TREATED AS PAID BY BENEFICIARY.—
- (1) IN GENERAL.—In the case of a trust—
 - (A) the trustee may elect to treat any portion of a payment of estimated tax made by such trust for any taxable year of the trust as a payment made by a beneficiary of such trust,
 - (B) any amount so treated shall be treated as paid or credited to the beneficiary on the last day of such taxable year, and
 - (C) for purposes of subtitle F, the amount so treated—

App. A BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS

- (i) shall not be treated as a payment of estimated tax made by the trust, but
- (ii) shall be treated as a payment of estimated tax made by such beneficiary on January 15 following the taxable year.

(2) TIME FOR MAKING ELECTION.—An election under paragraph (1) shall be made on or before the 65th day after the close of the taxable year of the trust and in such manner as the Secretary may prescribe.

(3) EXTENSION TO LAST YEAR OF ESTATE.—In the case of a taxable year reasonably expected to be the last taxable year of an estate—

- (A) any reference in this subsection to a trust shall be treated as including a reference to an estate, and
- (B) the fiduciary of the estate shall be treated as the trustee.

(h) DISTRIBUTIONS BY CERTAIN FOREIGN TRUSTS THROUGH NOMINEES.—For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person.

(i) LOANS FROM FOREIGN TRUSTS.—For purposes of subparts B, C, and D—

(1) GENERAL RULE.—Except as provided in regulations, if a foreign trust makes a loan of cash or marketable securities (or permits the use of any other trust property) directly or indirectly to or by—

- (A) any grantor or beneficiary of such trust who is a United States person, or
- (B) any United States person not described in subparagraph (A) who is related to such grantor or beneficiary,

the amount of such loan (or the fair market value of the use of such property) shall be treated as a distribution by such trust to such grantor or beneficiary (as the case may be).

(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

- (A) CASH.—The term “cash” includes foreign currencies and cash equivalents.
- (B) RELATED PERSON.—
 - (i) IN GENERAL.—A person is related to another person if the relationship between such persons would result in a disallowance of losses under section 267 or 707(b). In applying section 267 for purposes of the preceding sentence, section 267(c)(4) shall be applied as if the family of an individual includes the spouses of the members of the family.
 - (ii) ALLOCATION.—If any person described in paragraph (1)(B) is related to more than one person, the grantor or beneficiary to whom the treatment under this subsection applies shall be determined under regulations prescribed by the Secretary.
- (C) EXCLUSION OF TAX-EXEMPTS.—The term “United States person” does not include any entity exempt from tax under this chapter.
- (D) TRUST NOT TREATED AS SIMPLE TRUST.—Any trust which is treated under this subsection as making a distribution shall be treated as not described in section 651.

- (E) EXCEPTION FOR COMPENSATED USE OF PROPERTY.—In the case of the use of any trust property other than a loan of cash or marketable securities, paragraph (1) shall not apply to the extent that the trust is paid the fair market value of such use within a reasonable period of time of such use.

(3) SUBSEQUENT TRANSACTIONS.—If any loan (or use of property) is taken into account under paragraph (1), any subsequent transaction between the trust and the original borrower regarding the principal of the loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) or the return of such property shall be disregarded for purposes of this title.

SEC. 644. TAXABLE YEAR OF TRUSTS

(a) IN GENERAL.—For purposes of this subtitle, the taxable year of any trust shall be the calendar year.

(b) EXCEPTION FOR TRUSTS EXEMPT FROM TAX AND CHARITABLE TRUSTS.—Subsection (a) shall not apply to a trust exempt from taxation under section 501(a) or to a trust described in section 4947(a)(1).

SEC. 645. CERTAIN REVOCABLE TRUSTS TREATED AS PART OF ESTATE

(a) GENERAL RULE.—For purposes of this subtitle, if both the executor (if any) of an estate and the trustee of a qualified revocable trust elect the treatment provided in this section, such trust shall be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable date.

(b) DEFINITIONS.—For purposes of subsection (a)—

(1) QUALIFIED REVOCABLE TRUST.—The term “qualified revocable trust” means any trust (or portion thereof) which was treated under section 676 as owned by the decedent of the estate referred to in subsection (a) by reason of a power in the grantor (determined without regard to section 672(e)).

(2) APPLICABLE DATE.—The term “applicable date” means—

- (A) if no return of tax imposed by chapter 11 is required to be filed, the date which is 2 years after the date of the decedent's death, and
- (B) if such a return is required to be filed, the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11.

(c) ELECTION.—The election under subsection (a) shall be made not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions) and, once made, shall be irrevocable.

SEC. 651.
DEDUCTION FOR TRUSTS
DISTRIBUTING CURRENT INCOME ONLY

(a) DEDUCTION.—In the case of any trust the terms of which—

- (1) provide that all of its income is required to be distributed currently, and
- (2) do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642(c) (relating to deduction for charitable, etc., purposes),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. This section shall not apply in any taxable year in which the trust distributes amounts other than amounts of income described in paragraph (1).

(b) LIMITATION ON DEDUCTION.—If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income. For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable thereto.

SEC. 652.
INCLUSION OF AMOUNTS IN GROSS INCOME OF
BENEFICIARIES OF TRUSTS
DISTRIBUTING CURRENT INCOME ONLY

(a) INCLUSION.—Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

(b) CHARACTER OF AMOUNTS.—The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the trust, the amount which the beneficiary is required to include in gross income in accordance with the provisions of this section shall be based upon the amount of income of the trust for any taxable year or years of the trust ending within or with his taxable year.

SEC. 661.
DEDUCTION FOR ESTATES AND TRUSTS
ACCUMULATING INCOME OR DISTRIBUTING CORPUS

(a) DEDUCTION.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year; but such deduction shall not exceed the distributable net income of the estate or trust.

(b) CHARACTER OF AMOUNTS DISTRIBUTED.—The amount determined under subsection (a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

(c) LIMITATION ON DEDUCTION.—No deduction shall be allowed under subsection (a) in respect of any portion of the amount allowed as a deduction under that subsection (without regard to this subsection) which is treated under subsection (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

SEC. 662.
INCLUSION OF AMOUNTS IN GROSS INCOME OF
BENEFICIARIES OF ESTATES AND TRUSTS
ACCUMULATING INCOME OR DISTRIBUTING CORPUS

(a) INCLUSION.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase “the amount of income for the taxable year required to be distributed currently” includes any

amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) OTHER AMOUNTS DISTRIBUTED.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

- (A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and
- (B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries,

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

(b) CHARACTER OF AMOUNTS.—The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

SEC. 663.

SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662

(a) EXCLUSIONS.—There shall not be included as amounts falling within section 661(a) or 662(a)—

(1) GIFTS, BEQUESTS, ETC.—Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

(2) CHARITABLE, ETC., DISTRIBUTIONS.—Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to sections 508(d), 681, and 4948(c)(4)).

(3) DENIAL OF DOUBLE DEDUCTION.—Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

(b) DISTRIBUTIONS IN FIRST SIXTY-FIVE DAYS OF TAXABLE YEAR.—

(1) GENERAL RULE.—If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) LIMITATION.—Paragraph (1) shall apply with respect to any taxable year of an estate or a trust only if the executor of such estate or the fiduciary of such trust (as the case may be) elects, in such manner and at such time as the Secretary prescribes by regulations, to have paragraph (1) apply for such taxable year.

(c) SEPARATE SHARES TREATED AS SEPARATE ESTATES OR TRUSTS.—For the sole 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 in the trust shall be treated as separate trusts. Rules similar to the rules of the preceding provisions of this subsection shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than 1 beneficiary as separate estates. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts or estates, including the application of subpart D, shall be determined in accordance with regulations prescribed by the Secretary.

SEC. 664. CHARITABLE REMAINDER TRUSTS

(a) GENERAL RULE.—Notwithstanding any other provision of this subchapter, the provisions of this section shall, in accordance with regulations prescribed by the Secretary, apply in the case of a charitable remainder annuity trust and a charitable remainder unitrust.

(b) CHARACTER OF DISTRIBUTIONS.—Amounts distributed by a charitable remainder annuity trust or by a charitable remainder unitrust shall be considered as having the following characteristics in the hands of a beneficiary to whom is paid the annuity described in subsection (d)(1)(A) or the payment described in subsection (d)(2)(A):

(1) First, as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;

(2) Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years;

(3) Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and

(4) Fourth, as a distribution of trust corpus.

For purposes of this section, the trust shall determine the amount of its undistributed capital gain on a cumulative net basis.

(c) TAXATION OF TRUSTS.

(1) Income tax.—A charitable remainder annuity trust and a charitable remainder unitrust shall, for any taxable year, not be subject to any tax imposed by this subtitle.

(2) Excise tax.—

(A) In general.—In the case of a charitable remainder annuity trust or a charitable remainder unitrust which has unrelated business taxable income (within the meaning of section 512, determined as if part III of subchapter F applied to such trust) for a taxable year, there is hereby imposed on such trust or unitrust an excise tax equal to the amount of such unrelated business taxable income.

(B) Certain rules to apply.—The tax imposed by subparagraph (A) shall be treated as imposed by chapter 42 for purposes of this title other than subchapter E of chapter 42.

(C) Tax court proceedings.—For purposes of this paragraph, the references in section 6212(c)(1) to section 4940 shall be deemed to include references to this paragraph.

(d) DEFINITIONS.—

(1) CHARITABLE REMAINDER ANNUITY TRUST.—For purposes of this section, a charitable remainder annuity trust is a trust—

(A) from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c),

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)), and

(D) the value (determined under section 7520) of such remainder interest is at least 10 percent of the initial net fair market value of all property placed in the trust.

(2) CHARITABLE REMAINDER UNITRUST.—For purposes of this section, a charitable remainder unitrust is a trust—

(A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one

or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

- (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c),
- (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g)), and
- (D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

(3) EXCEPTION.—Notwithstanding the provisions of paragraphs (2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year—

- (A) the amount of the trust income, if such amount is less than the amount required to be distributed under paragraph (2)(A), and
- (B) any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph (A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(4) SEVERANCE OF CERTAIN ADDITIONAL CONTRIBUTIONS.—If—

- (A) any contribution is made to a trust which before the contribution is a charitable remainder unitrust, and
- (B) such contribution would (but for this paragraph) result in such trust ceasing to be a charitable unitrust by reason of paragraph (2)(D),

such contribution shall be treated as a transfer to a separate trust under regulations prescribed by the Secretary.

(e) VALUATION FOR PURPOSES OF CHARITABLE CONTRIBUTION.—For purposes of determining the amount of any charitable contribution, the remainder interest of a charitable remainder annuity trust or charitable remainder unitrust shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year.

(f) CERTAIN CONTINGENCIES PERMITTED.—

(1) GENERAL RULE.—If a trust would, but for a qualified contingency, meet the requirements of paragraph (1)(A) or (2)(A) of subsection (d), such trust shall be treated as meeting such requirements.

(2) VALUE DETERMINED WITHOUT REGARD TO QUALIFIED CONTINGENCY.—For purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account.

(3) QUALIFIED CONTINGENCY.—For purposes of this subsection, the term “qualified contingency” means any provision of a trust which provides that, upon the happening of a contingency, the payments described in paragraph (1)(A) or (2)(A) of subsection (d) (as the case may be) will terminate not later than such payments would otherwise terminate under the trust.

(g) QUALIFIED GRATUITOUS TRANSFER OF QUALIFIED EMPLOYER SECURITIES.—

(1) IN GENERAL.—For purposes of this section, the term “qualified gratuitous transfer” means a transfer of qualified employer securities to an employee stock ownership plan (as defined in section 4975(e)(7)) but only to the extent that—

- (A) the securities transferred previously passed from a decedent dying before January 1, 1999, to a trust described in paragraph (1) or (2) of subsection (d),
- (B) no deduction under section 404 is allowable with respect to such transfer,
- (C) such plan contains the provisions required by paragraph (3),
- (D) such plan treats such securities as being attributable to employer contributions but without regard to the limitations otherwise applicable to such contributions under section 404, and
- (E) the employer whose employees are covered by the plan described in this paragraph files with the Secretary a verified written statement consenting to the application of sections 4978 and 4979A with respect to such employer.

(2) EXCEPTION.—The term “qualified gratuitous transfer” shall not include a transfer of qualified employer securities to an employee stock ownership plan unless—

- (A) such plan was in existence on August 1, 1996,
- (B) at the time of the transfer, the decedent and members of the decedent’s family (within the meaning of section 2032A(e)(2)) own (directly or through the application of section 318(a)) no more than 10 percent of the value of the stock of the corporation referred to in paragraph (4), and
- (C) immediately after the transfer, such plan owns (after the application of section 318(a)(4)) at least 60 percent of the value of the outstanding stock of the corporation.

(3) PLAN REQUIREMENTS.—A plan contains the provisions required by this paragraph if such plan provides that—

- (A) the qualified employer securities so transferred are allocated to plan participants in a manner consistent with section 401(a)(4),
- (B) plan participants are entitled to direct the plan as to the manner in which such securities which are entitled to vote and are allocated to the account of such participant are to be voted,
- (C) an independent trustee votes the securities so transferred which are not allocated to plan participants,

- (D) each participant who is entitled to a distribution from the plan has the rights described in subparagraphs (A) and (B) of section 409(h)(1),
- (E) such securities are held in a suspense account under the plan to be allocated each year, up to the applicable limitation under paragraph (7) (determined on the basis of fair market value of securities when allocated to participants), after first allocating all other annual additions for the limitation year, up to the limitations under sections 415(c) and (e), and
- (F) on termination of the plan, all securities so transferred which are not allocated to plan participants as of such termination are to be transferred to, or for the use of, an organization described in section 170(c).

For purposes of the preceding sentence, the term “independent trustee” means any trustee who is not a member of the family (within the meaning of section 2032A(e)(2)) of the decedent or a 5-percent shareholder. A plan shall not fail to be treated as meeting the requirements of section 401(a) by reason of meeting the requirements of this subsection.

(4) QUALIFIED EMPLOYER SECURITIES.—For purposes of this section, the term “qualified employer securities” means employer securities (as defined in section 409(l)) which are issued by a domestic corporation—

- (A) which has no outstanding stock which is readily tradable on an established securities market, and
- (B) which has only 1 class of stock.

(5) TREATMENT OF SECURITIES ALLOCATED BY EMPLOYEE STOCK OWNERSHIP PLAN TO PERSONS RELATED TO DECEDENT OR 5-PERCENT SHAREHOLDERS.—

- (A) IN GENERAL.—If any portion of the assets of the plan attributable to securities acquired by the plan in a qualified gratuitous transfer are allocated to the account of—
 - (i) any person who is related to the decedent (within the meaning of section 267(b)) or a member of the decedent’s family (within the meaning of section 2032A(e)(2)), or
 - (ii) any person who, at the time of such allocation or at any time during the 1-year period ending on the date of the acquisition of qualified employer securities by the plan, is a 5-percent shareholder of the employer maintaining the plan, the plan shall be treated as having distributed (at the time of such allocation) to such person or shareholder the amount so allocated.
- (B) 5-PERCENT SHAREHOLDER.—For purposes of subparagraph (A), the term “5-percent shareholder” means any person who owns (directly or through the application of section 318(a)) more than 5 percent of the outstanding stock of the corporation which issued such qualified employer securities or of any corporation which is a member of the same controlled group of corporations (within the meaning of section 409(l)(4)) as such corporation. For purposes of the preceding sentence, section 318(a) shall be applied without regard to the exception in paragraph (2)(B)(i) thereof.

(C) CROSS REFERENCE.—

For excise tax on allocations described in subparagraph (A), see section 4979A.

(6) TAX ON FAILURE TO TRANSFER UNALLOCATED SECURITIES TO CHARITY ON TERMINATION OF PLAN.—If the requirements of paragraph (3)(F) are not met with respect to any securities, there is hereby imposed a tax on the employer maintaining the plan in an amount equal to the sum of—

(A) the amount of the increase in the tax which would be imposed by chapter 11 if such securities were not transferred as described in paragraph (1), and (B) interest on such amount at the underpayment rate under section 6621 (and compounded daily) from the due date for filing the return of the tax imposed by chapter 11.

(7) APPLICABLE LIMITATION.—

(A) IN GENERAL.—For purposes of paragraph (3)(E), the applicable limitation under this paragraph with respect to a participant is an amount equal to the lesser of—

(i) \$30,000, or

(ii) 25 percent of the participant's compensation (as defined in section 415(c)(3)).

(B) COST-OF-LIVING ADJUSTMENT.—The Secretary shall adjust annually the \$30,000 amount under subparagraph (A)(i) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning October 1, 1993, and any increase under this subparagraph which is not a multiple of \$5,000 shall be rounded to the next lowest multiple of \$5,000.

SEC. 665.

DEFINITIONS APPLICABLE TO SUBPART D

(a) UNDISTRIBUTED NET INCOME.—For purposes of this subpart, the term “undistributed net income” for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum of—

(1) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661(a), and

(2) the amount of taxes imposed on the trust attributable to such distributable net income.

(b) ACCUMULATION DISTRIBUTION.—For purposes of this subpart, except as provided in subsection (c), the term “accumulation distribution” means, for any taxable year of the trust, the amount by which—

(1) the amounts specified in paragraph (2) of section 661(a) for such taxable year, exceed

(2) distributable net income for such year reduced (but not below zero) by the amounts specified in paragraph (1) of section 661(a).

For purposes of section 667 (other than subsection (c) thereof, relating to multiple trusts), the amounts specified in paragraph (2) of section 661(a) shall not include

amounts properly paid, credited, or required to be distributed to a beneficiary from a trust (other than a foreign trust) as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21. If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year.

(c) EXCEPTION FOR ACCUMULATION DISTRIBUTIONS FROM CERTAIN DOMESTIC TRUSTS.—For purposes of this subpart—

(1) IN GENERAL.—In the case of a qualified trust, any distribution in any taxable year beginning after the date of the enactment of this subsection shall be computed without regard to any undistributed net income.

(2) QUALIFIED TRUST.—For purposes of this subsection, the term “qualified trust” means any trust other than—

(A) a foreign trust (or, except as provided in regulations, a domestic trust which at any time was a foreign trust), or

(B) a trust created before March 1, 1984, unless it is established that the trust would not be aggregated with other trusts under section 643(f) if such section applied to such trust.

(d) TAXES IMPOSED ON THE TRUST.—For purposes of this subpart—

(1) IN GENERAL.—The term “taxes imposed on the trust” means the amount of the taxes which are imposed for any taxable year of the trust under this chapter (without regard to this subpart or part IV of subchapter A) and which, under regulations prescribed by the Secretary, are properly allocable to the undistributed portions of distributable net income and gains in excess of losses from sales or exchanges of capital assets. The amount determined in the preceding sentence shall be reduced by any amount of such taxes deemed distributed under section 666(b) and (c) to any beneficiary.

(2) FOREIGN TRUSTS.—In the case of any foreign trust, the term “taxes imposed on the trust” includes the amount, reduced as provided in the last sentence of paragraph (1), of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on such foreign trust which, as determined under paragraph (1), are so properly allocable. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the term “taxes imposed on the trust” includes the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(e) PRECEDING TAXABLE YEAR.—For purposes of this subpart—

(1) In the case of a foreign trust created by a United States person, the term “preceding taxable year” does not include any taxable year of the trust to which this part does not apply.

(2) In the case of a preceding taxable year with respect to which a trust qualified, without regard to this subpart, under the provisions of subpart B, for purposes of the application of this subpart to such trust for such taxable year, such trust shall, in accordance with regulations prescribed by the Secretary, be treated as a trust to which subpart C applies.

SEC. 666.
ACCUMULATION DISTRIBUTION
ALLOCATED TO PRECEDING YEARS

(a) **AMOUNT ALLOCATED.**—In the case of a trust which is subject to subpart C, the amount of the accumulation distribution of such trust for a taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of each of the preceding taxable years, commencing with the earliest of such years, to the extent that such amount exceeds the total of any undistributed net income for all earlier preceding taxable years. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income for such preceding taxable year. For purposes of this subsection, undistributed net income for each of such preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(b) **TOTAL TAXES DEEMED DISTRIBUTED.**—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year, and such portion of such distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes (other than the tax imposed by section 55) imposed on the trust for such preceding taxable year attributable to the undistributed net income. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(c) **PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.**—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year and such portion of the accumulation distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes (other than the tax imposed by section 55) imposed on the trust for such taxable year attributable to the undistributed net income multiplied by the ratio of the portion of the accumulation distribution to the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income shall be computed without regard to the accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(d) **RULE WHEN INFORMATION IS NOT AVAILABLE.**—If adequate records are not available to determine the proper application of this subpart to an amount distributed by a trust, such amount shall be deemed to be an accumulation distribution consisting of undistributed net income earned during the earliest preceding taxable year of the trust in which it can be established that the trust was in existence.

(e) DENIAL OF REFUND TO TRUSTS AND BENEFICIARIES.—No refund or credit shall be allowed to a trust or a beneficiary of such trust for any preceding taxable year by reason of a distribution deemed to have been made by such trust in such year under this section.

SEC. 667.
TREATMENT OF AMOUNTS DEEMED DISTRIBUTED
BY TRUST IN PRECEDING YEARS

(a) GENERAL RULE.—The total of the amounts which are treated under section 666 as having been distributed by a trust in a preceding taxable year shall be included in the income of a beneficiary of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary under section 662(a)(2) (and, with respect to any tax-exempt interest to which section 103 applies, under section 662(b)) if such total had been paid to such beneficiary on the last day of such preceding taxable year. The tax imposed by this subtitle on a beneficiary for a taxable year in which any such amount is included in his income shall be determined only as provided in this section and shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to the total of such amounts, at the rate and in the manner as if this section had not been enacted,

(2) a partial tax determined as provided in subsection (b) of this section, and

(3) in the case of a foreign trust, the interest charge determined as provided in section 668.

(b) TAX ON DISTRIBUTION.—

(1) IN GENERAL.—The partial tax imposed by subsection (a)(2) shall be determined.

(A) by determining the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed,

(B) by taking from the 5 taxable years immediately preceding the year of the accumulation distribution the 1 taxable year for which the beneficiary's taxable income was the highest and the 1 taxable year for which his taxable income was the lowest,

(C) by adding to the beneficiary's taxable income for each of the 3 taxable years remaining after the application of subparagraph (B) an amount determined by dividing the amount deemed distributed under section 666 and required to be included in income under subsection (a) by the number of preceding taxable years determined under subparagraph (A), and

(D) by determining the average increase in tax for the 3 taxable years referred to in subparagraph (C) resulting from the application of such subparagraph.

The partial tax imposed by subsection (a)(2) shall be the excess (if any) of the average increase in tax determined under subparagraph (D), multiplied by the number of preceding taxable years determined under subparagraph (A), over the amount

of taxes (other than the amount of taxes described in section 665(d)(2)) deemed distributed to the beneficiary under sections 666(b) and (c).

(2) TREATMENT OF LOSS YEARS.—For purposes of paragraph (1), the taxable income of the beneficiary for any taxable year shall be deemed to be not less than zero.

(3) CERTAIN PRECEDING TAXABLE YEARS NOT TAKEN INTO ACCOUNT.—For purposes of paragraph (1), if the amount of the undistributed net income deemed distributed in any preceding taxable year of the trust is less than 25 percent of the amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated under section 666(a), the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall be determined without regard to such year.

(4) EFFECT OF OTHER ACCUMULATION DISTRIBUTIONS.—In computing the partial tax under paragraph (1) for any beneficiary, the income of such beneficiary for each of his prior taxable years shall include amounts previously deemed distributed to such beneficiary in such year under section 666 as a result of prior accumulation distributions (whether from the same or another trust).

(5) MULTIPLE DISTRIBUTIONS IN THE SAME TAXABLE YEAR.—In the case of accumulation distributions made from more than one trust which are includible in the income of a beneficiary in the same taxable year, the distributions shall be deemed to have been made consecutively in whichever order the beneficiary shall determine.

(6) ADJUSTMENT IN PARTIAL TAX FOR ESTATE AND GENERATION-SKIPPING TRANSFER TAXES ATTRIBUTABLE TO PARTIAL TAX.—

(A) IN GENERAL.—The partial tax shall be reduced by an amount which is equal to the pre-death portion of the partial tax multiplied by a fraction—

- (i) the numerator of which is that portion of the tax imposed by chapter 11 or 13, as the case may be, which is attributable (on a proportionate basis) to amounts included in the accumulation distribution, and
- (ii) the denominator of which is the amount of the accumulation distribution which is subject to the tax imposed by chapter 11 or 13, as the case may be.

(B) PARTIAL TAX DETERMINED WITHOUT REGARD TO THIS PARAGRAPH.—For purposes of this paragraph, the term “partial tax” means the partial tax imposed by subsection (a)(2) determined under this subsection without regard to this paragraph.

(C) PRE-DEATH PORTION.—For purposes of this paragraph, the pre-death portion of the partial tax shall be an amount which bears the same ratio to the partial tax as the portion of the accumulation distribution which is attributable to the period before the date of the death of the decedent or the date of the generation-skipping transfer bears to the total accumulation distribution.

(c) SPECIAL RULE FOR MULTIPLE TRUSTS.—

(1) IN GENERAL.—If, in the same prior taxable year of the beneficiary in which any part of the accumulation distribution from a trust (hereinafter in this paragraph referred to as “third trust”) is deemed under section 666(a) to have been

distributed to such beneficiary, some part of prior distributions by each of 2 or more other trusts is deemed under section 666(a) to have been distributed to such beneficiary, then subsections (b) and (c) of section 666 shall not apply with respect to such part of the accumulation distribution from such third trust.

(2) ACCUMULATION DISTRIBUTIONS FROM TRUST NOT TAKEN INTO ACCOUNT UNLESS THEY EQUAL OR EXCEED \$1,000.—For purposes of paragraph (1), an accumulation distribution from a trust to a beneficiary shall be taken into account only if such distribution, when added to any prior accumulation distributions from such trust which are deemed under section 666(a) to have been distributed to such beneficiary for the same prior taxable year of the beneficiary, equals or exceeds \$1,000.

(d) SPECIAL RULES FOR FOREIGN TRUST.—

(1) FOREIGN TAX DEEMED PAID BY BENEFICIARY.—

(A) IN GENERAL.—In determining the increase in tax under subsection (b)(1)(D) for any computation year, the taxes described in section 665(d)(2) which are deemed distributed under section 666(b) or (c) and added under subsection (b)(1)(C) to the taxable income of the beneficiary for any computation year shall, except as provided in subparagraphs (B) and (C), be treated as a credit against the increase in tax for such computation year under subsection (b)(1)(D).

(B) DEDUCTION IN LIEU OF CREDIT.—If the beneficiary did not choose the benefits of subpart A of part III of subchapter N with respect to the computation year, the beneficiary may in lieu of treating the amounts described in subparagraph (A) (without regard to subparagraph (C)) as a credit may treat such amounts as a deduction in computing the beneficiary's taxable income under subsection (b)(1)(C) for the computation year.

(C) LIMITATION ON CREDIT; RETENTION OF CHARACTER.—

(i) LIMITATION ON CREDIT.—For purposes of determining under subparagraph (A) the amount treated as a credit for any computation year, the limitations under subpart A of part III of subchapter N shall be applied separately with respect to amounts added under subsection (b)(1)(C) to the taxable income of the beneficiary for such computation year. For purposes of computing the increase in tax under subsection (b)(1)(D) for any computation year for which the beneficiary did not choose the benefits of subpart A of part III of subchapter N, the beneficiary shall be treated as having chosen such benefits for such computation year.

(ii) RETENTION OF CHARACTER.—The items of income, deduction, and credit of the Trust shall retain their character (subject to the application of section 904(f)(5)) to the extent necessary to apply this paragraph.

(D) COMPUTATION YEAR.—For purposes of this paragraph, the term “computation year” means any of the three taxable years remaining after application of subsection (b)(1)(B).

(e) RETENTION OF CHARACTER OF AMOUNTS DISTRIBUTED FROM ACCUMULATION TRUST TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—In the case of a distribution from a trust to a nonresident alien individual or to a foreign corporation,

the first sentence of subsection (a) shall be applied as if the reference to the determination of character under section 662(b) applied to all amounts instead of just to tax-exempt interest.

SEC. 668.
INTEREST CHARGE ON ACCUMULATION DISTRIBUTIONS
FROM FOREIGN TRUSTS

(a) GENERAL RULE.—For purposes of the tax determined under section 667(a)—

(1) INTEREST DETERMINED USING UNDERPAYMENT RATES.—The interest charge determined under this section with respect to any distribution is the amount of interest which would be determined on the partial tax computed under section 667(b) for the period described in paragraph (2) using the rates and the method under section 6621 applicable to underpayments of tax.

(2) PERIOD.—For purposes of paragraph (1), the period described in this paragraph is the period which begins on the date which is the applicable number of years before the date of the distribution and which ends on the date of the distribution.

(3) APPLICABLE NUMBER OF YEARS.—For purposes of paragraph (2)—

(A) IN GENERAL.—The applicable number of years with respect to a distribution is the number determined by dividing—

- (i) the sum of the products described in subparagraph (B) with respect to each undistributed income year, by
- (ii) the aggregate undistributed net income.

The quotient determined under the preceding sentence shall be rounded under procedures prescribed by the Secretary.

(B) PRODUCT DESCRIBED.—For purposes of subparagraph (A), the product described in this subparagraph with respect to any undistributed income year is the product of—

- (i) the undistributed net income for such year, and
- (ii) the sum of the number of taxable years between such year and the taxable year of the distribution (counting in each case the undistributed income year but not counting the taxable year of the distribution).

(4) UNDISTRIBUTED INCOME YEAR.—For purposes of this subsection, the term “undistributed income year” means any prior taxable year of the trust for which there is undistributed net income, other than a taxable year during all of which the beneficiary receiving the distribution was not a citizen or resident of the United States.

(5) DETERMINATION OF UNDISTRIBUTED NET INCOME.—Notwithstanding section 666, for purposes of this subsection, an accumulation distribution from the trust shall be treated as reducing proportionately the undistributed net income for undistributed income years.

(6) PERIODS BEFORE 1996.—Interest for the portion of the period described in paragraph (2) which occurs before January 1, 1996, shall be determined—

- (A) by using an interest rate of 6 percent, and
- (B) without compounding until January 1, 1996.

(b) **LIMITATION.**—The total amount of the interest charge shall not, when added to the total partial tax computed under section 667(b), exceed the amount of the accumulation distribution (other than the amount of tax deemed distributed by section 666(b) or (c)) in respect of which such partial tax was determined.

(c) **INTEREST CHARGE NOT DEDUCTIBLE.**—The interest charge determined under this section shall not be allowed as a deduction for purposes of any tax imposed by this title.

**[SEC. 669.
REPEALED. PUB. L. 94-455,
TITLE VII, SEC. 701(D)(1), OCT. 4, 1976, 90 STAT. 1578]**

Section, acts Oct. 16, 1962, Pub. L. 87-834, Sec. 7(c), 76 Stat. 986; Dec. 30, 1969, Pub. L. 91-172, title III, Sec. 331(a), 83 Stat. 596, related to the treatment of capital gain deemed distributed in preceding years.

Effective Date of Repeal

Repeal applicable to distributions made in taxable years beginning after Dec. 31, 1975, see section 701(h) of Pub. L. 94-455, set out as an Effective Date of 1976 Amendment note under section 667 of this title.

**SEC. 671.
TRUST INCOME, DEDUCTIONS, AND CREDITS
ATTRIBUTABLE TO GRANTORS AND OTHERS
AS SUBSTANTIAL OWNERS**

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

**SEC. 672.
DEFINITIONS AND RULES**

(a) **ADVERSE PARTY.**—For purposes of this subpart, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) **NONADVERSE PARTY.**—For purposes of this subpart, the term “nonadverse party” means any person who is not an adverse party.

(c) RELATED OR SUBORDINATE PARTY.—For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is—

- (1) the grantor’s spouse if living with the grantor;
- (2) any one of the following: The grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) RULE WHERE POWER IS SUBJECT TO CONDITION PRECEDENT.—A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

(e) GRANTOR TREATED AS HOLDING ANY POWER OR INTEREST OF GRANTOR’S SPOUSE.—

(1) IN GENERAL.—For purposes of this subpart, a grantor shall be treated as holding any power or interest held by—

- (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or
- (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) MARITAL STATUS.—For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(f) SUBPART NOT TO RESULT IN FOREIGN OWNERSHIP.—

(1) IN GENERAL.—Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

(2) EXCEPTIONS.—

- (A) CERTAIN REVOCABLE AND IRREVOCABLE TRUSTS.—Paragraph (1) shall not apply to any portion of a trust if—
 - (i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or
 - (ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

- (B) COMPENSATORY TRUSTS.—Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.
- (3) SPECIAL RULES.—Except as otherwise provided in regulations prescribed by the Secretary—
- (A) a controlled foreign corporation (as defined in section 957) shall be treated as a domestic corporation for purposes of paragraph (1), and
- (B) paragraph (1) shall not apply for purposes of applying section 1297.
- (4) RECHARACTERIZATION OF PURPORTED GIFTS—In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.
- (5) SPECIAL RULE WHERE GRANTOR IS FOREIGN PERSON.—If—
- (A) but for this subsection, a foreign person would be treated as the owner of any portion of a trust, and
- (B) such trust has a beneficiary who is a United States person,
- such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property (other than in a sale for full and adequate consideration) to such foreign person. For purposes of the preceding sentence, any gift shall not be taken into account to the extent such gift would be excluded from taxable gifts under section 2503(b).
- (6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations providing that paragraph (1) shall not apply in appropriate cases.

SEC. 673. REVERSIONARY INTERESTS

- (a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.
- (b) REVERSIONARY INTEREST TAKING EFFECT AT DEATH OF MINOR LINEAL DESCENDANT BENEFICIARY.—In the case of any beneficiary who—
- (1) is a lineal descendant of the grantor, and
- (2) holds all of the present interests in any portion of a trust, the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.
- (c) SPECIAL RULE FOR DETERMINING VALUE OF REVERSIONARY INTEREST.—For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.
- (d) POSTPONEMENT OF DATE SPECIFIED FOR REACQUISITION.—Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary

interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

SEC. 674.

POWER TO CONTROL BENEFICIAL ENJOYMENT

(a) **GENERAL RULE.**—The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) **EXCEPTIONS FOR CERTAIN POWERS.**—Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) **POWER TO APPLY INCOME TO SUPPORT OF A DEPENDENT.**—A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) **POWER AFFECTING BENEFICIAL ENJOYMENT ONLY AFTER OCCURRENCE OF EVENT.**—A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(3) **POWER EXERCISABLE ONLY BY WILL.**—A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) **POWER TO ALLOCATE AMONG CHARITABLE BENEFICIARIES.**—A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1)).

(5) **POWER TO DISTRIBUTE CORPUS.**—A power to distribute corpus either—

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) **POWER TO WITHHOLD INCOME TEMPORARILY.**—A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

- (A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or
- (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) **POWER TO WITHHOLD INCOME DURING DISABILITY OF A BENEFICIARY.**—A power exercisable only during—

- (A) the existence of a legal disability of any current income beneficiary, or
- (B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) **POWER TO ALLOCATE BETWEEN CORPUS AND INCOME.**—A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) **EXCEPTION FOR CERTAIN POWERS OF INDEPENDENT TRUSTEES.**—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

- (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or
- (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries

designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

(d) **POWER TO ALLOCATE INCOME IF LIMITED BY A STANDARD.**—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

SEC. 675. ADMINISTRATIVE POWERS

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) **POWER TO DEAL FOR LESS THAN ADEQUATE AND FULL CONSIDERATION.**—A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) **POWER TO BORROW WITHOUT ADEQUATE INTEREST OR SECURITY.**—A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) **BORROWING OF THE TRUST FUNDS.**—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

(4) **GENERAL POWERS OF ADMINISTRATION.**—A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term “power of administration” means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor

and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

SEC. 676. POWER TO REVOKE

(a) **GENERAL RULE.**—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) **POWER AFFECTING BENEFICIAL ENJOYMENT ONLY AFTER OCCURRENCE OF EVENT.**—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR

(a) **GENERAL RULE.**—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

- (1) distributed to the grantor or the grantor's spouse;
- (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or
- (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) **OBLIGATIONS OF SUPPORT.**—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

SEC. 678.
PERSON OTHER THAN GRANTOR TREATED AS
SUBSTANTIAL OWNER

(a) GENERAL RULE.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.

(b) EXCEPTION WHERE GRANTOR IS TAXABLE.—Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) OBLIGATIONS OF SUPPORT.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or cotrustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) EFFECT OF RENUNCIATION OR DISCLAIMER.—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) CROSS REFERENCE.—

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).

SEC. 679.
FOREIGN TRUSTS HAVING ONE OR MORE
UNITED STATES BENEFICIARIES

(a) TRANSFEROR TREATED AS OWNER.—

(1) IN GENERAL.—A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

(2) EXCEPTIONS.—Paragraph (1) shall not apply—

(A) TRANSFERS BY REASON OF DEATH.—To any transfer by reason of the death of the transferor.

(B) TRANSFERS AT FAIR MARKET VALUE.—To any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property. For purposes of the preceding

sentence, consideration other than cash shall be taken into account at its fair market value.

(3) CERTAIN OBLIGATIONS NOT TAKEN INTO ACCOUNT UNDER FAIR MARKET VALUE EXCEPTION.—

- (A) IN GENERAL.—In determining whether paragraph (2)(B) applies to any transfer by a person described in clause (ii) or (iii) of subparagraph (C), there shall not be taken into account—
 - (i) except as provided in regulations, any obligation of a person described in subparagraph (C), and
 - (ii) to the extent provided in regulations, any obligation which is guaranteed by a person described in subparagraph (C).
- (B) TREATMENT OF PRINCIPAL PAYMENTS ON OBLIGATION.—Principal payments by the trust on any obligation referred to in subparagraph (A) shall be taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.
- (C) PERSONS DESCRIBED.—The persons described in this subparagraph are—
 - (i) the trust,
 - (ii) any grantor, owner, or beneficiary of the trust, and
 - (iii) any person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner, or beneficiary of the trust.

(4) SPECIAL RULES APPLICABLE TO FOREIGN GRANTOR WHO LATER BECOMES A UNITED STATES PERSON.—

- (A) IN GENERAL.—If a nonresident alien individual has a residency starting date within 5 years after directly or indirectly transferring property to a foreign trust, this section and section 6048 shall be applied as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.
 - (B) TREATMENT OF UNDISTRIBUTED INCOME.—For purposes of this section, undistributed net income for periods before such individual's residency starting date shall be taken into account in determining the portion of the trust which is attributable to property transferred by such individual to such trust but shall not otherwise be taken into account.
 - (C) RESIDENCY STARTING DATE.—For purposes of this paragraph, an individual's residency starting date is the residency starting date determined under section 7701(b)(2)(A).
- (5) OUTBOUND TRUST MIGRATIONS.—If—
- (A) an individual who is a citizen or resident of the United States transferred property to a trust which was not a foreign trust, and
 - (B) such trust becomes a foreign trust while such individual is alive,

then this section and section 6048 shall be applied as if such individual transferred to such trust on the date such trust becomes a foreign trust an amount equal to the portion of such trust attributable to the property previously transferred by such individual to such trust. A rule similar to the rule of paragraph (4)(B) shall apply for purposes of this paragraph.

(b) TRUSTS ACQUIRING UNITED STATES BENEFICIARIES.—If—

- (1) subsection (a) applies to a trust for the transferor’s taxable year, and
- (2) subsection (a) would have applied to the trust for his immediately preceding taxable year but for the fact that for such preceding taxable year there was no United States beneficiary for any portion of the trust,

then, for purposes of this subtitle, the transferor shall be treated as having income for the taxable year (in addition to his other income for such year) equal to the undistributed net income (at the close of such immediately preceding taxable year) attributable to the portion of the trust referred to in subsection (a).

(c) TRUSTS TREATED AS HAVING A UNITED STATES BENEFICIARY.—

(1) IN GENERAL.—For purposes of this section, a trust shall be treated as having a United States beneficiary for the taxable year unless—

- (A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and
- (B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.

For purposes of subparagraph (A), an amount shall be treated as accumulated for the benefit of a United States person even if the United States person’s interest in the trust is contingent on a future event.

(2) ATTRIBUTION OF OWNERSHIP.—For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and—

- (A) in the case of a foreign corporation, such corporation is a controlled foreign corporation (as defined in section 957(a)),
- (B) in the case of a foreign partnership, a United States person is a partner of such partnership, or
- (C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

(3) CERTAIN UNITED STATES BENEFICIARIES DISREGARDED.—A beneficiary shall not be treated as a United States person in applying this section with respect to any transfer of property to foreign trust if such beneficiary first became a United States person more than 5 years after the date of such transfer.

(4) SPECIAL RULE IN CASE OF DISCRETION TO IDENTIFY BENEFICIARIES.—For purposes of paragraph (1)(A), if any person has the discretion (by authority given in the trust agreement, by power of appointment, or otherwise) of making a distribution from the trust to, or for the benefit of, any person, such trust shall be treated as having a beneficiary who is a United States person unless—

- (A) the terms of the trust specifically identify the class of persons to whom such distributions may be made, and
- (B) none of those persons are United States persons during the taxable year.

(5) CERTAIN AGREEMENTS AND UNDERSTANDINGS TREATED AS TERMS OF THE TRUST.—For purposes of paragraph (1)(A), if any United States person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a United States person, such agreement or understanding shall be treated as a term of the trust.

(6) UNCOMPENSATED USE OF TRUST PROPERTY TREATED AS A PAYMENT.—For purposes of this subsection, a loan of cash or marketable securities (or the use of any other trust property) directly or indirectly to or by any United States person (whether or not a beneficiary under the terms of the trust) shall be treated as paid or accumulated for the benefit of a United States person. The preceding sentence shall not apply to the extent that the United States person repays the loan at a market rate of interest (or pays the fair market value of the use of such property) within a reasonable period of time.

(d) PRESUMPTION THAT FOREIGN TRUST HAS UNITED STATES BENEFICIARY.—If a United States person directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)), the Secretary may treat such trust as having a United States beneficiary for purposes of applying this section to such transfer unless such person—

- (1) submits such information to the Secretary as the Secretary may require with respect to such transfer, and
- (2) demonstrates to the satisfaction of the Secretary that such trust satisfies the requirements of subparagraphs (A) and (B) of subsection (c)(1).

(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

SEC. 681. LIMITATION ON CHARITABLE DEDUCTION

(a) TRADE OR BUSINESS INCOME.—In computing the deduction allowable under section 642(c) to a trust, no amount otherwise allowable under section 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year. For purposes of the preceding sentence, the term “unrelated business income” means an amount equal to the amount which, if such trust were exempt from tax under section 501(a) by reason of section 501(c)(3), would be computed as its unrelated business taxable income under section 512 (relating to income derived from certain business activities and from certain property acquired with borrowed funds).

(b) CROSS REFERENCE.—

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4).

SEC. 682.
INCOME OF AN ESTATE OR TRUST
IN CASE OF DIVORCE, ETC.

(a) **INCLUSION IN GROSS INCOME OF WIFE.**—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

(b) **WIFE CONSIDERED A BENEFICIARY.**—For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) applies, such wife shall be considered as the beneficiary specified in this part.

(c) **CROSS REFERENCE.**—

For definitions of “husband” and “wife”, as used in this section, see section 7701(a)(17).

SEC. 683.
USE OF TRUST AS AN EXCHANGE FUND

(a) **GENERAL RULE.**—Except as provided in subsection (b), if property is transferred to a trust in exchange for an interest in other trust property and if the trust would be an investment company (within the meaning of section 351) if it were a corporation, then gain shall be recognized to the transferor.

(b) **EXCEPTION FOR POOLED INCOME FUNDS.**—Subsection (a) shall not apply to any transfer to a pooled income fund (within the meaning of section 642(c)(5)).

SEC. 684.
RECOGNITION OF GAIN ON CERTAIN TRANSFERS TO
CERTAIN FOREIGN TRUSTS AND ESTATES

(a) **IN GENERAL.**—Except as provided in regulations, in the case of any transfer of property by a United States person to a foreign estate or trust, for purposes of this subtitle, such transfer shall be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor shall recognize as gain the excess of—

- (1) the fair market value of the property so transferred, over
- (2) the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

(b) EXCEPTION.—Subsection (a) shall not apply to a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671.

(c) TREATMENT OF TRUSTS WHICH BECOME FOREIGN TRUSTS.—If a trust which is not a foreign trust becomes a foreign trust, such trust shall be treated for purposes of this section as having transferred, immediately before becoming a foreign trust, all of its assets to a foreign trust.

SEC. 685.

TREATMENT OF FUNERAL TRUSTS

(a) IN GENERAL.—In the case of a qualified funeral trust—

- (1) subparts B, C, D, and E shall not apply, and
- (2) no deduction shall be allowed by section 642(b).

(b) QUALIFIED FUNERAL TRUST.—For purposes of this subsection, the term “qualified funeral trust” means any trust (other than a foreign trust) if—

(1) the trust arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services,

(2) the sole purpose of the trust is to hold, invest, and reinvest funds in the trust and to use such funds solely to make payments for such services or property for the benefit of the beneficiaries of the trust,

(3) the only beneficiaries of such trust are individuals with respect to whom such services or property are to be provided at their death under contracts described in paragraph (1),

(4) the only contributions to the trust are contributions by or for the benefit of such beneficiaries,

(5) the trustee elects the application of this subsection, and

(6) the trust would (but for the election described in paragraph (5)) be treated as owned under subpart E by the purchasers of the contracts described in paragraph (1).

A trust shall not fail to be treated as meeting the requirement of paragraph (6) by reason of the death of an individual but only during the 60-day period beginning on the date of such death.

(c) APPLICATION OF RATE SCHEDULE.—Section 1(e) shall be applied to each qualified funeral trust by treating each beneficiary’s interest in each such trust as a separate trust.

(d) TREATMENT OF AMOUNTS REFUNDED TO PURCHASER ON CANCELLATION.—No gain or loss shall be recognized to a purchaser of a contract described in subsection (b)(1) by reason of any payment from such trust to such purchaser by reason of cancellation of such contract. If any payment referred to in the preceding sentence consists of property other than money, the basis of such property in the hands of such purchaser shall be the same as the trust’s basis in such property immediately before the payment.

(e) SIMPLIFIED REPORTING.—The Secretary may prescribe rules for simplified reporting of all trusts having a single trustee and of trusts terminated during the year.

SEC. 691.
RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS

(a) INCLUSION IN GROSS INCOME.—

(1) GENERAL RULE.—The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

- (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;
- (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
- (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

(2) INCOME IN CASE OF SALE, ETC.—If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

(3) CHARACTER OF INCOME DETERMINED BY REFERENCE TO DECEDENT.—The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under paragraph (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

(4) INSTALLMENT OBLIGATIONS ACQUIRED FROM DECEDENT—In the case of an installment obligation reportable by the decedent on the installment method under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent—

- (A) an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453B) shall, for the purpose of

paragraph (1), be considered as an item of gross income in respect of the decedent; and

- (B) such obligation shall, for purposes of paragraphs (2) and (3), be considered a right to receive an item of gross income in respect of the decedent, but the amount includible in gross income under paragraph (2) shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453B).
- (5) OTHER RULES RELATING TO INSTALLMENT OBLIGATIONS.—
- (A) IN GENERAL.—In the case of an installment obligation reportable by the decedent on the installment method under section 453, for purposes of paragraph (2)—
 - (i) the second sentence of paragraph (2) shall be applied by inserting “(other than the obligor)” after “or a transfer to a person”,
 - (ii) any cancellation of such an obligation shall be treated as a transfer, and
 - (iii) any cancellation of such an obligation occurring at the death of the decedent shall be treated as a transfer by the estate of the decedent (or, if held by a person other than the decedent before the death of the decedent, by such person).
 - (B) FACE AMOUNT TREATED AS FAIR MARKET VALUE IN CERTAIN CASES.—In any case to which the first sentence of paragraph (2) applies by reason of subparagraph (A), if the decedent and the obligor were related persons (within the meaning of section 453(f)(1)), the fair market value of the installment obligation shall be treated as not less than its face amount.
 - (C) CANCELLATION INCLUDES BECOMING UNENFORCEABLE.—For purposes of subparagraph (A), an installment obligation which becomes unenforceable shall be treated as if it were canceled.

(b) ALLOWANCE OF DEDUCTIONS AND CREDIT.—The amount of any deduction specified in section 162, 163, 164, 212, or 611 (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 27 (relating to foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

- (1) EXPENSES, INTEREST, AND TAXES.—In the case of a deduction specified in sections 162, 163, 164, or 212 and a credit specified in section 27, in the taxable year when paid—
 - (A) to the estate of the decedent; except that
 - (B) if the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, to the person who, by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.
- (2) DEPLETION.—In the case of the deduction specified in section 611, to the person described in subsection (a)(1)(A), (B), or (C) who, in the manner described

therein, receives the income to which the deduction relates, in the taxable year when such income is received.

(c) DEDUCTION FOR ESTATE TAX.—

(1) ALLOWANCE OF DEDUCTION.—

(A) GENERAL RULE.—A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a)(1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a)(1).

(B) ESTATES AND TRUSTS.—In the case of an estate or trust, the amount allowed as a deduction under subparagraph (A) shall be computed by excluding from the gross income of the estate or trust the portion (if any) of the items described in subsection (a)(1) which is properly paid, credited, or to be distributed to the beneficiaries during the taxable year.

(2) METHOD OF COMPUTING DEDUCTION.—For purposes of paragraph (1)—

(A) The term “estate tax” means the tax imposed on the estate of the decedent or any prior decedent under section 2001 or 2101, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a)(1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a)(1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with respect to the provisions of section 421(c)(2), relating to the deduction for estate tax with respect to stock options to which part II of subchapter D applies.

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

(3) SPECIAL RULE FOR GENERATION-SKIPPING TRANSFERS.—In the case of any tax imposed by chapter 13 on a taxable termination or a direct skip occurring as a result of the death of the transferor, there shall be allowed a deduction (under principles similar to the principles of this subsection) for the portion of such tax attributable to items of gross income of the trust which were not properly includible in the gross income of the trust for periods before the date of such termination.

(4) COORDINATION WITH CAPITAL GAIN PROVISIONS.—For purposes of sections 1(h), 1201, 1202, and 1211, the amount of any gain taken into account with respect to any item described in subsection (a)(1) shall be reduced (but not below zero) by the amount of the deduction allowable under paragraph (1) of this subsection with respect to such item.

(d) AMOUNTS RECEIVED BY SURVIVING ANNUITANT UNDER JOINT AND SURVIVOR ANNUITY CONTRACT.—

(1) DEDUCTION FOR ESTATE TAX.—For purposes of computing the deduction under subsection (c)(1)(A), amounts received by a surviving annuitant—

- (A) as an annuity under a joint and survivor annuity contract where the decedent annuitant died after the annuity starting date (as defined in section 72(c)(4)), and
- (B) during the surviving annuitant’s life expectancy period, shall, to the extent included in gross income under section 72, be considered as amounts included in gross income under subsection (a).

(2) NET VALUE FOR ESTATE TAX PURPOSES.—In determining the net value for estate tax purposes under subsection (c)(2)(B) for purposes of this subsection, the value for estate tax purposes of the items described in paragraph (1) of this subsection shall be computed—

- (A) by determining the excess of the value of the annuity at the date of the death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during the surviving annuitant’s life expectancy period, and
- (B) by multiplying the figure so obtained by the ratio which the value of the annuity for estate tax purposes bears to the value of the annuity at the date of the death of the deceased.

(3) DEFINITIONS.—For purposes of this subsection

- (A) The term “life expectancy period” means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant. For purposes of this subparagraph, the life expectancy of the surviving annuitant shall be determined, as of the date of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary.
- (B) The surviving annuitant’s expected return under the contract shall be computed, as of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary.

(e) CROSS REFERENCE—

For application of this section to income in respect of a deceased partner, see section 753.

Appendix B

Subchapter J Treasury Regulations

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§ 1.67-4 Costs paid or incurred by estates or non-grantor trusts.—(a) In general. Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust not described in §1.67-2T(g)(1)(i) (a non-grantor trust) and which would not have been incurred if the property were not held in such estate or trust. To the extent that a cost incurred by an estate or non-grantor trust is unique to such an entity, that cost is not subject to the 2-percent floor on miscellaneous itemized deductions. To the extent that a cost included in the definition of miscellaneous itemized deductions and incurred by an estate or non-grantor trust is not unique to such an entity, that cost is subject to the 2-percent floor.

(b) Unique. For purposes of this section, a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant. A non-exclusive list of products or services that are unique to an estate or trust includes those rendered in connection with: Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters. A non-exclusive list of products or services that are not unique to an estate or trust, and therefore are subject to the 2-percent floor, includes those rendered in connection with: Custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

(c) “Bundled fees.” If an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

§ 1.641(a)-0 Scope of subchapter J.—(a) In general. Subchapter J (sections 641 and following), chapter 1 of the Code, deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of subchapter J contains general rules for taxation of estates and trusts (subpart A), specific rules relating to trusts which distribute current income only (subpart B), estates and trusts which may accumulate income or which distribute corpus (subpart C), treatment of excess distributions by trusts (subpart D), grantors and other persons treated as substantial owners (subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of subchapter J are applicable (subpart F). Part I has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of § 301.7701-2, 301.7701-3, and 301.7701-4 of this chapter (Regulations on Procedure and Administration). Part II of subchapter J relates to the treatment of income in respect of decedents. However, the provisions of subchapter J do not apply to employee trusts subject to subchapters D and F, chapter 1 of the Code, and common trust funds subject to subchapter H, chapter 1 of the Code.

(b) Scope of subparts A, B, C, and D. Subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code, relate to the taxation of estates

and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners. See subpart E (section 671 and following), Part I, subchapter J, chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under subparts A, B, C, and D, except to the extent otherwise provided in section 71 or section 682. These subparts have no application to beneficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

(c) Multiple trusts. Multiple trusts that have:

(1) No substantially independent purposes (such as independent dispositive purposes),

(2) The same grantor and substantially the same beneficiary, and

(3) The avoidance or mitigation of (i) the progressive rates of tax (including mitigation as a result of deferral of tax) or (ii) the minimum tax for tax preferences imposed by section 56 as their principal purpose, shall be consolidated and treated as one trust for the purposes of subchapter J.

§ 1.641(a)-1 Imposition of tax; application of tax.—For taxable years beginning after December 31, 1970, section 641 prescribes that the taxes imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income of estates or of any kind of property held in trust. For taxable years ending before January 1, 1971, section 641 prescribes that the taxes imposed upon individuals by chapter 1 of the Code apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trust.

§ 1.641(a)-2 Gross income of estates and trusts.—The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including:

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated. The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

§ 1.641(b)-1 Computation and payment of tax; deductions and credits of estates and trusts.—Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the de-

ductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

§ 1.641(b)-2 Filing of returns and payment of the tax.—(a) The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U.S.C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012(b)(2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

§ 1.641(b)-3 Termination of estates and trusts.—(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the af-

fairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c)(1) Except as provided in subparagraph (2) of this paragraph, during the period between the occurrence of an event which causes a trust to terminate and the time when the trust is considered as terminated under this section, whether or not the income and the excess of capital gains over capital losses of the trust are to be considered as amounts required to be distributed currently to the ultimate distributee for the year in which they are received depends upon the principles stated in § 1.651(a)-2. See § 1.663-1 et seq. for application of the separate share rule.

(2)(i) Except in cases to which the last sentence of this subdivision applies, for taxable years of a trust ending before September 1, 1957, subparagraph (1) of this paragraph shall not apply and the rule of subdivision (ii) of this subparagraph shall apply unless the trustee elects to have subparagraph (1) of this paragraph apply. Such election shall be made by the trustee in a statement filed on or before April 15, 1959, with the district director with whom such trust's return for any such taxable year was filed. The election provided by this subdivision shall not be available if the treatment given the income and the excess of capital gains over capital losses for taxable years for which returns have been filed was consistent with the provisions of subparagraph (1) of this paragraph.

(ii) The rule referred to in subdivision (i) of this subparagraph is as follows: During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

§ 1.641(c)-0 Table of contents.—This section lists the major captions contained in § 1.641(c)-1.

§ 1.641(c)-1 Electing small business trust.

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§ 1.641(c)-1 Electing small business trust.—(a) In general.—An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See § 1.1361-1(m).

(b) Definitions.—(1) Grantor portion.—The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) S portion.—The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(3) Non-S portion.—The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) Taxation of grantor portion.—The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) Taxation of S portion.—(1) In general.—The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) Section 1366 amounts.—(i) In general.—The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) Special rule for charitable contributions.—If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) Multiple S corporations.—If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) Gains and losses on disposition of S stock.—(i) In general.—The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) Installment method.—If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361-1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) Distributions in excess of basis.—Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) State and local income taxes and administrative expenses.—(i) In general. State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) Special rule for certain interest.—Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) Tax rates and exemption of S portion.—(1) Income tax rate. Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) Alternative minimum tax exemption.—The exemption amount of the S portion under section 55(d) is zero.

(f) Adjustments to basis of stock in the S portion under section 1367.—The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) Taxation of non-S portion.—(1) In general.—The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) Dividend income under section 1368(c)(2).—Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) Interest on installment obligations.—If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) Charitable deduction.—For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) Allocation of state and local income taxes and administration expenses.—Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) Treatment of distributions from the trust.—Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) Termination or revocation of ESBT election.—If the ESBT election of the trust terminates pursuant to § 1.1361-1(m)(5) or the ESBT election is revoked pursuant to § 1.1361-1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under

section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) Effective date.—This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) Example 1 of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

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

Example 1. Comprehensive example. (i) Trust has a valid ESBT election in effect. Under section 678, B is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in X, an S corporation, and in Y, a C corporation. During 2000, Trust receives a distribution from X of \$5,100, of which \$5,000 is applied against Trust’s adjusted basis in the X stock in accordance with section 1368(c)(1) and \$100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to X under section 1366.....	\$5,000
Dividend income from Y	\$900
Dividend from X representing C corporation earnings and profits	\$100
Total trust income.....	\$6,000
Charitable contributions attributable to X under section 1366	\$300
Trustee fees	\$200
State and local income taxes	\$100

(iii) Trust’s items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from X.....	\$500
Dividend income from Y	\$90
Dividend income from X	\$10
Total grantor portion income.....	\$600

The total income of the S portion is \$4,500, determined as follows:

Ordinary income from X.....	\$5,000
Less: Grantor portion	(\$500)
Total S portion income.....	\$4,500

The total income of the non-S portion is \$900 determined as follows:

Dividend income from Y (less grantor portion).....	\$810
Dividend income from X (less grantor portion)	\$90

Total non-S portion income.....\$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the \$6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) B must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from X\$30
 Trustee fees\$20
 State and local income taxes\$10

(vi) The taxable income of the S portion is \$4,005, determined as follows:

Ordinary income from X.....\$4,500
 Less: Charitable contributions from X (less grantor portion).....\$270
 75% of trustee fees.....(\$150)
 75% of state and local income taxes.....(\$75)
 Taxable income of S portion\$4,005

(vii) The taxable income of the non-S portion is \$755, determined as follows:

Dividend income from Y\$810
 Dividend income from X\$90
 Total non-S portion income.....\$900
 Less: 15% of trustee fees(\$30)
 15% state and local income taxes(\$15)
 Personal exemption.....(\$100)
 Taxable income of non-S portion.....\$755

Example 2. Sale of S stock.—Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in X to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of \$5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

Example 3. (i) Sale of S stock for an installment note.—Assume the same facts as in Example 2, except that Trust sells its stock in X for a \$400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) Loss on installment sale.—Assume Trust’s basis in its X stock was \$500,000. Therefore, Trust sustains a capital loss of \$100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) Gain on installment sale.—Assume Trust’s basis in its X stock was \$300,000 and that the \$100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the \$100,000 gain recognized annually is taken into account

by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

Example 4. Charitable lead annuity trust.—Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in X, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays \$10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.

Example 5. ESBT distributions.—(i) As of January 1, 2002, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, X makes an \$8,000 distribution to Trust, of which \$3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the X stock under section 1368(b). The trustee of Trust makes a distribution of \$4,000 to Beneficiary during 2003. For 2003, Trust's share of X's section 1366 items is \$5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has \$5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has \$3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of \$3,000, which represents the amount distributed to Beneficiary during the year (\$4,000), not to exceed the amount of DNI (\$3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

§ 1.642(a)(1)-1 Partially tax-exempt interest.—An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2)-1 Foreign taxes.—An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term beneficiaries includes charitable beneficiaries.

§ 1.642(a)(3)-1 Dividends received by an estate or trust.—An estate or trust is allowed a credit against the tax for dividends received on or before December 31, 1964 (see section 34), only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. Section 642(a)(3), and this section do not apply to amounts received as dividends after December 31, 1964. For treatment of the credit in the hands of the beneficiary see § 1.652(b)-1.

§ 1.642(a)(3)-2 Time of receipt of dividends by beneficiary.—In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34 and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limitations of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954 (or after December 31, 1964). Section 642(a)(3) and this section do not apply to amounts received by an estate or trust as dividends after December 31, 1964. However, the rules in this section relating to time of receipt of dividends by a beneficiary are applicable to dividends received by an estate or trust prior to January 1, 1965, and accordingly, such dividends are deemed to be received by the beneficiary (even though received after December 31, 1964) on the same dates that the estate or trust received them for purposes of determining the credit under section 34 or the exclusion under section 116.

§ 1.642(a)(3)-3 Cross reference.—See § 1.683-2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

§ 1.642(b)-1 Deduction for personal exemption.—In lieu of the deduction for personal exemptions provided by section 151:

(a) An estate is allowed a deduction of \$600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of \$300, and

(c) All other trusts are allowed a deduction of \$100. A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of \$300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642(c) (and therefore does not qualify as a “simple trust” under sections 651-652). A trust for the payment of an annuity is allowed a deduction of \$300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term income required to be distributed currently, see § 1.651(a)-2.

§ 1.642(c)-0 Effective dates.—The provisions of section 642(c) (other than section 642(c)(5)) and of §§ 1.642(c)-1 through 1.642(c)-4 apply to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning after December 31, 1969. The provisions of section 642(c)(5) and of §§ 1.642(c)-5 through 1.642(c)-7 apply to transfers in trust made after July 31, 1969. For provisions relating

to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning before January 1, 1970, see 26 CFR 1.642(c)-1 through 1.642(c)-4 (Rev. as of Jan. 1, 1971).

§ 1.642(c)-1 Unlimited deduction for amounts paid for a charitable purpose.—(a) In general.—(1) Any part of the gross income of an estate, or trust which, pursuant to the terms of the governing instrument is paid (or treated under paragraph (b) of this section as paid) during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to such estate or trust in lieu of the limited charitable contributions deduction authorized by section 170(a). In applying this paragraph without reference to paragraph (b) of this section, a deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year to the estate or trust, or in the case of a section 645 election, to a related estate, as defined under § 1.645-1(b), for the amount so paid.

(2) In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.

(3) See section 642(c)(6) and § 1.642(c)-4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were a private foundation (as defined in section 509(a) and the regulations thereunder) and not exempt from taxation under section 501(a).

(b) Election to treat contributions as paid in preceding taxable year.—(1) In general. For purposes of determining the deduction allowed under paragraph (a) of this section, the fiduciary (as defined in section 7701(a)(6)) of an estate or trust may elect under section 642(c)(1) to treat as paid during the taxable year (whether or not such year begins before January 1, 1970) any amount of gross income received during such taxable year or any preceding taxable year which is otherwise deductible under such paragraph and which is paid after the close of such taxable year but on or before the last day of the next succeeding taxable year of the estate or trust. The preceding sentence applies only in the case of payments actually made in a taxable year which is a taxable year beginning after December 31, 1969. No election shall be made, however, in respect of any amount which was deducted for any previous taxable year or which is deducted for the taxable year in which such amount is paid.

(2) Time for making election.—The election under subparagraph (1) of this paragraph shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year. Such election shall, except as provided in subparagraph (4) of this paragraph, become irrevocable after the last day prescribed for making it. Having made the election for any taxable year, the fiduciary may, within the time prescribed for making it, revoke the election without the consent of the Commissioner.

(3) Manner of making the election.—The election shall be made by filing with the income tax return (or an amended return) for the taxable year in which the contribution is treated as paid a statement which:

- (i) States the name and address of the fiduciary,
- (ii) Identifies the estate or trust for which the fiduciary is acting,

(iii) Indicates that the fiduciary is making an election under section 642(c)(1) in respect of contributions treated as paid during such taxable year,

(iv) Gives the name and address of each organization to which any such contribution is paid, and

(v) States the amount of each contribution and date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year.

(4) Revocation of certain elections with consent.—An application to revoke with the consent of the Commissioner any election made on or before June 8, 1970, must be in writing and must be filed not later than September 2, 1975. No consent will be granted to revoke an election for any taxable year for which the assessment of a deficiency is prevented by the operation of any law or rule of law. If consent to revoke the election is granted, the fiduciary must attach a copy of the consent to the return (or amended return) for each taxable year affected by the revocation. The application must be addressed to the Commissioner of Internal Revenue, Washington, DC 20224, and must indicate:

(i) The name and address of the fiduciary and the estate or trust for which he was acting,

(ii) The taxable year for which the election was made,

(iii) The office of the district director, or the service center, where the return (or amended return) for the year of election was filed, and

(iv) The reason for revoking the election.

§ 1.642(c)-2 Unlimited deduction for amounts permanently set aside for a charitable purpose.—(a) Estates. Any part of the gross income of an estate which pursuant to the terms of the will:

(1) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(2) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit, shall be allowed as a deduction to the estate in lieu of the limited charitable contributions deduction authorized by section 170(a).

(b) Certain trusts.—(1) In general.—Any part of the gross income of a trust to which either subparagraph (3) or (4) of this paragraph applies, that by the terms of the governing instrument:

(i) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(ii) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit, shall be allowed, subject to the limitation provided in subparagraph (2) of this paragraph, as a deduction to the trust in lieu of the limited charitable contributions deduction authorized by section 170(a). The preceding sentence applied only to a trust which is required by the terms of its governing instrument to set amounts aside. See section 642(c)(6) and § 1.642(c)-4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation

(as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a).

(2) Limitation of deduction.—Subparagraph (1) of this paragraph applies only to the gross income earned by a trust with respect to amounts transferred to the trust under a will executed on or before October 9, 1969, and satisfying the requirements of subparagraph (4) of this paragraph or transferred to the trust on or before October 9, 1969. For such purposes, any income, gains, or losses, which are derived at any time from the amounts so transferred to the trust shall also be taken into account in applying subparagraph (1) of this paragraph. If any such amount so transferred to the trust is invested or reinvested at any time, any asset received by the trust upon such investment or reinvestment shall also be treated as an amount which was so transferred to the trust. In the case of a trust to which this paragraph applies which contains (i) amounts transferred pursuant to transfers described in the first sentence of this subparagraph and (ii) amounts transferred pursuant to transfers not so described, subparagraph (1) of this paragraph shall apply only if the amounts described in subdivision (i) of this subparagraph, together with all income, gains, and losses derived therefrom, are separately accounted for from the amounts described in subdivision (ii) of this subparagraph, together with all income, gains, and losses derived therefrom. Such separate accounting shall be carried out consistently with the principles of paragraph (c)(4) of § 53.4947-1 of this chapter (Foundation Excise Tax Regulations), relating to accounting for segregated amounts of split-interest trusts.

(3) Trusts created on or before October 9, 1969.—A trust to which this subparagraph applies is a trust, testamentary or otherwise, which was created on or before October 9, 1969, and which qualifies under either subdivision (i) or (ii) of this subparagraph.

(i) Transfer of irrevocable remainder interest to charity.—To qualify under this subdivision the trust must have been created under the terms of an instrument granting an irrevocable remainder interest in such trust to or for the use of an organization described in section 170(c). If the instrument granted a revocable remainder interest but the power to revoke such interest terminated on or before October 9, 1969, without the remainder interest having been revoked, the remainder interest will be treated as irrevocable for purposes of the preceding sentence.

(ii) Grantor under a mental disability to change terms of trust.—(A) To qualify under this subdivision (ii) the trust must have been created by a grantor who was at all times after October 9, 1969, under a mental disability to change the terms of the trust. The term mental disability for this purpose means mental incompetence to change the terms of the trust, whether or not there has been an adjudication of mental incompetence and whether or not there has been an appointment of a committee, guardian, fiduciary, or other person charged with the care of the person or property of the grantor.

(B) If the grantor has not been adjudged mentally incompetent, the trustee must obtain from a qualified physician a certificate stating that the grantor of the trust has been mentally incompetent at all times after October 9, 1969, and that there is no reasonable probability that the grantor's mental capacity will ever improve to the extent that he will be mentally competent to change the terms of the trust. A copy of this certification must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such medical opinion must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. The original certificate must be retained by the trustee of the trust.

(C) If the grantor has been adjudged mentally incompetent, a copy of the judgment or decree, and any modification thereof, must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such judgment or decree must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. A copy of such judgment or decree must also be retained by the trustee of the trust.

(D) This subdivision (ii) applies even though a person charged with the care of the person or property of the grantor has the power to change the terms of the trust.

(4) Testamentary trust established by will executed on or before October 9, 1969. A trust to which this subparagraph applies is a trust which was established by will executed on or before October 9, 1969, and which qualifies under either subdivision (i), (ii), or (iii) of this subparagraph. This subparagraph does not apply, however, to that portion of any trust, not established by a will executed on or before October 9, 1969, which was transferred to such trust by a will executed on or before October 9, 1969. Nor does it apply to that portion of any trust, not established by a will executed on or before October 9, 1969, which was subject to a testamentary power of appointment that fails by reason of the testator's nonexercise of the power in a will executed on or before October 9, 1969.

(i) Testator dying within 3 years without republishing his will.—To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise.

(ii) Testator having no right to change his will.—To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, and who at no time after that date had the right to change any portion of such will pertaining to such trust. This subdivision could apply, for example, where a contract has been entered into for the execution of wills containing reciprocal provisions as well as provisions for the benefit of an organization described in section 170(c) and under applicable local law the surviving testator is prohibited from revoking his will because he has accepted the benefit of the provisions of the will of the other contracting party.

(iii) Testator under a mental disability to republish his will.—To qualify under this subdivision the trust must have been established by the will of a testator who died after October 8, 1972, without having amended any dispositive provision of such will after October 9, 1969, and before October 9, 1972, by codicil or otherwise, and who is under a mental disability at all times after October 8, 1972, to amend such will, by codicil or otherwise. The provisions of subparagraph (3)(ii) of this paragraph with respect to mental incompetence apply for purposes of this subdivision.

(iv) Amendment of dispositive provisions.—The provisions of paragraph (e)(4) and (5) of § 20.2055-2 of this chapter (Estate Tax Regulations) are to be applied under subdivisions (i) and (iii) of this subparagraph in determining whether there has been an amendment of a dispositive provision of a will.

(c) Pooled income funds.—Any part of the gross income of a pooled income fund to which § 1.642(c)-5 applies for the taxable year that is attributable to net long-term capital gain (as defined in section 1222(7)) which, pursuant to the terms of the governing instrument, is permanently set aside during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to the fund in lieu of the limited chari-

table contributions deduction authorized by section 170(a). No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of either: an amount equal to a fixed percentage of the fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis); or any amount that takes into account unrealized appreciation in the value of the fund's assets. In addition, no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income within the meaning of § 1.642(c)-5(a)(5)(i). No deduction shall be allowed under this paragraph for any portion of the gross income of such fund which is (1) attributable to income other than net long-term capital gain (2) earned with respect to amounts transferred to such fund before August 1, 1969. However, see paragraph (b) of this section for a deduction (subject to the limitations of such paragraph) for amounts permanently set aside by a pooled income fund which meets the requirements of that paragraph. The principles of paragraph (b) or (2) of this section with respect to investment, reinvestment, and separate accounting shall apply under this paragraph in the case of amounts transferred to the fund after July 31, 1969.

(d) Disallowance of deduction for certain amounts not deemed to be permanently set aside for charitable purposes. No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible. Thus, for example, where there is possibility of the invasion of the corpus of a charitable remainder trust, as defined in § 1.664-1(a)(1)(ii), in order to make payment of the annuity amount or unitrust amount, no deduction will be allowed under paragraph (a) of this section in respect of any amount set aside by an estate for distribution to such a charitable remainder trust.

(e) Effective dates.—Generally, the second sentence of paragraph (c) of this section, concerning the loss of any charitable deduction for long-term capital gains if the fund's income may be determined by a fixed percentage of the fair market value of the fund's assets or by any amount that takes into account unrealized appreciation in the value of the fund's assets, applies for taxable years beginning after January 2, 2004. In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner. For treatment of distributions by an estate to a charitable remainder trust, see paragraph (a)(5)(iii) of § 1.664-1.

§ 1.642(c)-3 Adjustments and other special rules for determining unlimited charitable contributions deduction.—(a) Income in respect of a decedent. For purposes of §§ 1.642(c)-1 and 1.642(c)-2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(b) Reduction of charitable contributions deduction by amounts not included in gross income.—(1) If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c)(1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)-1 or § 1.642(c)-2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of § 1.642(c)-2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in section 1222(7)) shall be taken into account.

(2) In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust not included in gross income, the specific provision controls if the governing instrument specifically provides as to the source out of which amounts are to be paid, permanently set aside, or used for such a purpose. In the absence of specific provisions in the governing instrument, an amount to which section 642(c)(1), (2) or (3) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643(a)-5 for the method of determining the allocable portion of exempt income and foreign income.

(3) For examples showing the determination of the character of an amount deductible under § 1.642(c)-1 or § 1.642(c)-2, see examples 1 and 2 in § 1.662(b)-2 and paragraph (e) of the example in § 1.662(c)-4.

(4) For the purpose of this paragraph, the provisions of section 116 are not to be taken into account.

(c) Capital gains included in charitable contribution.—Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)-1 or § 1.642(c)-2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

Example 1. Under the terms of the trust instrument, the income of a trust described in § 1.642(c)-2(b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of \$100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes \$100,000 in gross income but is allowed a deduction of \$50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of \$50,000 under section 642(c)(2) (\$100,000 permanently set aside for charitable purposes less \$50,000 allowed as a deduction under section 1202 with respect to such \$100,000).

Example 2. Under the terms of the will, \$200,000 of the income (including \$100,000 capital gains) for the taxable year 1972 of an estate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization

described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of \$200,000, long-term capital gains of \$100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of \$100,000 are included in the gross income of the estate for 1972, and N University receives \$100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of \$25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to \$25,000 [(\$100,000 capital gains less \$50,000 capital gains includible in income of individual beneficiaries under section 662) \times 50%]. Since the whole of this \$25,000 deduction under section 1202 is attributable to the distribution of \$50,000 of capital gains to N University, the deduction allowable to the estate in 1972 under section 642(c)(1) is \$75,000 [\$100,000 (distributed to N) less \$25,000 (proper adjustment for section 1202 deduction)].

Example 3. Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)-2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of \$100,000, long-term capital gains of \$15,000, short-term capital gains of \$1,000, long-term capital losses of \$5,000, and short-term capital losses of \$2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of \$116,000 [\$100,000 (ordinary income) + \$16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of \$30,000 (\$100,000 \times 30%). The balance of \$78,500 [(\$116,000 less \$7,500 capital losses)-\$30,000 distribution] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of \$7,500 (\$5,000 + \$2,500) are allowable in full under section 1211(b)(1). The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of \$8,500 (\$16,000 less \$7,500) is the excess of the net long-term capital gain of \$10,000 (\$15,000 less \$5,000) over the net short-term capital loss of \$1,500 (\$2,500 less \$1,000). The deduction under section 1202 is \$4,250 (\$8,500 \times 50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is \$74,250 [\$78,500 (set-aside for M) less \$4,250 (proper adjustment for section 1202 deduction)].

Example 4. During the taxable year a pooled income fund, as defined in § 1.642(c)-5, has in addition to ordinary income long-term capital gains of \$150,000, short-term capital gains of \$15,000, long-term capital losses of \$100,000, and short-term capital losses of \$10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of \$5,000 (\$15,000 less \$10,000) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to \$25,000 [(\$150,000 (long-term capital gains) less \$100,000 (long-term capital losses)) \times 50%]. Since the whole of this deduction under section 1202 is attributable

to the set-aside for charitable purposes, the deduction of \$50,000 (\$150,000 less \$100,000) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is \$25,000 [\$50,000 (set-aside for public charity) less \$25,000 (proper adjustment for section 1202 deduction)].

Example 5. The facts are the same as in example 4 except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of \$165,000 (\$150,000 + \$15,000). In determining taxable income for the taxable year the capital losses of \$110,000 (\$100,000 + \$10,000) are allowable in full under section 1211(b)(1). The net capital gain of \$55,000 (\$165,000 less \$110,000) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the net long-term capital gain of \$50,000 (\$150,000 long-term gains less \$100,000 long-term losses). The deduction under section 1202 is \$25,000 (\$50,000 × 50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is \$25,000 [\$50,000 (set-aside for public charity) less \$25,000 (proper adjustment for section 1202 deduction)]. The \$5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) Disallowance of deduction for amounts allocable to unrelated business income.—In the case of a trust, the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) Disallowance of deduction in certain cases.—For disallowance of certain deductions otherwise allowable under section 642(c)(1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) Information returns.—For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

§ 1.642(c)-3 Adjustments and other special rules for determining unlimited charitable contributions deduction.—(a) Income in respect of a decedent. For purposes of §§ 1.642(c)-1 and 1.642(c)-2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(b) Reduction of charitable contributions deduction by amounts not included in gross income.—(1) If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c)(1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)-1 or § 1.642(c)-2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of § 1.642(c)-2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in section 1222(7)) shall be taken into account.

(2) In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust not included in gross income, the specific provision controls if the governing instrument specifically provides as to the source out of

which amounts are to be paid, permanently set aside, or used for such a purpose. In the absence of specific provisions in the governing instrument, an amount to which section 642(c)(1), (2) or (3) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643(a)-5 for the method of determining the allocable portion of exempt income and foreign income.

(3) For examples showing the determination of the character of an amount deductible under § 1.642(c)-1 or § 1.642(c)-2, see examples 1 and 2 in § 1.662(b)-2 and paragraph (e) of the example in § 1.662(c)-4.

(4) For the purpose of this paragraph, the provisions of section 116 are not to be taken into account.

(c) Capital gains included in charitable contribution.—Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)-1 or § 1.642(c)-2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

Example 1. Under the terms of the trust instrument, the income of a trust described in § 1.642(c)-2(b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of \$100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes \$100,000 in gross income but is allowed a deduction of \$50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of \$50,000 under section 642(c)(2) (\$100,000 permanently set aside for charitable purposes less \$50,000 allowed as a deduction under section 1202 with respect to such \$100,000).

Example 2. Under the terms of the will, \$200,000 of the income (including \$100,000 capital gains) for the taxable year 1972 of an estate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of \$200,000, long-term capital gains of \$100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of \$100,000 are included in the gross income of the estate for 1972, and N University receives \$100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of \$25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to \$25,000 [(\$100,000 capital gains less \$50,000 capital gains includible in income of individual beneficiaries under section 662) × 50%]. Since the whole of this \$25,000 deduction under section 1202 is attributable to the distribution of \$50,000 of capital gains to N University, the deduction allowable to the es-

tate in 1972 under section 642(c)(1) is \$75,000 [\$100,000 (distributed to N) less \$25,000 (proper adjustment for section 1202 deduction)].

Example 3. Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)-2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of \$100,000, long-term capital gains of \$15,000, short-term capital gains of \$1,000, long-term capital losses of \$5,000, and short-term capital losses of \$2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of \$116,000 [\$100,000 (ordinary income) + \$16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of \$30,000 ($\$100,000 \times 30\%$). The balance of \$78,500 [$(\$116,000 \text{ less } \$7,500 \text{ capital losses}) - \$30,000 \text{ distribution}$] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of \$7,500 ($\$5,000 + \$2,500$) are allowable in full under section 1211(b)(1). The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of \$8,500 ($\$16,000 \text{ less } \$7,500$) is the excess of the net long-term capital gain of \$10,000 ($\$15,000 \text{ less } \$5,000$) over the net short-term capital loss of \$1,500 ($\$2,500 \text{ less } \$1,000$). The deduction under section 1202 is \$4,250 ($\$8,500 \times 50\%$), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is \$74,250 [$\$78,500 \text{ (set-aside for M) less } \$4,250 \text{ (proper adjustment for section 1202 deduction)}$].

Example 4. During the taxable year a pooled income fund, as defined in § 1.642(c)-5, has in addition to ordinary income long-term capital gains of \$150,000, short-term capital gains of \$15,000, long-term capital losses of \$100,000, and short-term capital losses of \$10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of \$5,000 ($\$15,000 \text{ less } \$10,000$) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to \$25,000 [$(\$150,000 \text{ (long-term capital gains) less } \$100,000 \text{ (long-term capital losses)}) \times 50\%$]. Since the whole of this deduction under section 1202 is attributable to the set-aside for charitable purposes, the deduction of \$50,000 ($\$150,000 \text{ less } \$100,000$) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is \$25,000 [$\$50,000 \text{ (set-aside for public charity) less } \$25,000 \text{ (proper adjustment for section 1202 deduction)}$].

Example 5. The facts are the same as in example 4 except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of \$165,000 ($\$150,000 + \$15,000$). In determining taxable income for the taxable year the capital losses of \$110,000 ($\$100,000 + \$10,000$) are allowable in full under section 1211(b)(1). The net capital gain of \$55,000 ($\$165,000 \text{ less } \$110,000$) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the

net long-term capital gain of \$50,000 (\$150,000 long-term gains less \$100,000 long-term losses). The deduction under section 1202 is \$25,000 ($\$50,000 \times 50\%$), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is \$25,000 [$\$50,000$ (set-aside for public charity) less \$25,000 (proper adjustment for section 1202 deduction)]. The \$5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) Disallowance of deduction for amounts allocable to unrelated business income.—In the case of a trust, the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) Disallowance of deduction in certain cases.—For disallowance of certain deductions otherwise allowable under section 642(c)(1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) Information returns.—For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

§ 1.642(c)-4 Nonexempt private foundations.—In the case of a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a) for the taxable year, a deduction for amounts paid or permanently set aside, or used for a purpose specified in section 642(c)(1), or (2) shall not be allowed under § 1.642(c)-1 or § 1.642(c)-2, but such trust shall, subject to the provisions applicable to individuals, be allowed a deduction under section 170 for charitable contributions paid during the taxable year. Section 642(c)(6) and this section do not apply to a trust described in section 4947(a)(1) unless such trust fails to meet the requirements of section 508(e). However, if on October 9, 1969, or at any time thereafter, a trust is recognized as being exempt from taxation under section 501(a) as an organization described in section 501(c)(3), if at such time such trust is a private foundation, and if at any time thereafter such trust is determined not to be exempt from taxation under section 501(a) as an organization described in section 501(c)(3), section 642(c)(6) and this section will apply to such trust. See § 1.509(b)-1(b).

§ 1.642(c)-5 Definition of pooled income fund.—(a) In general—(1) Application of provisions. Section 642(c)(5) prescribes certain rules for the valuation of contributions involving transfers to certain funds described in that section as pooled income funds. This section sets forth the requirements for qualifying as a pooled income fund and provides for the manner of allocating the income of the fund to the beneficiaries. Section 1.642(c)-6 provides for the valuation of a remainder interest in property transferred to a pooled income fund. Section 1.642(c)-7 provides transitional rules under which certain funds may be amended so as to qualify as pooled income funds in respect to transfers of property occurring after July 31, 1969.

(2) Tax status of fund and its beneficiaries.—Notwithstanding any other provision of this chapter, a fund which meets the requirements of a pooled income fund, as defined in section 642(c)(5) and paragraph (b) of this section, shall not be treated as an association within the meaning of section 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under Part I, Subchapter J, Chapter 1 of the Code, but the provisions of Subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

(3) Recognition of gain or loss on transfer to fund.—No gain or loss shall be recognized to the donor on the transfer of property to a pooled income fund. In such case, the fund's basis and holding period with respect to property transferred to the fund by a donor shall be determined as provided in sections 1015(b) and 1223(2). If, however, a donor transfers property to a pooled income fund and, in addition to creating or retaining a life income interest therein, receives property from the fund, or transfers property to the fund which is subject to an indebtedness, this subparagraph shall not apply to the gain realized by reason of (i) the receipt of such property or (ii) the amount of such indebtedness, whether or not assumed by the pooled income fund, which is required to be treated as an amount realized on the transfer. For applicability of the bargain sale rules, see section 1011(b) and the regulations thereunder.

(4) Charitable contributions deduction.—A charitable contributions deduction for the value of the remainder interest, as determined under § 1.642(c)-6, may be allowed under section 170, 2055, 2106, or 2522, where there is a transfer of property to a pooled income fund. For a special rule relating to the reduction of the amount of a charitable contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or (B)(i) and the regulations thereunder.

(5) Definitions.—For purposes of this section, §§ 1.642(c)-6, and 1.642(c)-7:

(i) The term income has the same meaning as it does under section 643(b) and the regulations thereunder, except that income generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both 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. In exercising a power to adjust, the trustee must allocate to principal, not to income, the proceeds from the sale or exchange of any assets contributed to the fund by any donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution to the fund or of the purchase price of those assets purchased by the fund. This definition of income applies for taxable years beginning after January 2, 2004.

(ii) The term donor includes a decedent who makes a testamentary transfer of property to a pooled income fund.

(iii) The term governing instrument means either the governing plan under which the pooled income fund is established and administered or the instrument of transfer, as the context requires.

(iv) The term public charity means an organization described in clause (i) to (vi) of section 170(b)(1)(A). If an organization is described in clause (i) to (vi) of section 170(b)(1)(A) and is also described in clause (viii) of such section, it shall be treated as a public charity.

(v) The term fair market value, when used with respect to property, means its value in excess of the indebtedness or charges against such property.

(vi) The term determination date means each day within the taxable year of a pooled income fund on which a valuation is made of the property in the fund. The property in the fund shall be valued on the first day of the taxable year of the fund and on at least 3 other days within the taxable year. The period between any two consecutive determination dates within the taxable year shall not be greater than 3 calendar months. In the case of a taxable year of less than 12 months, the property in the fund shall be valued on the first day of such taxable year and on such other days within such year as occur at successive intervals of no greater than 3 calendar months. Where a val-

uation date falls on a Saturday, Sunday, or legal holiday (as defined in section 7503 and the regulations thereunder), the valuation may be made on either the next preceding day which is not a Saturday, Sunday, or legal holiday or the next succeeding day which is not a Saturday, Sunday, or legal holiday, so long as the next such preceding day or next such succeeding day is consistently used where the valuation date falls on a Saturday, Sunday, or legal holiday.

(6) Cross references.—(i) See section 4947(a)(2) and section 4947(b)(3)(B) for the application to pooled income funds of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the governing instrument prohibiting certain activities specified in section 4947(a)(2).

(ii) For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

(b) Requirements for qualification as a pooled income fund. A pooled income fund to which this section applies must satisfy all of the following requirements:

(1) Contribution of remainder interest to charity.—Each donor must transfer property to the fund and contribute an irrevocable remainder interest in such property to or for the use of a public charity, retaining for himself, or creating for another beneficiary or beneficiaries, a life income interest in the transferred property. A contingent remainder interest shall not be treated as an irrevocable remainder interest for purposes of this subparagraph.

(2) Creation of life income interest.—Each donor must retain for himself for life an income interest in the property transferred to such fund, or create an income interest in such property for the life of one or more beneficiaries, each of whom must be living at the time of the transfer of the property to the fund by the donor. The term one or more beneficiaries includes those members of a named class who are alive and can be ascertained at the time of the transfer of the property to the fund. In the event more than one beneficiary of the income interest is designated, such beneficiaries may enjoy their shares of income concurrently, consecutively, or both concurrently and consecutively. The donor may retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity. The governing instrument must specify at the time of the transfer the particular beneficiary or beneficiaries to whom the income is payable and the share of income distributable to each person so specified. The public charity to or for the use of which the remainder interest is contributed may also be designated as one of the beneficiaries of an income interest. The donor need not retain or create a life interest in all the income from the property transferred to the fund provided any income not payable under the terms of the governing instrument to an income beneficiary is contributed to, and within the taxable year in which it is received is paid to, the same public charity to or for the use of which the remainder interest is contributed. No charitable contributions deduction shall be allowed to the donor for the value of such income interest of the public charity or for the amount of any such income paid to such organization.

(3) Commingling of property required.—The property transferred to the fund by each donor must be commingled with, and invested or reinvested with, other property transferred to the fund by other donors satisfying the requirements of subparagraphs (1) and (2) of this paragraph. The governing instrument of the pooled income fund must contain a provision requiring compliance with the preceding sentence. The public charity to or for the use of which the remainder interest is contributed may maintain more than one pooled income fund, provided that each such fund is maintained by the organization and is not a device to permit a group of donors to create a fund which may be subject to their manipulation. The fund must not include property transferred under ar-

rangements other than those specified in section 642(c)(5) and this paragraph. However, a fund shall not be disqualified as a pooled income fund under this paragraph because any portion of its properties is invested or reinvested jointly with other properties, not a part of the pooled income fund, which are held by, or for the use of, the public charity which maintains the fund, as for example, with securities in the general endowment fund of the public charity to or for the use of which the remainder interest is contributed. Where such joint investment or reinvestment of properties occurs, records must be maintained which sufficiently identify the portion of the total fund which is owned by the pooled income fund and the income earned by, and attributable to, such portion. Such a joint investment or reinvestment of properties shall not be treated as an association or partnership for purposes of the Code. A bank which serves as trustee of more than one pooled income fund may maintain a common trust fund to which section 584 applies for the collective investment and reinvestment of moneys of such funds.

(4) Prohibition against exempt securities.—The property transferred to the fund by any donor must not include any securities, the income from which is exempt from tax under subtitle A of the Code, and the fund must not invest in such securities. The governing instrument of the fund must contain specific prohibitions against accepting or investing in such securities.

(5) Maintenance by charitable organization required.—The fund must be maintained by the same public charity to or for the use of which the irrevocable remainder interest is contributed. The requirement of maintenance will be satisfied where the public charity exercises control directly or indirectly over the fund. For example, this requirement of control shall ordinarily be met when the public charity has the power to remove the trustee or trustees of the fund and designate a new trustee or trustees. A national organization which carries out its purposes through local organizations, chapters, or auxiliary bodies with which it has an identity of aims and purposes may maintain a pooled income fund (otherwise satisfying the requirements of this paragraph) in which one or more local organizations, chapters, or auxiliary bodies which are public charities have been named as recipients of the remainder interests. For example, a national church body may maintain a pooled income fund where donors have transferred property to such fund and contributed an irrevocable remainder interest therein to or for the use of various local churches or educational institutions of such body. The fact that such local organizations or chapters have been separately incorporated from the national organization is immaterial.

(6) Prohibition against donor or beneficiary serving as trustee.—The fund must not have, and the governing instrument must prohibit the fund from having, as a trustee a donor to the fund or a beneficiary (other than the public charity to or for the use of which the remainder interest is contributed) of an income interest in any property transferred to such fund. Thus, if a donor or beneficiary (other than such public charity) directly or indirectly has general responsibilities with respect to the fund which are ordinarily exercised by a trustee, such fund does not meet the requirements of section 642(c)(5) and this paragraph. The fact that a donor of property to the fund, or a beneficiary of the fund, is a trustee, officer, director, or other official of the public charity to or for the use of which the remainder interest is contributed ordinarily will not prevent the fund from meeting the requirements of section 642(c)(5) and this paragraph.

(7) Income of beneficiary to be based on rate of return of fund.—Each beneficiary entitled to income of any taxable year of the fund must receive such income in an amount determined by the rate of return earned by the fund for such taxable year with respect to his income interest, computed as provided in paragraph (c) of this section. The governing instrument of the fund shall direct the trustee to distribute income

currently or within the first 65 days following the close of the taxable year in which the income is earned. Any such payment made after the close of the taxable year shall be treated as paid on the last day of the taxable year. A statement shall be attached to the return of the pooled income fund indicating the date and amount of such payments after the close of the taxable year. Subject to the provisions of Part I, Subchapter J, Chapter 1 of the Code, the beneficiary shall include in his gross income all amounts properly paid, credited, or required to be distributed to the beneficiary during the taxable year or years of the fund ending within or with his taxable year. The governing instrument shall provide that the income interest of any designated beneficiary shall either terminate with the last regular payment which was made before the death of the beneficiary or be prorated to the date of his death.

(8) Termination of life income interest.—Upon the termination of the income interest retained or created by any donor, the trustee shall sever from the fund an amount equal to the value of the remainder interest in the property upon which the income interest is based. The value of the remainder interest for such purpose may be either (i) its value as of the determination date next succeeding the termination of the income interest or (ii) its value as of the date on which the last regular payment was made before the death of the beneficiary if the income interest is terminated on such payment date. The amount so severed from the fund must either be paid to, or retained for the use of, the designated public charity, as provided in the governing instrument. However, see subparagraph (3) of this paragraph for rules relating to commingling of property.

(c) Allocation of income to beneficiary.—(1) In general.—Every income interest retained or created in property transferred to a pooled income fund shall be assigned a proportionate share of the annual income earned by the fund, such share, or unit of participation, being based on the fair market value of such property on the date of transfer, as provided in this paragraph.

(2) Units of participation—(i) Unit plan. (a) On each transfer of property by a donor to a pooled income fund, one or more units of participation in the fund shall be assigned to the beneficiary or beneficiaries of the income interest retained or created in such property, the number of units of participation being equal to the number obtained by dividing the fair market value of the property by the fair market value of a unit in the fund at the time of the transfer.

(b) The fair market value of a unit in the fund at the time of the transfer shall be determined by dividing the fair market value of all property in the fund at such time by the number of units then in the fund. The initial fair market value of a unit in a pooled income fund shall be the fair market value of the property transferred to the fund divided by the number of units assigned to the income interest in that property. The value of each unit of participation will fluctuate with each new transfer of property to the fund in relation to the appreciation or depreciation in the fair market value of the property in the fund, but all units in the fund will always have equal value.

(c) The share of income allocated to each unit of participation shall be determined by dividing the income of the fund for the taxable year by the outstanding number of units in the fund at the end of such year, except that, consistently with paragraph (b)(7) of this section, income shall be allocated to units outstanding during only part of such year by taking into consideration the period of time such units are outstanding. For this purpose the actual income of such part of the taxable year, or a prorated portion of the annual income, may be used, after making such adjustments as are reasonably necessary to reflect fluctuations during the year in the fair market value of the property in the fund.

(ii) Other plans.—The governing instrument of the fund may provide any other reasonable method not described in subdivision (i) of this subparagraph for assigning units of participation in the fund and allocating income to such units which reaches a result reasonably consistent with the provisions of such subdivision.

(iii) Transfers between determination dates.—For purposes of subdivisions (i) and (ii) of this subparagraph, if a transfer of property to the fund by a donor occurs on other than a determination date, the number of units of participation assigned to the income interest in such property may be determined by using the fair market value of the property in the fund on the determination date immediately preceding the date of transfer (determined without regard to the property so transferred), subject, however, to appropriate adjustments on the next succeeding determination date. Such adjustments may be made by any reasonable method, including the use of a method whereby the fair market value of the property in the fund at the time of the transfer is deemed to be the average of the fair market values of the property in the fund on the determination dates immediately preceding and succeeding the date of transfer. For purposes of determining such average any property transferred to the fund between such preceding and succeeding dates, or on such succeeding date, shall be excluded. The application of this subdivision may be illustrated by the following example:

Example. The determination dates of a pooled income fund are the first day of each calendar month. On April 1, 1971, the fair market value of the property in the fund is \$100,000, at which time 1,000 units of participation are outstanding with a value of \$100 each. On April 15, 1971, B transfers property with a fair market value of \$50,000 to the fund, retaining for himself for life an income interest in such property. No other property is transferred to the fund after April 1, 1971. On May 1, 1971, the fair market value of the property in the fund, including the property transferred by B, is \$160,000. The average of the fair market values of the property in the fund (excluding the property transferred by B) on April 1 and May 1, 1971, is \$105,000 $(\$100,000 + [\$160,000 - \$50,000] / 2)$. Accordingly, the fair market value of a unit of participation in the fund on April 15, 1971, at the time of B's transfer may be deemed to be \$105 $(\$105,000 / 1,000 \text{ units})$, and B is assigned 476.19 units of participation in the fund $(\$50,000 / \$105)$.

(3) Special rule for partial allocation of income to charity.—Notwithstanding subparagraph (2) of this paragraph, the governing instrument may provide that a unit of participation is entitled to share in the income of the fund in a lesser amount than would otherwise be determined under such subparagraph, provided that the income otherwise allocable to the unit under such subparagraph is paid within the taxable year in which it is received to the public charity to or for the use of which the remainder interest is contributed under the governing instrument.

(4) Illustrations.—The application of this paragraph may be illustrated by the following examples:

Example 1. On July 1, 1970, A and B transfer separate properties with a fair market value of \$20,000 and \$10,000, respectively, to a newly created pooled income fund which is maintained by Y University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves for life an income interest in such property, the remainder interest being contributed to Y University. The pooled income fund assigns an initial value of \$100 to each unit of participation in the fund, and under the governing instruments A receives 200 units, and B receives 100 units, in the fund. On October 1, 1970, which is a determination date, C transfers property to the fund with a fair market value of \$12,000, retaining in himself for life an income interest in such property and contributing the remainder interest to Y University. The fair market value of the property in the fund at the time of C's transfer is \$36,000. The fair market value of A's and B's units at the time of such transfer is \$120 each $(\$36,000 / 300)$. By reason

of his transfer of property C is assigned 100 units of participation in the fund (\$12,000/\$120).

Example 2. Assume that the pooled income fund in example 1 earns \$2,600 for its taxable year ending June 30, 1971, and there are no further contributions of property to the fund in such year. Further assume \$300 is earned in the first quarter ending September 30, 1970. Therefore, the fund earns \$1 per unit for the first quarter (\$300 divided by 300 units outstanding) and \$5.75 per unit for the remainder of the taxable year ([\$2,600-\$300] divided by 400 units outstanding). If the fund distributes its income for the year based on its actual earnings per quarter, the income must be distributed as follows:

<i>Beneficiary</i>	<i>Share of income</i>
A.....	\$1,350 ([200 × \$1] + [200 × \$5.75].
B.....	\$675 ([100 × \$1] + [100 × \$5.75].
C.....	\$575 (100 × \$5.75).

Example 3. (a) On July 1, 1970, A and B transfer separate properties with a fair market value of \$10,000 and \$20,000, respectively, to a newly created pooled income fund which is maintained by X University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves an income interest for life in such property, the remainder interest being contributed to X University. The governing instrument provides that each unit of participation in the fund shall have a value of not more than its initial fair market value; the instrument also provides that the income allocable to appreciation in the fair market value of such unit (to the extent in excess of its initial fair market value) at the end of each quarter of the fiscal year is to be distributed currently to X University. On October 1, 1970, which is a determination date, C contributes to the fund property with a fair market value of \$60,000 and retains in himself an income interest for life in such property, the remainder interest being contributed to X University. The initial fair market value of the units assigned to A, B, and C is \$100. A, B, and C's units of participation are as follows:

<i>Beneficiary</i>	<i>Units of Participation</i>
A.....	100 (\$10,000 divided by \$100).
B.....	200 (\$20,000 divided by \$100).
C.....	100 (\$10,000 divided by \$100).

(b) The fair market value of the property in the fund at the time of C's contribution is \$40,000. Assuming the fair market value of the property in the fund is \$100,000 on December 31, 1970, and that the income of the fund for the second quarter ending December 31, 1970, is \$2,000, the income is shared by the income beneficiaries and X University as follows:

<i>Beneficiary</i>	<i>Allocation of Income</i>
A, B, and C	90% (\$90,000 divided by \$100,000).
X University	10% (\$10,000 divided by \$100,000).

(c) For the quarter ending December 31, 1970, each unit of participation is allocated \$2 (90 percent \times \$2,000 divided by 900) of the income earned for that quarter. A, B, C, and X University share in the income as follows:

<i>Beneficiary</i>	<i>Units of Participation</i>
A.....	\$200 (100 \times \$2).
B.....	\$400 (200 \times \$2).
C.....	\$1,200 (600 \times \$2).
X University	\$200 (10% \times \$2,000).

§ 1.642(c)-6 Valuation of a remainder interest in property transferred to a pooled income fund.—(a) In general. (1) For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in property transferred to a pooled income fund is its present value determined under paragraph (d) of this section.

(2) The present value of a remainder interest at the time of the transfer of property to the pooled income fund is determined by computing the present value (at the time of the transfer) of the life income interest and subtracting that value from the fair market value of the transferred property on the valuation date. The fact that the income beneficiary may not receive the last income payment, as provided in paragraph (b)(7) of § 1.642(c)-5, is not taken into account for purposes of determining the value of the life income interest. For purposes of this section, the valuation date is the date on which property is transferred to the fund by the donor except that, for purposes of section 2055 or 2106, it is the alternate valuation date, if elected, under the provisions and limitations set forth in section 2032 and the regulations thereunder.

(3) Any claim for a deduction on any return for the value of the remainder interest in property transferred to a pooled income fund must be supported by a statement attached to the return showing the computation of the present value of the interest.

(b) Actuarial computations by the Internal Revenue Service.—The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520-1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the pooled income fund’s highest yearly rate of return for the 3 taxable years immediately preceding the date of transfer, the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see §§ 601.201 and 601.601(d)(2)(ii)(b) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) Computation of pooled income fund’s yearly rate of return.—(1) For purposes of determining the present value of the life income interest, the yearly rate of return earned by a pooled income fund for a taxable year is the percentage obtained by dividing the amount of income earned by the pooled income fund for the taxable year by an amount equal to—

(i) The average fair market value of the property in such fund for that taxable year; less

(ii) The corrective term adjustment.

(2) The average fair market value of the property in a pooled income fund for a taxable year shall be the sum of the amounts of the fair market value of all property held by the pooled income fund on each determination date, as defined in paragraph (a)(5)(vi) of § 1.642(c)-5, of such taxable year divided by the number of determination dates in such taxable year. For such purposes the fair market value of property held by the fund shall be determined without including any income earned by the fund.

(3)(i) The corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within its taxable year by the percentage set forth in column (2) of the following table opposite the period within such year, set forth in column (1), which includes the date on which that payment is made:

Table (1) (2)

<u>Payment period</u>	<u>Percentage of payment</u>
Last week of 4th quarter	0
Balance of 4th quarter .....	.25
Last week of 3d quarter .....	.25
Balance of 3d quarter .....	.50
Last week of 2d quarter .....	.50
Balance of 2d quarter .....	.75
Last week of 1st quarter .....	.75
Balance of 1st quarter.....	100

(ii) If the taxable year of the fund consists of less than 12 months, the corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within such taxable year by the percentage obtained by subtracting from 1 a fraction the numerator of which is the number of days from the first day of such taxable year to the date of such income payment and the denominator of which is 365.

(4) A pooled income fund's method of calculating its yearly rate of return must be supported by a full statement attached to the income tax return of the pooled income fund for each taxable year.

(5) The application of this paragraph may be illustrated by the following examples:

Example 1. (a) The pooled income fund maintained by W University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned \$5,000 of income during 1971. The fair market value of its property (determined without including any in-

come earned by the fund), and the income paid out, on the first day of each calendar quarter in 1971 are as follows:

Date	Fair Market Income Value of Property	Payment
Jan. 1	\$100,000	\$1,200
Apr. 1	105,000	1,200
July 1	95,000	1,200
Oct. 1	100,000	1,400
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is \$100,000 (\$400,000, divided by 4).

(c) The corrective term adjustment for 1971 is \$3,050, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication	Product
100% × \$1,200	\$1,200
75% × \$1,200	900
50% × \$1,200	600
25% × \$1,400	350
Sum of products	3,050

(d) The pooled income fund's yearly rate of return for 1971 is 5.157 percent, determined as follows: $\$5,000 / \$100,000 - \$3,050 = 0.05157$

Example 2. (a) The pooled income fund maintained by X University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned \$5,000 of income during 1971 and paid out \$3,000 on December 15, 1971, and \$2,000 on January 15, 1972, the last amount being treated under paragraph (b)(7) of § 1.642(c)-5 as paid on December 31, 1971. The fair market value of its property (determined without including any income earned by the fund) on the determination dates in 1971 and the income paid out during 1971 are as follows:

Date	Fair market value of property	Income Payment
Jan. 1	\$125,000	...
Apr. 1	125,000	...
July 1	75,000	...
Oct. 1	75,000	...

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Date	Fair market value of property	Income Payment
Dec. 15	\$3,000
Dec. 31	<u>2,000</u>
	<u>400,000</u>	<u>5,000</u>

(b) The average fair market value of the property in the fund for 1971 is \$100,000 (\$400,000 divided by 4).

(c) The corrective term adjustment for 1971 is \$750, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication	Product
0% × \$2,000	\$
25% × \$3,000 .....	.750
Sum of products .....	.750

(d) The pooled income fund's yearly rate of return for 1971 is 5.038 percent, determined as follows:

$$\$5,000 / \$100,000 - \$750 = 0.05038$$

(d) Valuation. The present value of the remainder interest in property transferred to a pooled income fund after April 30, 1999, is determined under paragraph (e) of this section. The present value of the remainder interest in property transferred to a pooled income fund for which the valuation date is before May 1, 1999, is determined under the following sections:

Valuation Dates

After	Before	Applicable Regulations
	01-01-52	1.642(c)-6A(a)
12-31-51	01-01-71	1.642(c)-6A(b)
12-31-70	12-01-83	1.642(c)-6A(c)
11-30-83	05-01-89	1.642(c)-6A(d)
04-30-89	05-01-99	1.642(c)-6A(e)

(e) Present value of the remainder interest in the case of transfers to pooled income funds for which the valuation date is after April 30, 1999.—(1) In general.—In the case of transfers to pooled income funds for which the valuation date is after April 30, 1999, the present value of a remainder interest is determined under this section. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by the use of Table S in paragraph (e)(6) of this section. For purposes of the computations under this section, the age of an individual is the age at the individual's nearest birthday.

(2) Transitional rules for valuation of transfers to pooled income funds.—(i) For purposes of sections 2055, 2106, or 2624, if on May 1, 1999, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1999, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1999, the present value of a remainder interest is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1999, or after April 30, 1999, at the option of the decedent's executor.

(ii) For purposes of sections 170, 2055, 2106, 2522, or 2624, in the case of transfers to a pooled income fund for which the valuation date is after April 30, 1999, and before July 1, 1999, the present value of the remainder interest under this section is determined by use of the section 7520 interest rate for the month in which the valuation date occurs (see §§ 1.7520-1(b) and 1.7520-2(a)(2)) and the appropriate actuarial tables under either paragraph (e)(6) of this section or § 1.642(c)-6A(e)(5), at the option of the donor or the decedent's executor, as the case may be.

(iii) For purposes of paragraphs (e)(2)(i) and (ii) of this section, where the donor or decedent's executor is given the option to use the appropriate actuarial tables under either paragraph (e)(6) of this section or § 1.642(c)-6A(e)(5), the donor or decedent's executor must use the same actuarial table with respect to each individual transaction and with respect to all transfers occurring on the valuation date (for example, gift and income tax charitable deductions with respect to the same transfer must be determined based on the same tables, and all assets includible in the gross estate and/or estate tax deductions claimed must be valued based on the same tables).

(3) Present value of a remainder interest.—The present value of a remainder interest in property transferred to a pooled income fund is computed on the basis of

(i) Life contingencies determined from the values of *lx* that are set forth in Table 90CM in § 20.2031-7(d)(7) of this chapter (see § 20.2031-7A of this chapter for certain prior periods); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (e), the yearly rate of return of a pooled income fund is determined as provided in paragraph (c) of this section unless the highest rate of return is deemed to be the rate described in paragraph (e)(4) of this section for funds in existence less than 3 taxable years. For purposes of this paragraph (e)(3)(ii), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return of the fund for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years.

(4) Pooled income funds in existence less than 3 taxable years.—If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer is made to the fund and the transfer to the fund is made after April 30, 1989, the highest rate of return is deemed to be the interest rate (rounded to the nearest two-tenths of one percent) that is 1 percent less than the highest

annual average of the monthly section 7520 rates for the 3 calendar years immediately preceding the calendar year in which the transfer to the pooled income fund is made. The deemed rate of return for transfers to new pooled income funds is recomputed each calendar year using the monthly section 7520 rates for the 3-year period immediately preceding the calendar year in which each transfer to the fund is made until the fund has been in existence for 3 taxable years and can compute its highest rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made in accordance with the rules set forth in the first sentence of paragraph (e)(3)(ii) of this section.

(5) Computation of value of remainder interest.—The factor that is used in determining the present value of a remainder interest that is dependent on the termination of the life of one individual is the factor from Table S in paragraph (e)(6) of this section under the appropriate yearly rate of return opposite the number that corresponds to the age of the individual upon whose life the value of the remainder interest is based (see § 1.642(c)-6A for certain prior periods). The tables in paragraph (e)(6) of this section include factors for yearly rates of return from 4.2 to 14 percent. Many actuarial factors not contained in the tables in paragraph (e)(6) of this section are contained in Table S in Internal Revenue Service Publication 1457, “Actuarial Values, Book Aleph,” (7-1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. For other situations, see paragraph (b) of this section. If the yearly rate of return is a percentage that is between the yearly rates of return for which factors are provided, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the fair market value of the property on the valuation date by the appropriate remainder factor. This paragraph (e)(5) may be illustrated by the following example:

Example. A, who is 54 years and 8 months, transfers \$100,000 to a pooled income fund, and retains a life income interest in the property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.47 percent. In Table S, the remainder factor opposite 55 years under 9.4 percent is .17449 and under 9.6 percent is .17001. The present value of the remainder interest is \$17,292.00, computed as follows:

Factor at 9.4 percent for age 55 .....	.17449
Factor at 9.6 percent for age 55	<u>.17001</u>
Difference .....	.00448

Interpolation adjustment:

$$\frac{9.47\% - 9.4\%}{0.2\%} = \frac{X}{.00448}$$

$$X = .00157$$

Factor at 9.4 percent for age 55 .....	.17449
Less: Interpolation adjustment.....	.00157
Interpolated factor.....	.17292

Present value of remainder interest:

(\$100,000 × .17292).....	\$17,292.00
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(f) Effective dates.—This section applies after April 30, 1999.

§ 1.642(c)-6A Valuation of charitable remainder interests for which the valuation date is before May 1, 1999.—(a) Valuation of charitable remainder interests for which the valuation date is before January 1, 1952.—There was no provision for the qualification of pooled income funds under section 642 until 1969. See § 20.2031-7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest created before January 1, 1952.

(b) Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971.—No charitable deduction is allowable for a transfer to a pooled income fund for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the pooled income fund meets the requirements of section 642(c)(5). See § 20.2031-7A(b) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) Present value of remainder interest in the case of transfers to pooled income funds for which the valuation date is after December 31, 1970, and before December 1, 1983.—For the determination of the present value of a remainder interest in property transferred to a pooled income fund for which the valuation date is after December 31, 1970, and before December 1, 1983, see § 20.2031-7A(c) of this chapter (Estate Tax Regulations) and former § 1.642(c)-6(e) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) Present value of remainder interest dependent on the termination of one life in the case of transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989.—(1) In general.—For transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of the remainder interest at the time of the transfer of property to the fund is determined by computing the present value (at the time of the transfer) of the life income interest in the transferred property (as determined under paragraph (d)(2) of this section) and subtracting that value from the fair market value of the transferred property on the valuation date. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by use of Table G in paragraph (d)(4) of this section. For purposes of the computation under this section, the age of an individual is to be taken as the age of the individual at the individual's nearest birthday.

(2) Present value of life income interest.—The present value of the life income interest in property transferred to a pooled income fund shall be computed on the basis of:

(i) Life contingencies determined from the values of l_x that are set forth in Table LN of § 20.2031-7A(d)(6) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (d)(2), the yearly rate of return of a pooled income fund is determined as provided in § 1.642(c)-6(c) unless the highest yearly rate of return is deemed to be 9 percent. For purposes of this paragraph (d)(2), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely

manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years. If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return is deemed to be 9 percent.

(3) Computation of value of remainder interest.—The factor which is used in determining the present value of the remainder interest is the factor under the appropriate yearly rate of return in column (2) of Table G opposite the number in column (1) which corresponds to the age of the individual upon whose life the value of the remainder interest is based. If the yearly rate of return is a percentage which is between yearly rates of return for which factors are provided in Table G, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying, by the factor determined under this paragraph (d)(3), the fair market value on the appropriate valuation date. If the yearly rate of return is below 2.2 percent or above 14 percent, see § 1.642(c)-6(b). This paragraph (d)(3) may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers \$100,000 to a pooled income fund on January 1, 1985, and retains a life income interest in such property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.9 percent. In Table G the figure in column (2) opposite 50 years under 9.8 percent is .15653 and under 10 percent is .15257. The present value of the remainder interest is \$15,455, computed as follows:

Factor at 9.8 percent for person aged 50.....	.15653
Factor at 10 percent for person aged 50.....	.15257
Difference .....	.00396

Interpolation adjustment:

$$\frac{9.9\% - 9.8\%}{0.2\%} = \frac{X}{.00396}$$

Factor at 9.8 percent for person aged 50.....	0.15653
Less: Interpolation adjustment.....	.00198
Interpolated factor.....	.15455
Present value of remainder interest (\$100,000 × .15455).....	\$15,455

(e) Present value of the remainder interest in the case of transfers to pooled income funds for which the valuation date is after April 30, 1989, and before May 1, 1999—(1) In general.—In the case of transfers to pooled income funds for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a remainder interest is determined under this section. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by the use of Table S in paragraph (e)(5) of this section. For purposes of the computations under this section, the age of an individual is the age at the individual's nearest birthday. If the valuation date of a transfer to a pooled income fund is after April 30, 1989, and before June 10, 1994, a transferor can rely on Notice 89-24, 1989-1

C.B. 660, or Notice 89-60, 1989-1 C.B. 700, in valuing the transferred interest. (See § 601.601(d)(2)(ii)(b) of this chapter.)

(2) Present value of a remainder interest.—The present value of a remainder interest in property transferred to a pooled income fund is computed on the basis of—

(i) Life contingencies determined from the values of *lx* that are set forth in Table 80CNSMT in § 20.2031-7A(e)(4) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. The provisions of § 1.642(c)-6(c) apply for determining the yearly rate of return. However, where the taxable year is less than 12 months, the provisions of § 1.642(c)-6(e)(3)(ii) apply for the determining the yearly rate of return.

(3) Pooled income funds in existence less than 3 taxable years. The provisions of § 1.642(c)-6(e)(4) apply for determining the highest yearly rate of return when the pooled income fund has been in existence less than three taxable years.

(4) Computation of value of remainder interest.—The factor that is used in determining the present value of a remainder interest that is dependent on the termination of the life of one individual is the factor from Table S in paragraph (e)(5) of this section under the appropriate yearly rate of return opposite the number that corresponds to the age of the individual upon whose life the value of the remainder interest is based. Table S in paragraph (e)(5) of this section includes factors for yearly rates of return from 4.2 to 14 percent. Many actuarial factors not contained in Table S in paragraph (e)(5) of this section are contained in Table S in Internal Revenue Service Publication 1457, “Actuarial Values, Alpha Volume,” (8-89). Publication 1457 is no longer available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. However, pertinent factors in this publication may be obtained by a written request to: CC:DOM:CORP:R (IRS Publication 1457), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. For other situations, see § 1.642(c)-6(b). If the yearly rate of return is a percentage that is between the yearly rates of return for which factors are provided, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the fair market value of the property on the valuation date by the appropriate remainder factor. For an example of a computation of the present value of a remainder interest requiring a linear interpolation adjustment, see § 1.642(c)-6(e)(5).

§ 1.642(c)-7 Transitional rules with respect to pooled income funds.—(a) In general.—(1) Amendment of certain funds. A fund created before May 7, 1971, and not otherwise qualifying as a pooled income fund may be treated as a pooled income fund to which § 1.642(c)-5 applies if on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969, it possessed the initial characteristics described in paragraph (b) of this section and is amended, in the time and manner provided in paragraph (c) of this section, to meet all the requirements of section 642(c)(5) and § 1.642(c)-5. If a fund to which this subparagraph applies is amended in the time and manner provided in paragraph (c) of this section it shall be treated as provided in paragraph (d) of this section for the period beginning on August 1, 1969, or, if later, on the date of its creation and ending the day before the date on which it meets the requirements of section 642(c)(5) and § 1.642(c)-5.

(2) Severance of a portion of a fund.—Any portion of a fund created before May 7, 1971, which consists of property transferred to such fund after July 31, 1969, may be severed from such fund consistently with the principles of paragraph (c)(2) of this section and established before January 1, 1972, as a separate pooled income fund,

provided that on and after the date of severance the severed fund meets all the requirements of section 642(c)(5) and § 1.642(c)-5. A separate fund which is established pursuant to this subparagraph shall be treated as provided in paragraph (d) of this section for the period beginning on the day of the first transfer of property which becomes part of the separate fund and ending the day before the day on which the separate fund meets the requirements of section 642(c)(5) and § 1.642(c)-5.

(b) Initial characteristics required.—A fund described in paragraph (a)(1) of this section shall not be treated as a pooled income fund to which section 642(c)(5) applies, even though it is amended as provided in paragraph (c) of this section, unless it possessed the following characteristics on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969:

(1) It satisfied the requirements of section 642(c)(5)(A) other than that the fund be a trust;

(2) It was constituted in a way to attract and contain commingled properties transferred to the fund by more than one donor satisfying such requirements; and

(3) Each beneficiary of a life income interest which was retained or created in any property transferred to the fund was entitled to receive, but not less often than annually, a proportional share of the annual income earned by the fund, such share being based on the fair market value of the property in which such life interest was retained or created.

(c) Amendment requirements.—(1) A fund described in paragraph (a)(1) of this section and possessing the initial characteristics described in paragraph (b) of this section on the date prescribed therein shall be treated as a pooled income fund if it is amended to meet all the requirements of section 642(c)(5) and § 1.642(c)-5 before January 1, 1972, or, if later, on or before the 30th day after the date on which any judicial proceedings commenced before January 1, 1972, which are required to amend its governing instrument or any other instrument which does not permit it to meet such requirements, become final. However, see paragraph (d) of this section for limitation on the period in which a claim for credit or refund may be filed.

(2) In addition, if the transferred property described in paragraph (b)(2) of this section is commingled with other property, the transferred property must be separated on or before the date specified in subparagraph (1) of this paragraph from the other property and allocated to the fund in accordance with the transferred property's percentage share of the fair market value of the total commingled property on the date of separation. The percentage share shall be the ratio which the fair market value of the transferred property on the date of separation bears to the fair market value of the total commingled property on that date and shall be computed in a manner consistent with paragraph (c) of § 1.642(c)-5. The property which is so allocated to the fund shall be treated as property received from transfers which meet the requirements of section 642(c)(5), and such transfers shall be treated as made on the dates on which the properties giving rise to such allocation were transferred to the fund by the respective donors. The property so allocated to the fund must be representative of all the commingled property other than securities the income from which is exempt from tax under subtitle A of the Code; compensating increases in other commingled property allocated to the fund shall be made where such tax-exempt securities are not allocated to the fund. The application of this subparagraph may be illustrated by the following example:

Example. (a) The trustees of X fund are in the process of amending it in order to qualify as a pooled income fund. The property transferred to the X fund was commingled with other property transferred to the organization by which the fund was established. After taking into account the various transfers and the appreciation in the fair

market value of all the properties, the fair market value of the property allocated to the fund on the various transfer dates is set forth in the following schedule and determined in the manner indicated:

Transfers					
Date of Transfer	Value of All Property Before Transfer	Trust Property	Other Property	Value Of All Property After Transfer	Property Allocated to Fund
	1	2	3	4	5
1/1/68	.....	\$100,000	\$100,000	\$200,000	\$100,000 ¹
9/30/68	\$300,000	100,000	.....	400,000	250,000 ²
1/15/69	480,000	60,000	.....	540,000	360,000 ³
11/11/69	600,000	200,000	.....	800,000	600,000 ⁴

¹ \$100,000 = (the amount in column (2))
² 250,000 = $([\$100,000/\$200,000 \times \$300,000]) + \$100,000$
³ 360,000 = $([\$250,000/\$400,000 \times \$480,000]) + \$60,000$
⁴ 600,000 = $([\$360,000/\$540,000 \times \$600,000]) + \$200,000$

(b) On September 30, 1970, the trustees decide to separate the property of X fund from the other property. The fair market value of all the commingled property is \$1 million on September 30, 1970, and there were no additional transfers to the fund after November 11, 1969. Accordingly, the fair market value of the property required to be allocated to X fund must be \$750,000 $(\$600,000/\$800,000 \times \$1,000,000)$, and X fund's percentage share of the commingled property is 75 percent $(\$750,000/\$1,000,000)$. Accordingly, assuming that the commingled property consists of Y stock with a fair market value of \$800,000 and Z bonds with a fair market value of \$200,000, there must be allocated to X fund at the close of September 30, 1970, Y stock with a value of \$600,000 $(\$800,000 \times 75\%)$ and Z bonds with a value of \$150,000 $(\$200,000 \times 75\%)$.

(d) Transactions before amendment of or severance from fund.—(1) A fund which is amended pursuant to paragraph (c) of this section, or is severed from a fund pursuant to paragraph (a)(2) of this section, shall be treated for all purposes, including the allowance of a deduction for any charitable contribution, as if it were before its amendment or severance a pooled income fund to which section 642(c)(5) and § 1.642(c)-5 apply. Thus, for example, where a donor transferred property in trust to such an amended or severed fund on August 1, 1969, but before its amendment or severance under this section, a charitable contributions deduction for the value of the remainder interest may be allowed under section 170, 2055, 2106, or 2522. The deduction may not be allowed, however, until the fund is amended or severed pursuant to this section and shall be allowed only if a claim for credit or refund is filed within the period of limitation prescribed by section 6511(a).

(2) For purposes of determining under § 1.642(c)-6 the highest yearly rate of return earned by a fund (which is amended pursuant to paragraph (c) of this section) for the 3 preceding taxable years, taxable years of the fund preceding its taxable year in

which the fund is so amended and qualifies as a pooled income fund under this section shall be used provided that the fund did not at any time during such preceding years hold any investments in securities the income from which is exempt from tax under subtitle A of the Code. If any such tax-exempt securities were held during such period by such amended fund, or if the fund consists of a portion of a fund which is severed pursuant to paragraph (a)(2) of this section, the highest yearly rate of return under § 1.642(c)-6 shall be determined by treating the fund as a pooled income fund which has been in existence for less than 3 taxable years preceding the taxable year in which the transfer of property to the fund is made.

(3) Property transferred to a fund before its amendment pursuant to paragraph (c) of this section, or before its severance under paragraph (a)(2) of this section, shall be treated as property received from transfers which meet the requirements of section 642(c)(5).

§ 1.642(d)-1 Net operating loss deduction.—The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642(c) (relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

§ 1.642(e)-1 Depreciation and depletion.—An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term beneficiaries includes charitable beneficiaries. See the regulations under those sections.

§ 1.642(f)-1 Amortization deductions.—An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168(d), with respect to a certified pollution control facility as defined in section 169(d), with respect to qualified railroad rolling stock as defined in section 184(d), with respect to certified coal mine safety equipment as defined in section 187(d), with respect to on-the-job training and child-care facilities as defined in section 188(b), and with respect to certain rehabilitations of certified historic structures as defined in section 191, in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between fiduciaries and the beneficiaries of an estate or trust (see sections 167(h) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

§ 1.642(g)-1 Disallowance of double deductions; in general.—Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the

return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

§ 1.642(g)-2 Deductions included.—It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213(d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

§ 1.642(h)-1 Unused loss carryovers on termination of an estate or trust.—(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642(h)(1) to the beneficiaries succeeding to the property of the estate or trust. See § 1.641(b)-3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust, except that the capital loss carryover in the hands of a beneficiary which is a corporation is a short-term loss irrespective of whether it would have been a long-term or short-term capital loss in the hands of the estate or trust. The net operating loss carryover and the capital loss carryover are taken into account in computing taxable income, adjusted gross income, and the tax imposed by section 56 (relating to the minimum tax for tax preferences). The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, for purposes of determining the number of years to which a net operating loss, or a capital loss under paragraph (a) of § 1.1212-1, may be carried over by a beneficiary, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year, and, in the case of a beneficiary of an estate or trust that is a corporation, capital losses carried over by the estate or trust to any taxable year of the estate or trust beginning after December 31, 1963, shall be treated as if they were incurred in the last taxable year of the estate or trust (whether or not a short taxable year). For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see § 1.642(h)-2.

(c) The application of this section may be illustrated by the following examples:

Example 1. A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of \$10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of \$10,000 and capital gains of \$4,000 for the taxable year 1954. A would offset his capital gains of \$4,000 against the capital loss of the trust and, in addition, deduct under section 1211(b) \$1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of \$5,000 may be carried over only to the years 1955 and 1956, in accordance with paragraph (a) of § 1.1212-1 and the rules of this section.

Example 2. A trust distributes all of its assets, one-half to A, an individual, and one-half to X, a corporation, who are the sole remaindermen, and terminates on December 31, 1966, when it has a short-term capital loss carryover of \$20,000 attributable to short-term transactions during the taxable years 1964, 1965, and 1966, and a long-term capital loss carryover of \$12,000 attributable to long-term transactions during such years. A, who reports on the calendar year basis, otherwise has ordinary income of \$15,000, short-term capital gains of \$4,000 and long-term capital gains of \$6,000, for the taxable year 1966. A would offset his short-term capital gains of \$4,000 against his share of the short-term capital loss carryover of the trust, \$10,000 (one-half of \$20,000), and, in addition deduct under section 1211(b) \$1,000 (treated as a short-term gain for purposes of computing capital loss carryovers) on his return for the taxable year 1966. A would also offset his long-term capital gains of \$6,000 against his share of the long-term capital loss carryover of the trust, \$6,000 (one-half of \$12,000). The balance of A's share of the short-term capital loss carryover, \$5,000, may be carried over as a short-term capital loss carryover to the succeeding taxable year and treated as a short-term capital loss incurred in such succeeding taxable year in accordance with paragraph (b) of § 1.1212-1. X, which also reports on the calendar year basis, otherwise has capital gains of \$4,000 for the taxable year 1966. X would offset its capital gains of \$4,000 against its share of the capital loss carryovers of the trust, \$16,000 (the sum of one-half of each the short-term carryover and the long-term carryover of the trust), on its return for the taxable year 1966. The balance of X's share, \$12,000, may be carried over as a short-term capital loss only to the years 1967, 1968, 1969, and 1970, in accordance with paragraph (a) of § 1.1212-1 and the rules of this section.

§ 1.642(h)-2 Excess deductions on termination of an estate or trust.—(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it has excess deductions, for example, because of corpus commissions on termination, of \$18,000. B, who reported on the calendar year basis, could claim the \$18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deductions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding to the property of the estate or trust under the provisions of paragraph (1) of section 642(h) cannot also be considered a deduction for purposes of paragraph (2) of section 642(h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an “excess deduction” under section 642(h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642(h)(2) and paragraph (a) of this section (see example in § 1.642(h)-5).

§ 1.642(h)-3 Meaning of “beneficiaries succeeding to the property of the estate or trust”.—(a) The phrase beneficiaries succeeding to the property of the estate or trust means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent’s spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary succeeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent’s estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent’s net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay \$10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B \$10,000.

§ 1.642(h)-4 Allocation.—The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see § 1.642(h)-3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves \$100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only \$90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of \$5,000, and a capital loss carryover of \$15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of \$10,000, and since the total of the excess of deductions and the loss carryover is \$20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

§ 1.642(h)-5 Example.—The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	\$2,500
Business income.....	<u>3,000</u>
Total	5,500
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses and corpus commissions not allocable to business income.....	<u>9,800</u>
Total deductions	14,800

It also has a capital loss of \$5,000.

(b) Under section 642(h)(1), an unused net operating loss carryover of the estate on termination of \$2,000 will be allowable to: A to the extent of \$1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of \$1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	\$14,800
Less adjustment under section 172(d)(4) (deductions not attributable to a trade or business (\$9,800) allowable only to extent of gross income not derived from such trade or business (\$2,500))	<u>7,300</u>
Deductions as adjusted.....	7,500
Gross income of estate for 1954	<u>5,500</u>

Net operating loss of estate for 19542,000
 (No deduction for capital loss of \$5,000 under
 section 172(d)(2))

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642(h)(1).

(c) Under section 642(h)(2), excess deductions of the estate of \$7,300 will be allowed as a deduction to A to the extent of \$3,650 for the calendar year 1954 and to the trust to the extent of \$3,650 for the taxable year ending August 31, 1955. The deduction of \$7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate (\$9,800 of such expenses less \$2,500 taken into account).

(d) Under section 642(h)(1), there will be allowable to A a capital loss carryover of \$2,500 for his taxable year 1954 and for his next 4 taxable years in accordance with paragraph (a) of § 1.1212-1. There will be allowable to the trust a similar capital loss carryover of \$2,500 for its taxable year ending August 31, 1955, and its next 4 taxable years (but see paragraph (b) of § 1.643(a)-3) (for taxable years beginning after December 31, 1963, net capital losses may be carried over indefinitely by beneficiaries other than corporations, in accordance with § 1.642(h)-1 and paragraph (b) of § 1.1212-1.)

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

§ 1.642(i)-1 Certain distributions by cemetery perpetual care funds.—(a) In general.—Section 642(i) provides that amounts distributed during taxable years ending after December 31, 1963, by a cemetery perpetual care fund trust for the care and maintenance of gravesites shall be treated as distributions solely for purposes of sections 651 and 661. The deduction for such a distribution is allowable only if the fund is taxable as a trust. In addition, the fund must have been created pursuant to local law by a taxable cemetery corporation (as defined in § 1.642(i)-2 (a)) expressly for the care and maintenance of cemetery property. A care fund will be treated as having been created by a taxable cemetery corporation (“cemetery”) if the distributee cemetery is taxable, even though the care fund was created by the distributee cemetery in a year that it was tax-exempt or by a predecessor of such distributee cemetery which was tax-exempt in the year the fund was established. The deduction is the amount of the distributions during the fund’s taxable year to the cemetery corporation for such care and maintenance that would be otherwise allowable under section 651 or 661, but in no event is to exceed the limitations described in paragraphs (b) and (c) of this section. The provisions of this paragraph shall not have the effect of extending the period of limitations under section 6511.

(b) Limitation on amount of deduction.—The deduction in any taxable year may not exceed the product of \$5 multiplied by the aggregate number of gravesites sold by the cemetery corporation before the beginning of the taxable year of the trust. In general, the aggregate number of gravesites sold shall be the aggregate number of interment rights sold by the cemetery corporation (including gravesites sold by the cemetery before a care fund trust law was enacted). In addition, the number of gravesites sold shall include gravesites used to make welfare burials. Welfare burials and pre-trust fund law gravesites shall be included only to the extent that the cemetery cares for and maintain such gravesites. For purposes of this section, a gravesite is sold as of the date on which the purchaser acquires interment rights enforceable under local law. The aggregate number of gravesites includes only those gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance.

(c) Requirements for deductibility of distributions for care and maintenance.—(1) Obligation for care and maintenance.—A deduction is allowed only for distributions for the care and maintenance of gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance. Such obligation may be established by the trust instrument, by local law, or by the cemetery's practice of caring for and maintaining gravesites, such as welfare burial plots or gravesites sold before the enactment of a care fund trust law.

(2) Distribution actually used for care and maintenance.—The amount of a deduction otherwise allowable for care fund distributions in any taxable year shall not exceed the portion of such distributions expended by the distributee cemetery corporation for the care and maintenance of gravesites before the end of the fund's taxable year following the taxable year in which it makes the distributions. A 6-month extension of time for filing the trust's return may be obtained upon request under section 6081. The failure of a cemetery to expend the care fund's distributions within a reasonable time before the due date for filing the return will be considered reasonable grounds for granting a 6-month extension of time for section 6081. For purposes of this paragraph, any amount expended by the care fund directly for the care and maintenance of gravesites shall be treated as an additional care fund distribution which is expended on the day of distribution by the cemetery corporation. The fund shall be allowed a deduction for such direct expenditure in the fund's taxable year during which the expenditure is made.

(3) Example. The application of paragraph (c)(2) of this section is illustrated by the following example:

A, a calendar-year perpetual care fund trust, meeting the requirements of section 642(i), makes a \$10,000 distribution on December 1, 1978 to X, a taxable cemetery corporation operating on a May 31 fiscal year. From this \$10,000 distribution, the cemetery makes the following expenditures for the care and maintenance of gravesites: \$2,000 on December 20, 1978; \$4,000 on June 1, 1979; \$2,000 on October 1, 1979; and \$1,000 on April 1, 1980. In addition, as authorized by the trust instrument, A itself makes a direct \$1,000 payment to a contractor on September 1, 1979 for qualifying care and maintenance work performed. As a result of these transactions, A will be allowed an \$8,000 deduction for its 1978 taxable year attributable to the cemetery's expenditures, and a \$1,000 deduction for its 1979 taxable year attributable to the fund's direct payment. A will not be allowed a deduction for its 1978 taxable year for the cemetery's expenditure of either the \$1,000 expended on April 1, 1980 or the remaining unspent portion of the original \$10,000 distribution. The trustee may request a 6-month extension in order to allow the fund until October 15, 1979 to file its return for 1978.

(d) Certified statement made by cemetery officials to fund trustees.—A trustee of a cemetery perpetual care fund shall not be held personally liable for civil or criminal penalties resulting from false statements on the trust's tax return to the extent that such false statements resulted from the trustee's reliance on a certified statement made by the cemetery specifying the number of interments sold by the cemetery or the amount of the cemetery's expenditures for care and maintenance. The statement must indicate the basis upon which the cemetery determined what portion of its expenditures were made for the care and maintenance of gravesites. The statement must be certified by an officer or employee of the cemetery who has the responsibility to make or account for expenditures for care and maintenance. A copy of this statement shall be retained by the trustee along with the trust's return and shall be made available for inspection upon request by the Secretary. This paragraph does not relieve the care fund trust of its liability to pay the proper amount of tax due and to maintain adequate records to substantiate

each of its deductions, including the deduction provided in section 642(i) and this section. [T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.642(i)-2 Definitions.—(a) Taxable cemetery corporation.—For purposes of section 642(i) and this section, the meaning of the term taxable cemetery corporation is limited to a corporation (within the meaning of section 7701(a)(3)) engaged in the business of owning and operating a cemetery that either (1) is not exempt from Federal tax, or (2) is subject to tax under section 511 with respect to its cemetery activities.

(b) Pursuant to local law.—A cemetery perpetual care fund is created pursuant to local law if:

(1) The governing law of the relevant jurisdiction (State, district, county, parish, etc.) requires or expressly permits the creation of such a fund, or

(2) The legally enforceable bylaws or contracts of a taxable cemetery corporation require a perpetual care fund.

(c) Gravesite.—A gravesite is any type of interment right that has been sold by a cemetery, including, but not limited to, a burial lot, mausoleum, lawn crypt, niche, or scattering ground. For purposes of § 1.642(i)-1, the term gravesites includes only those gravesites with respect to which the care fund or cemetery has an obligation for care and maintenance within the meaning of § 1.642(i)-1(c)(1).

(d) Care and maintenance.—For purposes of section 642(i) and this section, the term care and maintenance of gravesite shall be generally defined in accordance with the definition of such term under the local law pursuant to which the cemetery perpetual care fund is created. If the applicable local law contains no definition, care and maintenance of gravesites may include the upkeep, repair and preservation of those portions of cemetery property in which gravesites (as defined in paragraph (c) of this section) have been sold; including gardening, road maintenance, water line and drain repair and other activities reasonably necessary to the preservation of cemetery property. The costs for care and maintenance include, but are not limited to, expenditures for the maintenance, repair and replacement of machinery, tools, and equipment, compensation of employees performing such work, insurance premiums, reasonable payments for employees' pension and other benefit plans, and the costs of maintaining necessary records of lot ownership, transfers and burials. However, if some of the expenditures of the cemetery corporation, such as officers' salaries, are for both care and maintenance and for other purposes, the expenditures must be properly allocated between care and maintenance of gravesites and the other purposes. Only those expenditures that are properly allocable to those portions of cemetery property in which gravesites have been sold qualify as expenditures for care and maintenance of gravesites.

§ 1.643(a)-0 Distributable net income; deduction for distributions; in general.—The term distributable net income has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643(a)-1 through 1.643(a)-7.

§ 1.643(a)-1 Deduction for distributions.—The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

§ 1.643(a)-2 Deduction for personal exemption.—The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

§ 1.643(a)-3 Capital gains and losses.—(a) In general. Except as provided in § 1.643(a)-6 and 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 impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently 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 actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that 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. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal 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 Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by 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 5. 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 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 6. 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 7. 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. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, 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 8. The facts are the same as Example 7, except Trustee is directed to pay B \$10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as Example 7, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of \$1,000,000 and an adjusted basis of \$300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as Example 9, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The \$500,000 distribution to A may be treated as including a minimum of \$200,000 of capital gain (and all of the principal amount of \$300,000) and a maximum of \$500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt 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 statute. Trustee makes the unitrust election under state statute. 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 ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in Example 11, except that neither state statute 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, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt 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 of not allocating realized capital gains to income.

Example 13. The facts are the same as in Example 11, except that neither state statutes 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 and tax-exempt 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 and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to 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. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion

of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

(f) Effective date.—This section applies for taxable years of trusts and estates ending after January 2, 2004.

§ 1.643(a)-4 Extraordinary dividends and taxable stock dividend.—In the case solely of a trust which qualifies under Subpart B (section 651 and following) as a “simple trust,” there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(e), paragraph (b) of § 1.665(e)-1, and paragraph (b) of § 1.665(e)-1A for the treatment of such dividends upon subsequent distribution.

§ 1.643(a)-5 Tax-exempt interest.—(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see examples 1 and 2 of § 1.662(b)-2 and paragraph (e) of § 1.662(c)-4.

§ 1.643(a)-6 Income of foreign trust.—(a) Distributable net income of a foreign trust. In the case of a foreign trust (see section 7701(a)(31)), the determination of distributable net income is subject to the following rules:

(1) There is included in distributable net income the amounts of gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax exempt income). See paragraph (b) of § 1.643(a)-5 for rules applicable when an estate or trust is allowed a charitable contributions deduction under section 642(c).

(2) In the case of a distribution made by a trust before January 1, 1963, for purposes of determining the distributable net income of the trust for the taxable year in which the distribution is made, or for any prior taxable year;

(i) Gross income from sources within the United States is determined by taking into account the provisions of section 894 (relating to income exempt under treaty); and

(ii) Distributable net income is determined by taking into account the provisions of section 643(a)(3) (relating to exclusion of certain gains from the sale or exchange of capital assets).

(3) In the case of a distribution made by a trust after December 31, 1962, for purposes of determining the distributable net income of the trust for any taxable year, whether ending before January 1, 1963, or after December 31, 1962;

(i) Gross income (for the entire foreign trust) from sources within the United States is determined without regard to the provisions of section 894 (relating to income exempt under treaty);

(ii) In respect of a foreign trust created by a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)-1), there shall be included in gross income gains from the sale or exchange of capital assets reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and the deduction under section 1202 (relating to deduction for capital gains) shall not be taken into account; and

(iii) In respect of a foreign trust created by a person other than a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)-1), distributable net income is determined by taking into account all of the provisions of section 643 except section 643(a)(6)(C) (relating to gains from the sale or exchange of capital assets by a foreign trust created by a U.S. person).

(b) Examples. The application of this section, showing the computation of distributable net income for one of the taxable years for which such a computation must be made, may be illustrated by the following examples:

Example 1. (1) A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The income from the trust corpus is to be accumulated until the beneficiary, a resident citizen of the United States who was born in 1944, reaches the age of 21 years, and upon his reaching that age, the corpus and accumulated income are to be distributed to him. The trust instrument provides that capital gains are to be allocated to corpus and are not to be paid, credited, or required to be distributed to any beneficiary during the taxable year or paid, permanently set aside, or to be used for the purposes specified in section 642(c). Under the terms of a tax convention between the United States and Country X, interest income received by the trust from U.S. sources is exempt from U.S. taxation. In 1965 the corpus and accumulated income are distributed to the beneficiary. During the taxable year 1964, the trust has the following items of income, loss, and expense:

Interest on bonds of a U.S. corporation	\$10,000
Net long-term capital gain from U.S. sources.....	30,000
Gross income from investments in Country X	40,000
Net short-term capital loss from U.S. sources	5,000
Expenses allocable to gross income from investments in Country X.....	5,000

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is \$70,000, computed as follows:

Interest on bonds of a U.S. corporation	\$10,000
Gross income from investments in Country X	40,000
Net long-term capital gain from U.S. sources.....	\$30,000
Less: Net short-term capital loss from U.S. sources	<u>5,000</u>
Excess of net long-term capital gain over net short-term capital loss.....	<u>25,000</u>
Total	75,000
Less: Expenses allocable to income from investments in Country X.....	<u>5,000</u>
Distributable net income	70,000

(3) In determining the distributable net income of \$70,000, the taxable income of the trust is computed with the following modifications: No deduction is allowed for the personal exemption of the trust (section 643(a)(2)); the interest received on bonds of a U.S. corporation is included in the trust gross income despite the fact that such interest is exempt from U.S. tax under the provisions of the tax treaty between Country X and the United States (section 643(a)(6) (see H. Con. Res. (B))); the excess of net long-term capital gain over net short-term capital loss allocable to corpus is included in distributable net income, but such excess is not subject to the deduction under section 1202 (section 643(a)(6)(C)); and the amount representing gross income from investments in Country X is included, but such amount is reduced by the amount of the disbursements allocable to such income (section 643(a)(6)(A)).

Example 2. (1) The facts are the same as in example 1 except that money or property has also been transferred to the trust by a person other than a U.S. person and, pursuant to the provisions of § 1.643(d)-1, during 1964 only 60 percent of the entire trust constitutes a foreign trust created by a U.S. person.

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is \$42,000 computed as follows:

Interest on bonds of a U.S. corporation (60 percent of \$10,000).....	\$6,000
Gross income from investments in Country X (60 percent of \$40,000).....	24,000
Net long-term capital gain from U.S. sources (60 percent of \$30,000).....	\$18,000
Less: Net short-term capital loss from U.S. sources (60 percent of \$5,000).....	<u>3,000</u>
Total	45,000
Less: Expenses allocable to income from investments in Country X (60 percent of 5,000).....	<u>3,000</u>
Distributable net income	\$42,000

(3) The distributable net income for the taxable year 1964 of the portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person, determined under section 643(a), is \$18,000, computed as follows:

Interest on bonds of a U.S. corporation (40 percent of \$10,000).....	\$4,000
Gross income from investments in Country X (40 percent of \$40,000).....	<u>16,000</u>
Total	\$20,000
Less: Expenses allocable to income from investments in Country X (40 percent of \$5,000).....	<u>2,000</u>
Distributable net income	\$18,000

(4) The distributable net income of the entire foreign trust for the taxable year 1964 is \$60,000, computed as follows:

Distributable net income of the foreign trust created by a U.S. person	\$42,000
Distributable net income of that portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person	<u>18,000</u>
Distributable net income of the entire foreign trust	60,000

It should be noted that the difference between the \$70,000 distributable net income of the foreign trust in example (1) and the \$60,000 distributable net income of the entire foreign trust in this example is due to the \$10,000 (40 percent of \$25,000) net capital gain (capital gain net income for taxable years beginning after December 31, 1976) which under section 643(a)(3) is excluded from the distributable net income of that portion of the foreign trust in example (2) which does not constitute a foreign trust created by a U.S. person.

§ 1.643(a)-7 Dividends.—Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)-5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See the regulations under section 642(c).

§ 1.643(a)-8 Certain distributions by charitable remainder trusts.—(a) Purpose and scope.—This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules regarding the characterizations of distributions from those trusts in the hands of the recipients and should be interpreted in a manner consistent with this purpose. This section applies to all charitable remainder trusts described in section 664 and the beneficiaries of such trusts.

(b) Deemed sale by trust.—(1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year in which a distribution of an annuity or unitrust amount is made from the trust, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount would (but for the application of this paragraph (b)) be characterized in the hands of the recipient as being from the category described in section 664(b)(4) and exceeds the amount of the previously undistributed

(i) Cash contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); plus

(ii) Basis in any contributed property (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522) that was sold by the trust.

(2) Any transaction that has the purpose or effect of circumventing the rules in this paragraph (b) shall be disregarded.

(3) For purposes of paragraph (b)(1) of this section, trust assets do not include cash or assets purchased with the proceeds of a trust borrowing, forward sale, or similar transaction.

(4) Proper adjustment shall be made to any gain or loss subsequently realized for gain or loss taken into account under paragraph (b)(1) of this section.

(c) Examples. The following examples illustrate the rules of paragraph (b) of this section:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of \$2 million to a charitable remainder unitrust with a unitrust amount of 50 percent of the net fair market value of the trust assets and a two-year term. The stock has a total adjusted basis of \$400,000. In Year 1, the trust receives dividend income of \$20,000. As of the valuation date, the trust's assets have a net fair market value of \$2,020,000 (\$2 million in stock, plus \$20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows \$990,000 against the value of the stock. The trust then distributes \$1,010,000 to the beneficiary before the end of Year 1. Under section 664(b)(1), \$20,000 of the distribution is characterized in the hands of the beneficiary as dividend income. The rest of the distribution, \$990,000, is attributable to an amount received by the trust that did not represent either cash contributed to the trust or a return of basis in any contributed asset sold by the trust during Year 1. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore, in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold \$990,000 of stock and as having realized \$792,000 of capital gain (the trust's basis in the shares deemed sold is \$198,000). Thus, in the hands of the beneficiary, \$792,000 of the distribution is characterized as capital gain under section 664(b)(2) and \$198,000 is characterized as a tax-free return of corpus under section 664(b)(4). No part of the \$990,000 loan is treated as acquisition indebtedness under section 514(c) because the entire loan has been recharacterized as a deemed sale.

Example 2. Adjustment to trust's basis in assets deemed sold.—The facts are the same as in Example 1. During Year 2, the trust sells the stock for \$2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(4) of this section, the trust's adjusted basis in the stock is \$1,192,000 (\$400,000 plus the \$792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of \$908,000.

Example 3. Distribution of cash contributions.—Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to \$x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the \$x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the

distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

(d) Effective date.—This section is applicable to distributions made by a charitable remainder trust after October 18, 1999.

§ 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 will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts 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 and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make 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. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

§ 1.643(b)-2 Dividends allocated to corpus.—Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered “income” for purposes of Subpart A, B, C, or D, Part I, Subchapter J, Chapter 1 of the Code. See section 643(a)(4), § 1.643(a)-4, § 1.643(d)-2, section 665(e), paragraph (b) of § 1.665(e)-1, and paragraph (b) of § 1.665(e)-1A for the treatment of such items in the computation of distributable net income.

§ 1.643(c)-1 Definition of “beneficiary”.—An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent’s will is a beneficiary of the decedent’s estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person’s legal obligation as that term is used in § 1.662(a)-4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust.

§ 1.643(d)-1 Definition of “foreign trust created by a United States person”.—

(a) In general.—For the purpose of Part I, Subchapter J, Chapter 1 of the Internal Revenue Code, the term foreign trust created by a United States person means that portion of a foreign trust (as defined in section 7701(a)(31)) attributable to money or property (including all accumulated earnings, profits, or gains attributable to such money or property) of a U.S. person (as defined in section 7701(a)(30)) transferred directly or indirectly, or under the will of a decedent who at the date of his death was a U.S. citizen or resident, to the foreign trust. A foreign trust created by a person who is not a U.S. person, to which a U.S. person transfers his money or property, is a foreign trust created by a U.S. person to the extent that the fair market value of the entire foreign trust is attributable to money or property of the U.S. person transferred to the foreign trust. The transfer of money or property to the foreign trust may be made either directly or indirectly by a U.S. person. Transfers of money or property to a foreign trust do not include transfers of money or property pursuant to a sale or exchange which is made for a full and adequate consideration. Transfers to which section 643(d) and this section apply are transfers of money or property which establish or increase the corpus of a foreign trust. The rules set forth in this section with respect to transfers by a U.S. person to a foreign trust also are applicable with respect to transfers under the will of a decedent who at the date of his death was a U.S. citizen or resident. For provisions relating to the information returns which are required to be filed with respect to the creation of or transfers to foreign trusts, see section 6048 and § 16.3-1 of this chapter (Temporary Regulations under the Revenue Act of 1962).

(b) Determination of a foreign trust created by a U.S. person—(1) Transfers of money or property only by a U.S. person. If all the items of money or property constituting the corpus of a foreign trust are transferred to the trust by a U.S. person, the entire foreign trust is a foreign trust created by a U.S. person.

(2) Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers required to be treated as separate funds. Where there are transfers of money or property by both a U.S. person and a person other than a U.S. person to a foreign trust, and it is necessary, either by reason of the provisions of the governing instrument of the trust or by reason of some other requirement such as local law, that the trustee treat the entire foreign trust as composed of two separate funds, one

consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the U.S. person and the other consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the person other than the U.S. person, the foreign trust created by a U.S. person shall be the fund consisting of the money or property transferred by the U.S. person. See example 1 in paragraph (c) of this section.

(3) Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers not required to be treated as separate funds. Where the corpus of a foreign trust consists of money or property transferred to the trust (simultaneously or at different times) by a U.S. person and by a person who is not a U.S. person, the foreign trust created by a U.S. person within the meaning of section 643(d) is that portion of the entire foreign trust which, immediately after any transfer of money or property to the trust, the fair market value of money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred to the foreign trust by the U.S. person bears to the fair market value of the corpus (including all accumulated earnings, profits, or gains attributable to the corpus) of the entire foreign trust.

(c) Examples. The provisions of paragraph (b) of this section may be illustrated by the following examples. Example 1 illustrates the application of paragraph (b)(2) of this section. Example (2) illustrates the application of paragraph (b)(3) of this section in a case where there is no provision in the governing instrument of the trust or elsewhere which would require the trustee to treat the corpus of the trust as composed of more than one fund.

Example 1. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it stock of a U.S. corporation with a fair market value of \$50,000. On the same day, a person other than a U.S. person transfers to the trust Country X bonds with a fair market value of \$25,000. The governing instrument of the trust provides that the income from the stock of the U.S. corporation is to be accumulated until A, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the stock and income accumulated thereon are to be distributed to him. The governing instrument of the trust further provides that the income from the Country X bonds is to be accumulated until B, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the bonds and income accumulated thereon are to be distributed to him. To comply with the provisions of the governing instrument of the trust that the income from the stock of the U.S. corporation be accumulated and distributed to A and that the income from the Country X bonds be accumulated and distributed to B, it is necessary that the trustee treat the transfers as two separate funds. The fund consisting of the stock of the U.S. corporation is a foreign trust created by a U.S. person.

Example 2. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it property having a fair market value of \$60,000 and a person other than a U.S. person transfers to it property having a fair market value of \$40,000. Immediately after these transfers, the foreign trust created by a U.S. person is 60 percent of the entire foreign trust, determined as follows:

$$\frac{\$60,000}{\$100,000} \quad \begin{array}{l} \text{(Value of property transferred by U.S. person)} \\ \text{(Value of entire property transferred to trust)} \end{array} = 60 \text{ percent}$$

The undistributed net income for the calendar years 1964 and 1965 is \$20,000 which increases the value of the entire foreign trust to \$120,000 (\$100,000 plus

\$20,000). Accordingly, as of December 31, 1965, the portion of the foreign trust created by the U.S. person is \$72,000 (60 percent of \$120,000). On January 1, 1966, the U.S. person transfers property having a fair market value of \$40,000 increasing the value of the entire foreign trust to \$160,000 (\$120,000 plus \$40,000) and increasing the value of the portion of the foreign trust created by the U.S. person to \$112,000 (\$72,000 plus \$40,000). Immediately, after this transfer, the foreign trust created by the U.S. person is 70 percent of the entire foreign trust, determined as follows:

$$\frac{\$112,000 \text{ (Value of property transferred by U.S. person)}}{\$160,000 \text{ (Value of entire property transferred to trust)}} = 70 \text{ percent}$$

§ 1.643(d)-2 Illustration of the provisions of section 643.—(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	\$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee’s commissions and miscellaneous expenses allocable to corpus	5,000

(2) The “income” of the trust determined under section 643(b) which is currently distributable to W is \$50,000, consisting of dividends of \$30,000, taxable interest of \$10,000, and tax-exempt interest of \$10,000. The trustee’s commissions and miscellaneous expenses allocable to tax-exempt interest amount to \$1,000 (10,000/50,000 × \$5,000).

(3) The “distributable net income” determined under section 643(a) amounts to \$45,000, computed as follows:

Dividends from domestic corporations	\$30,000
Taxable interest	10,000
Nontaxable interest	\$10,000
Less: Expenses allocable thereto	<u>1,000</u>
Total	<u>9,000</u>
Less: Expenses (\$5,000 less \$1,000 allocable to tax-exempt interest)	<u>4,000</u>
Distributable net income	45,000

In determining the distributable net income of \$45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)); the extraordinary dividends allocated to

corpus by the trustee in good faith are excluded (sections 643(a)(4)); and the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of \$50 are included (section 643(a)(5) and (7)).

(b) See paragraph (c) of the example in § 1.661(c)-2 for the computation of distributable net income where there is a charitable contributions deduction.

§ 1.643(h)-1 Distributions by certain foreign trusts through intermediaries.—

(a) In general—(1) Principal purpose of tax avoidance. Except as provided in paragraph (b) of this section, for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, and section 6048, any property (within the meaning of paragraph (f) of this section) that is transferred to a United States person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the United States person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of United States tax.

(2) Principal purpose of tax avoidance deemed to exist. For purposes of paragraph (a)(1) of this section, a transfer will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if the United States person—

(i) Is related (within the meaning of paragraph (e) of this section) to a grantor of the foreign trust, or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) to the United States person;

(ii) Receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

(iii) Cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with the United States person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the United States person;

(B) The intermediary acted independently of the grantor and the trustee of the foreign trust;

(C) The intermediary is not an agent of the United States person under generally applicable United States agency principles; and

(D) The United States person timely complied with the reporting requirements of section 6039F, if applicable, if the intermediary is a foreign person.

(b) Exceptions—(1) Nongratuitous transfers. Paragraph (a) of this section does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the United States person is a transfer that is not a gratuitous transfer within the meaning of § 1.671-2(e)(2).

(2) Grantor as intermediary. Paragraph (a) of this section does not apply if the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. For the definition of grantor, see § 1.671-2(e).

(c) Effect of disregarding intermediary—(1) General rule.—Except as provided in paragraph (c)(2) of this section, the intermediary is treated as an agent of the foreign trust, and the property is treated as transferred to the United States person in the year

the property is transferred, or made available, by the intermediary to the United States person. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the United States person. For purposes of section 665(d)(2), the term taxes imposed on the trust includes any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred.

(2) Exception.—If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the United States person under generally applicable United States agency principles, the property will be treated as transferred to the United States person in the year the intermediary receives the property from the foreign trust. The fair market value of the property transferred will be determined as of the date of the transfer by the foreign trust to the intermediary. For purposes of section 901(b), any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred will be treated as having been imposed on the United States person.

(3) Computation of gross income of intermediary.—If property is treated as transferred directly by the foreign trust to a United States person pursuant to this section, the fair market value of such property is not taken into account in computing the gross income of the intermediary (if otherwise required to be taken into account by the intermediary but for paragraph (a) of this section).

(d) Transfers not in excess of \$10,000.—This section does not apply if, during the taxable year of the United States person, the aggregate fair market value of all property transferred to such person from all foreign trusts either directly or through one or more intermediaries does not exceed \$10,000.

(e) Related parties.—For purposes of this section, a United States person is treated as related to a grantor of a foreign trust if the United States person and the grantor are related for purposes of section 643(i)(2)(B), with the following modifications—

(1) For purposes of applying section 267 (other than section 267(f) and section 707(b)(1), “at least 10 percent” is used instead of “more than 50 percent” each place it appears; and

(2) The principles of section 267(b)(10), using “at least 10 percent” instead of “more than 50 percent,” apply to determine whether two corporations are related.

(f) Definition of property.—For purposes of this section, the term property includes cash.

(g) Examples. The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust that is not treated as owned by any other person and the fair market value of the property that is transferred exceeds \$10,000. The examples are as follows:

Example 1. Principal purpose of tax avoidance. FT was created in 1980 by A, a nonresident alien, for the benefit of his children and their descendants. FT’s trustee, T, determines that 1000X of accumulated income should be distributed to A’s granddaughter, B, who is a resident alien. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, T causes FT to make a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) of 1000X to I, a foreign person. I subsequently makes a gratuitous transfer of 1000X to B. Under paragraph (a)(1) of this section, FT is deemed to have made an accumulation distribution of 1000X directly to B.

Example 2. United States person unable to demonstrate that intermediary acted independently. GM and her daughter, M, are both nonresident aliens. M's daughter, D, is a resident alien. GM creates and funds FT for the benefit of her children. On July 1, 2001, FT makes a gratuitous transfer of XYZ stock to M. M immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2002, M makes a gratuitous transfer of the ABC stock to D. D is unable to demonstrate that M acted independently of GM and the trustee of FT in making the transfer to D. Under paragraph (a)(2) of this section, FT is deemed to have distributed the ABC stock to D. Under paragraph (c)(1) of this section, M is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 3. United States person demonstrates that specified conditions are satisfied. Assume the same facts as in Example 2, except that M receives 1000X cash from FT instead of XYZ stock. M gives 1000X cash to D on January 1, 2002. Also assume that M receives annual income of 5000X from her own investments and that M has given D 1000X at the beginning of each year for the past ten years. Based on this and additional information provided by D, D demonstrates to the satisfaction of the Commissioner that M has a relationship with D that establishes a reasonable basis for concluding that M would make a gratuitous transfer to D, that M acted independently of GM and the trustee of FT, that M is not an agent of D under generally applicable United States agency principles, and that D timely complied with the reporting requirements of section 6039F. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to D.

Example 4. Transfer to United States person less than 24 months before transfer to intermediary. Several years ago, A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. A has a close friend, C, who also is a nonresident alien. A's granddaughter, B, is a resident alien. On December 31, 2001, C makes a gratuitous transfer of 1000X to B. On January 15, 2002, FT makes a gratuitous transfer of 1000X to C. B is unable to demonstrate that C has a relationship with B that would establish a reasonable basis for concluding that C would make a gratuitous transfer to B or that C acted independently of A and the trustee of FT in making the transfer to B. Under paragraph (a)(2) of this section, FT is deemed to have distributed 1000X directly to B. Under paragraph (c)(1) of this section, C is treated as an agent of FT, and the distribution is deemed to have been made on December 31, 2001.

Example 5. United States person receives property in substitution for property transferred to intermediary. GM and her son, S, are both nonresident aliens. S's daughter, GD, is a resident alien. GM creates and funds FT for the benefit of her children and their descendants. On July 1, 2001, FT makes a gratuitous transfer of ABC stock with a fair market value of approximately 1000X to S. On January 1, 2002, S makes a gratuitous transfer of DEF stock with a fair market value of approximately 1000X to GD. GD is unable to demonstrate that S acted independently of GM and the trustee of FT in transferring the DEF stock to GD. Under paragraph (a)(2) of this section, FT is deemed to have distributed the DEF stock to GD. Under paragraph (c)(1) of this section, S is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 6. United States person receives indirect loan from foreign trust. Several years ago, A, a nonresident alien, created and funded FT for the benefit of her children and their descendants. A's daughter, B, is a resident alien. B needs funds temporarily while she is starting up her own business. If FT were to loan money directly to B, section 643(i) would apply. FT deposits 500X with FB, a foreign bank, on June 30, 2001. On July 1, 2001, FB loans 400X to B. Repayment of the loan is guaranteed by FT's 500X deposit. B is unable to demonstrate to the satisfaction of the Commissioner that

FB has a relationship with B that establishes a reasonable basis for concluding that FB would make a loan to B or that FB acted independently of A and the trustee of FT in making the loan. Under paragraph (a)(2) of this section, FT is deemed to have loaned 400X directly to B on July 1, 2001. Under paragraph (c)(1) of this section, FB is treated as an agent of FT. For the treatment of loans from foreign trusts, see section 643(i).

Example 7. United States person demonstrates that specified conditions are satisfied. GM, a nonresident alien, created and funded FT for the benefit of her children and their descendants. One of GM's children is M, who is a resident alien. During the year 2001, FT makes a gratuitous transfer of 500X to M. M reports the 500X on Form 3520 as a distribution received from a foreign trust. During the year 2002, M makes a gratuitous transfer of 400X to her son, S, who also is a resident alien. M files a Form 709 treating the gratuitous transfer to S as a gift. Based on this and additional information provided by S, S demonstrates to the satisfaction of the Commissioner that M has a relationship with S that establishes a reasonable basis for concluding that M would make a gratuitous transfer to S, that M acted independently of GM and the trustee of FT, and that M is not an agent of S under generally applicable United States agency principles. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to S.

Example 8. Intermediary as agent of trust; increase in FMV. A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. On December 1, 2001, FT makes a gratuitous transfer of XYZ stock with a fair market value of 85X to B, a nonresident alien. On November 1, 2002, B sells the XYZ stock to a third party in an arm's length transaction for 100X in cash. On November 1, 2002, B makes a gratuitous transfer of 98X to A's grandson, C, a resident alien. C is unable to demonstrate to the satisfaction of the Commissioner that B acted independently of A and the trustee of FT in making the transfer. Under paragraph (a)(2) of this section, FT is deemed to have made a distribution directly to C. Under paragraph (c)(1) of this section, B is treated as an agent of FT, and FT is deemed to have distributed 98X to C on November 1, 2002.

Example 9. Intermediary as agent of United States person; increase in FMV. Assume the same facts as in Example 8, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed 85X to C on December 1, 2001. C must take the gain of 15X into account in the year 2002.

Example 10. Intermediary as agent of trust; decrease in FMV. Assume the same facts as in Example 8, except that the value of the XYZ stock on November 1, 2002, is only 80X. Instead of selling the XYZ stock to a third party and transferring cash to C, B transfers the XYZ stock to C in a gratuitous transfer. Under paragraph (c)(1) of this section, FT is deemed to have distributed XYZ stock with a value of 80X to C on November 1, 2002.

Example 11. Intermediary as agent of United States person; decrease in FMV. Assume the same facts as in Example 10, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed XYZ stock with a value of 85X to C on December 1, 2001.

(h) Effective date.—The rules of this section are applicable to transfers made to United States persons after August 10, 1999.

§ 1.645-1 Election by certain revocable trusts to be treated as part of estate.—

(a) In general.—If an election is filed for a qualified revocable trust, as defined in paragraph (b)(1) of this section, in accordance with the rules set forth in paragraph (c) of

this section, the qualified revocable trust is treated and taxed for purposes of subtitle A of the Internal Revenue Code as part of its related estate, as defined in paragraph (b)(5) of this section (and not as a separate trust) during the election period, as defined in paragraph (b)(6) of this section. Rules regarding the use of taxpayer identification numbers (TINs) and the filing of a Form 1041, “U.S. Income Tax Return for Estates and Trusts,” for a qualified revocable trust are in paragraph (d) of this section. Rules regarding the tax treatment of an electing trust and related estate and the general filing requirements for the combined entity during the election period are in paragraph (e)(2) of this section. Rules regarding the tax treatment of an electing trust and its filing requirements during the election period if no executor, as defined in paragraph (b)(4) of this section, is appointed for a related estate are in paragraph (e)(3) of this section. Rules for determining the duration of the section 645 election period are in paragraph (f) of this section. Rules regarding the tax effects of the termination of the election are in paragraph (h) of this section. Rules regarding the tax consequences of the appointment of an executor after a trustee has made a section 645 election believing that an executor would not be appointed for a related estate are in paragraph (g) of this section.

(b) Definitions. For purposes of this section:

(1) Qualified revocable trust.—A qualified revocable trust (QRT) is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under section 676 by reason of a power held by the decedent (determined without regard to section 672(e)). A trust that was treated as owned by the decedent under section 676 by reason of a power that was exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent’s spouse is a QRT. A trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party or by reason of a power held by the decedent’s spouse is not a QRT.

(2) Electing trust.—An electing trust is a QRT for which a valid section 645 election has been made. Once a section 645 election has been made for the trust, the trust shall be treated as an electing trust throughout the entire election period.

(3) Decedent.—The decedent is the individual who was treated as the owner of the QRT under section 676 on the date of that individual’s death.

(4) Executor.—An executor is an executor, personal representative, or administrator that has obtained letters of appointment to administer the decedent’s estate through formal or informal appointment procedures. Solely for purposes of this paragraph (b)(4), an executor does not include a person that has actual or constructive possession of property of the decedent unless that person is also appointed or qualified as an executor, administrator, or personal representative of the decedent’s estate. If more than one jurisdiction has appointed an executor, the executor appointed in the domiciliary or primary proceeding is the executor of the related estate for purposes of this paragraph (b)(4).

(5) Related estate.—A related estate is the estate of the decedent who was treated as the owner of the QRT on the date of the decedent’s death.

(6) Election period. The election period is the period of time during which an electing trust is treated and taxed as part of its related estate. The rules for determining the duration of the election period are in paragraph (f) of this section.

(c) The election—(1) Filing the election if there is an executor—(i) Time and manner for filing the election. If there is an executor of the related estate, the trustees of each QRT joining in the election and the executor of the related estate make an election under section 645 and this section to treat each QRT joining in the election as part of the related estate for purposes of subtitle A of the Internal Revenue Code by filing a

form provided by the IRS for making the election (election form) properly completed and signed under penalties of perjury, or in any other manner prescribed after December 24, 2002 by forms provided by the Internal Revenue Service (IRS), or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the related estate (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the related estate, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the Form 1041.

(ii) Conditions to election.—In addition to providing the information required by the election form, as a condition to a valid section 645 election, the trustee of each QRT joining in the election and the executor of the related estate agree, by signing the election form under penalties of perjury, that:

(A) With respect to a trustee—

- (1) The trustee agrees to the election;
- (2) The trustee is responsible for timely providing the executor of the related estate with all the trust information necessary to permit the executor to file a complete, accurate, and timely Form 1041 for the combined electing trust(s) and related estate for each taxable year during the election period;
- (3) The trustee of each QRT joining the election and the executor of the related estate have agreed to allocate the tax burden of the combined electing trust(s) and related estate for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust and the related estate; and
- (4) The trustee is responsible for insuring that the electing trust's share of the tax obligations of the combined electing trust(s) and related estate is timely paid to the Secretary.

(B) With respect to the executor—

- (1) The executor agrees to the election;
- (2) The executor is responsible for filing a complete, accurate, and timely Form 1041 for the combined electing trust(s) and related estate for each taxable year during the election period;
- (3) The executor and the trustee of each QRT joining in the election have agreed to allocate the tax burden of the combined electing trust(s) and related estate for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust and the related estate;
- (4) The executor is responsible for insuring that the related estate's share of the tax obligations of the combined electing trust(s) and related estate is timely paid to the Secretary.

(2) Filing the election if there is no executor.—(i) Time and manner for filing the election.—If there is no executor for a related estate, an election to treat one or more QRTs of the decedent as an estate for purposes of subtitle A of the Internal Revenue Code is made by the trustees of each QRT joining in the election, by filing a properly completed election form, or in any other manner prescribed after December 24, 2002 by forms provided by the IRS, or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of

the trust, taking into account the trustee's election to treat the trust as an estate under section 645 (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041.

(ii) Conditions to election.—In addition to providing the information required by the election form, as a condition to a valid section 645 election, the trustee of each QRT joining in the election agrees, by signing the election form under penalties of perjury, that—

(A) The trustee agrees to the election;

(B) If there is more than one QRT joining in the election, the trustees of each QRT joining in the election have appointed one trustee to be responsible for filing the Form 1041 for the combined electing trusts for each taxable year during the election period (filing trustee) and the filing trustee has agreed to accept that responsibility;

(C) If there is more than one QRT, the trustees of each QRT joining in the election have agreed to allocate the tax liability of the combined electing trusts for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust;

(D) The trustee agrees to:

(1) Timely file a Form 1041 for the electing trust(s) for each taxable year during the election period; or

(2) If there is more than one QRT and the trustee is not the filing trustee, timely provide the filing trustee with all of the electing trust's information necessary to permit the filing trustee to file a complete, accurate, and timely Form 1041 for the combined electing trusts for each taxable year during the election period;

(3) Insure that the electing trust's share of the tax burden is timely paid to the Secretary;

(E) There is no executor and, to the knowledge and belief of the trustee, one will not be appointed; and

(F) If an executor is appointed after the filing of the election form and the executor agrees to the section 645 election, the trustee will complete and file a revised election form with the executor.

(3) Election for more than one QRT.—If there is more than one QRT, the election may be made for some or all of the QRTs. If there is no executor, one trustee must be appointed by the trustees of the electing trusts to file Forms 1041 for the combined electing trusts filing as an estate during the election period.

(d) TIN and filing requirements for a QRT.—(1) Obtaining a TIN. Regardless of whether there is an executor for a related estate and regardless of whether a section 645 election will be made for the QRT, a TIN must be obtained for the QRT following the death of the decedent. See § 301.6109-1(a)(3) of this chapter. The trustee must furnish this TIN to the payors of the QRT. See § 301.6109-1(a)(5) of this chapter for the definition of payor.

(2) Filing a Form 1041 for a QRT.—(i) Option not to file a Form 1041 for a QRT for which a section 645 election will be made. If a section 645 election will be made for a QRT, the executor of the related estate, if any, and the trustee of the QRT may treat the QRT as an electing trust from the decedent's date of death until the due

date for the section 645 election. Accordingly, the trustee of the QRT is not required to file a Form 1041 for the QRT for the short taxable year beginning with the decedent's date of death and ending December 31 of that year. However, if a QRT is treated as an electing trust under this paragraph from the decedent's date of death until the due date for the section 645 election but a valid section 645 election is not made for the QRT, the QRT will be subject to penalties and interest for failing to timely file a Form 1041 and pay the tax due thereon.

(ii) Requirement to file a Form 1041 for a QRT if paragraph (d)(2)(i) of this section does not apply—(A) Requirement to file Form 1041.—If the trustee of the QRT and the executor of the related estate, if any, do not treat the QRT as an electing trust as provided under paragraph (d)(2)(i) of this section, or if the trustee of the electing trust and the executor, if any, are uncertain whether a section 645 election will be made for a QRT, the trustee of the QRT must file a Form 1041 for the short taxable year beginning with the decedent's death and ending December 31 of that year (unless the QRT is not required to file a Form 1041 under section 6012 for this period).

(B) Requirement to amend Form 1041 if a section 645 election is made—(1) If there is an executor.—If there is an executor and a valid section 645 election is made for a QRT after a Form 1041 has been filed for the QRT as a trust (see paragraph (d)(2)(ii)(A) of this section), the trustee must amend the Form 1041. The QRT's items of income, deduction, and credit must be excluded from the amended Form 1041 filed under this paragraph and must be included on the Form 1041 filed for the first taxable year of the combined electing trust and related estate under paragraph (e)(2)(ii)(A) of this section.

(2) If there is no executor.—If there is no executor and a valid section 645 election is made for a QRT after a Form 1041 has been filed for the QRT as a trust (see paragraph (d)(2)(ii)(A) of this section) for the short taxable year beginning with the decedent's death and ending December 31 of that year, the trustee must file an amended return for the QRT. The amended return must be filed consistent with paragraph (e)(3) of this section and must be filed by the due date of the Form 1041 for the QRT, taking into account the trustee's election under section 645.

(e) Tax treatment and general filing requirements of electing trust and related estate during the election period—(1) Effect of election.—The section 645 election once made is irrevocable.

(2) If there is an executor—(i) Tax treatment of the combined electing trust and related estate.—If there is an executor, the electing trust is treated, during the election period, as part of the related estate for all purposes of subtitle A of the Internal Revenue Code. Thus, for example, the electing trust is treated as part of the related estate for purposes of the set-aside deduction under section 642(c)(2), the subchapter S shareholder requirements of section 1361(b)(1), and the special offset for rental real estate activities in section 469(i)(4).

(ii) Filing requirements.—(A) Filing the Form 1041 for the combined electing trust and related estate during the election period.—If there is an executor, the executor files a single income tax return annually (assuming a return is required under section 6012) under the name and TIN of the related estate for the combined electing trust and the related estate. Information regarding the name and TIN of each electing trust must be provided on the Form 1041 as required by the instructions to that form. The period of limitations provided in section 6501 for assessments with respect to an electing trust and the related estate starts with the filing of the return required under this paragraph. Except as required under the separate share rules of section 663(c), for purposes of filing the Form 1041 under this paragraph and computing the tax, the items of income, deduction, and credit of the electing trust and related estate are combined. One

personal exemption in the amount of \$600 is permitted under section 642(b), and the tax is computed under section 1(e), taking into account section 1(h), for the combined taxable income.

(B) Filing a Form 1041 for the electing trust is not required.—Except for any final Form 1041 required to be filed under paragraph (h)(2)(i)(B) of this section, if there is an executor, the trustee of the electing trust does not file a Form 1041 for the electing trust during the election period. Although the trustee is not required to file a Form 1041 for the electing trust, the trustee of the electing trust must timely provide the executor of the related estate with all the trust information necessary to permit the executor to file a complete, accurate and timely Form 1041 for the combined electing trust and related estate. The trustee must also insure that the electing trust's share of the tax obligations of the combined electing trust and related estate is timely paid to the Secretary. In certain situations, the trustee of a QRT may be required to file a Form 1041 for the QRT's short taxable year beginning with the date of the decedent's death and ending December 31 of that year. See paragraph (d)(2) of this section.

(iii) Application of the separate share rules.—(A) Distributions to beneficiaries (other than to a share (or shares) of the combined electing trust and related estate).—Under the separate share rules of section 663(c), the electing trust and related estate are treated as separate shares for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. Further, the electing trust share or the related estate share may each contain two or more shares. Thus, if during the taxable year, a distribution is made by the electing trust or the related estate, the DNI of the share making the distribution must be determined and the distribution provisions of sections 661 and 662 must be applied using the separately determined DNI applicable to the distributing share.

(B) Adjustments to the DNI of the separate shares for distributions between shares to which sections 661 and 662 would apply. A distribution from one share to another share to which sections 661 and 662 would apply if made to a beneficiary other than another share of the combined electing trust and related estate affects the computation of the DNI of the share making the distribution and the share receiving the distribution. The share making the distribution reduces its DNI by the amount of the distribution deduction that it would be entitled to under section 661 (determined without regard to section 661(c)), had the distribution been made to another beneficiary, and, solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. The distribution has the same character in the hands of the recipient share as in the hands of the distributing share. The following example illustrates the provisions of this paragraph (e)(2)(iii)(B):

Example. (i) A's will provides that, after the payment of debts, expenses, and taxes, the residue of A's estate is to be distributed to Trust, an electing trust. The sole beneficiary of Trust is C. The estate share has \$15,000 of gross income, \$5,000 of deductions, and \$10,000 of taxable income and DNI for the taxable year based on the assets held in A's estate. During the taxable year, A's estate distributes \$15,000 to Trust. The distribution reduces the DNI of the estate share by \$10,000.

(ii) For the same taxable year, the trust share has \$25,000 of gross income and \$5,000 of deductions. None of the modifications provided for under section 643(a) apply. In calculating the DNI for the trust share, the gross income of the trust share is increased by \$10,000, the amount of the reduction in the DNI of the estate share as a result of the distribution to Trust. Thus, solely for purposes of calculating DNI, the trust share has gross income of \$35,000, and taxable income of \$30,000. Therefore, the trust share has \$30,000 of DNI for the taxable year.

(iii) During the same taxable year, Trust distributes \$35,000 to C. The distribution deduction reported on the Form 1041 filed for A's estate and Trust is \$30,000. As a result of the distribution by Trust to C, C must include \$30,000 in gross income for the taxable year. The gross income reported on the Form 1041 filed for A's estate and Trust is \$40,000.

(iv) Application of the governing instrument requirement of section 642(c). A deduction is allowed in computing the taxable income of the combined electing trust and related estate to the extent permitted under section 642(c) for—

(A) Any amount of the gross income of the related estate that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the related estate for a purpose specified in section 170(c); and

(B) Any amount of gross income of the electing trust that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the electing trust for a purpose specified in section 170(c).

(3) If there is no executor—(i) Tax treatment of the electing trust.—If there is no executor, the trustee treats the electing trust, during the election period, as an estate for all purposes of subtitle A of the Internal Revenue Code. Thus, for example, an electing trust is treated as an estate for purposes of the set-aside deduction under section 642(c)(2), the subchapter S shareholder requirements of section 1361(b)(1), and the special offset for rental real estate activities under section 469(i)(4). The trustee may also adopt a taxable year other than a calendar year.

(ii) Filing the Form 1041 for the electing trust.—If there is no executor, the trustee of the electing trust must, during the election period, file a Form 1041, under the TIN obtained by the trustee under § 301.6109-1(a)(3) of this chapter upon the death of the decedent, treating the trust as an estate. If there is more than one electing trust, the Form 1041 must be filed by the filing trustee (see paragraph (c)(2)(ii)(B) of this section) under the name and TIN of the electing trust of the filing trustee. Information regarding the names and TINs of the other electing trusts must be provided on the Form 1041 as required by the instructions to that form. Any return filed in accordance with this paragraph shall be treated as a return filed for the electing trust (or trusts, if there is more than one electing trust) and not as a return filed for any subsequently discovered related estate. Accordingly, the period of limitations provided in section 6501 for assessments with respect to a subsequently discovered related estate does not start until a return is filed with respect to the related estate. See paragraph (g) of this section.

(4) Application of the section 6654(l)(2) to the electing trust.—Each electing trust and related estate (if any) is treated as a separate taxpayer for all purposes of subtitle F of the Internal Revenue Code, including, without limitation, the application of section 6654. The provisions of section 6654(l)(2)(A) relating to the two year exception to an estate's obligation to make estimated tax payments, however, will apply to each electing trust for which a section 645 election has been made.

(f) Duration of election period—(1) In general.—The election period begins on the date of the decedent's death and terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the applicable date. The election does not apply to successor trusts (trusts that are distributees under the trust instrument).

(2) Definition of applicable date.—(i) Applicable date if no Form 706 “United States Estate (and Generation Skipping Transfer) Tax Return” is required to be filed. If a Form 706 is not required to be filed as a result of the decedent's death, the applicable date is the day which is 2 years after the date of the decedent's death.

(ii) Applicable date if a Form 706 is required to be filed.—If a Form 706 is required to be filed as a result of the decedent's death, the applicable date is the later of the day that is 2 years after the date of the decedent's death, or the day that is 6 months after the date of final determination of liability for estate tax. Solely for purposes of determining the applicable date under section 645, the date of final determination of liability is the earliest of the following—

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

(iii) Definition of final disposition of claim for refund.—For purposes of paragraph (f)(2)(ii)(B) of this section, a claim for refund shall be deemed finally disposed of by the Secretary when all items have been either allowed or disallowed. If a waiver of notification with respect to disallowance is filed with respect to a claim for refund prior to disallowance of the claim, the claim for refund will be treated as disallowed on the date the waiver is filed.

(iv) Examples. The application of this paragraph (f)(2) is illustrated by the following examples:

Example 1. A died on October 20, 2002. The executor of A's estate and the trustee of Trust, an electing trust, made a section 645 election. A Form 706 is not required to be filed as a result of A's death. The applicable date is October 20, 2004, the day that is two years after A's date of death. The last day of the election period is October 19, 2004. Beginning October 20, 2004, Trust will no longer be treated and taxed as part of A's estate.

Example 2. Assume the same facts as Example 1, except that a Form 706 is required to be filed as the result of A's death. The Internal Revenue Service issues an estate tax closing letter accepting the Form 706 as filed on March 15, 2005. The estate does not file a claim for refund by March 15, 2006, the day that is twelve months after the date of issuance of the estate tax closing letter. The date of final determination of liability is September 15, 2005, and the applicable date is March 15, 2006. The last day of the election period is March 14, 2006. Beginning March 15, 2006, Trust will no longer be treated and taxed as part of A's estate.

Example 3. Assume the same facts as Example 1, except that a Form 706 is required to be filed as the result of A's death. The Form 706 is audited, and a notice of deficiency authorized under section 6212 is mailed to the executor of A's estate as a result of the audit. The executor files a petition in Tax Court. The Tax Court issues a decision resolving the liability for estate tax on December 14, 2005, and neither party appeals within 90 days after the issuance of the decision. The date of final determination of liability is December 14, 2005. The applicable date is June 14, 2006, the day that is six

months after the date of final determination of liability. The last day of the election period is June 13, 2006. Beginning June 14, 2006, Trust will no longer be treated and taxed as part of A's estate.

(g) Executor appointed after the section 645 election is made—(1) Effect on the election. If an executor for the related estate is not appointed until after the trustee has made a valid section 645 election, the executor must agree to the trustee's election, and the IRS must be notified of that agreement by the filing of a revised election form (completed as required by the instructions to that form) within 90 days of the appointment of the executor, for the election period to continue past the date of appointment of the executor. If the executor does not agree to the election or a revised election form is not timely filed as required by this paragraph, the election period terminates the day before the appointment of the executor. If the IRS issues other guidance after December 24, 2002 for notifying the IRS of the executor's agreement to the election, the IRS must be notified in the manner provided in that guidance for the election period to continue.

(2) Continuation of election period.—(i) Correction of returns filed before executor appointed.—If the election period continues under paragraph (g)(1) of this section, the executor of the related estate and the trustee of each electing trust must file amended Forms 1041 to correct the Forms 1041 filed by the trustee before the executor was appointed. The amended Forms 1041 must be filed under the name and TIN of the electing trust and must reflect the items of income, deduction, and credit of the related estate and the electing trust. The name and TIN of the related estate must be provided on the amended Forms 1041 as required in the instructions to that Form. The amended return for the taxable year ending immediately before the executor was appointed must indicate that this Form 1041 is a final return. If the period of limitations for making assessments has expired with respect to the electing trust for any of the Forms 1041 filed by the trustee, the executor must file Forms 1041 for any items of income, deduction, and credit of the related estate that cannot be properly included on amended forms for the electing trust. The personal exemption under section 642(b) is not permitted to be taken on these Forms 1041 filed by the executor.

(ii) Returns filed after the appointment of the executor.—All returns filed by the combined electing trust and related estate after the appointment of the executor are to be filed under the name and TIN of the related estate in accordance with paragraph (e)(2) of this section. Regardless of the change in the name and TIN under which the Forms 1041 for the combined electing trust and related estate are filed, the combined electing trust and related estate will be treated as the same entity before and after the executor is appointed.

(3) Termination of the election period.—If the election period terminates under paragraph (g)(1) of this section, the executor must file Forms 1041 under the name and TIN of the estate for all taxable years of the related estate ending after the death of the decedent. The trustee of the electing trust is not required to amend any returns filed for the electing trust during the election period. Following termination of the election period, the trustee of the electing trust must obtain a new TIN. See § 301.6109-1(a)(4) of this chapter.

(h) Treatment of an electing trust and related estate following termination of the election.—(1) The share (or shares) comprising the electing trust is deemed to be distributed upon termination of the election period. On the close of the last day of the election period, the combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is deemed to distribute the share (or shares, as determined under section 663(c)) comprising the electing trust to a new trust in a distribution to which sections 661 and 662 apply. All items of income, including net capital gains, that are attributable to the share (or shares) comprising the electing trust are in-

cluded in the calculation of the distributable net income of the electing trust and treated as distributed by the combined electing trust and related estate, if there is an executor, or by the electing trust, if there is no executor, to the new trust. The combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is entitled to a distribution deduction to the extent permitted under section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust shall include the amount of the deemed distribution in gross income to the extent required under section 662.

(2) Filing of the Form 1041 upon the termination of the section 645 election.—(i) If there is an executor—(A) Filing the Form 1041 for the year of termination. If there is an executor, the Form 1041 filed under the name and TIN of the related estate for the taxable year in which the election terminates includes—

(1) The items of income, deduction, and credit of the electing trust attributable to the period beginning with the first day of the taxable year of the combined electing trust and related estate and ending with the last day of the election period;

(2) The items of income, deduction, and credit, if any, of the related estate for the entire taxable year; and

(3) A deduction for the deemed distribution of the share (or shares) comprising the electing trust to the new trust as provided for under paragraph (h)(1) of this section.

(B) Requirement to file a final Form 1041 under the name and TIN of the electing trust. If the electing trust terminates during the election period, the trustee of the electing trust must file a Form 1041 under the name and TIN of the electing trust and indicate that the return is a final return to notify the IRS that the electing trust is no longer in existence. The items of income, deduction, and credit of the trust are not reported on this final Form 1041 but on the appropriate Form 1041 filed for the combined electing trust and related estate.

(ii) If there is no executor.—If there is no executor, the taxable year of the electing trust closes on the last day of the election period. A Form 1041 is filed in the manner prescribed under paragraph (e)(3)(ii) of this section reporting the items of income, deduction, and credit of the electing trust for the short period ending with the last day of the election period. The Form 1041 filed under this paragraph includes a distribution deduction for the deemed distribution provided for under paragraph (h)(1) of this section. The Form 1041 must indicate that it is a final return.

(3) Use of TINs following termination of the election.—(i) If there is an executor.—Upon termination of the section 645 election, a former electing trust may need to obtain a new TIN. See § 301.6109-1(a)(4) of this chapter. If the related estate continues after the termination of the election period, the related estate must continue to use the TIN assigned to the estate during the election period.

(ii) If there is no executor.—If there is no executor, the former electing trust must obtain a new TIN if the trust will continue after the termination of the election period. See § 301.6109-1(a)(4) of this chapter.

(4) Taxable year of estate and trust upon termination of the election.—(i) Estate.—Upon termination of the section 645 election period, the taxable year of the estate is the same taxable year used during the election period.

(ii) Trust.—Upon termination of the section 645 election, the taxable year of the new trust is the calendar year. See section 644.

(i) [Reserved]

(j) Effective date.—Paragraphs (a), (b), (c), (d), (f), and (g) of this section apply to trusts and estates of decedents dying on or after December 24, 2002. Paragraphs (e) and (h) of this section apply to taxable years ending on or after December 24, 2002.

§ 1.651(a)-1 Simple trusts; deduction for distributions; in general.—Section 651 is applicable only to a trust the governing instruments of which:

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c), and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a “simple” trust. Trusts subject to section 661 are referred to as “complex” trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.

§ 1.651(a)-2 Income required to be distributed currently.—(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a “simple” trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust’s taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter’s income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term “income” see section 643(b) and § 1.643(b)-1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to “sprinkle” the income among a class of beneficiaries, or among named beneficiaries, in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.

(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. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

§ 1.651(a)-3 Distribution of amounts other than income.—(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642(c).

§ 1.651(a)-4 Charitable purposes.—A trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642(c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642 (c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

§ 1.651(a)-5 Estates.

Subpart B has no application to an estate.

§ 1.651(b)-1 Deduction for distributions to beneficiaries.—In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see § 1.652(b)-2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7)

of section 643(a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643(a) amounts to \$99,000 but includes nontaxable income of \$9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is \$90,000 (\$99,000 less \$9,000 nontaxable income).

§ 1.652(a)-1 Simple trusts; inclusion of amounts in income of beneficiaries.—Subject to the rules in §§ 1.652(a)-2 and 1.652(b)-1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See § 1.642(a)(3)-2 with respect to time of receipt of dividends. See § 1.652(c)-1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term income required to be distributed currently includes income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

§ 1.652(a)-2 Distributions in excess of distributable net income.—If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643(a)), each beneficiary includes in his gross income an amount equivalent to his proportionate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is \$99,000, A will receive \$66,000 and B, \$33,000. However, if the distributable net income, as determined under section 643(a) is only \$90,000, A will include two-thirds (\$60,000) of that sum in his gross income, and B will include one-third (\$30,000) in his gross income. See §§ 1.652(b)-1 and 1.652(b)-2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

§ 1.652(b)-1 Character of amounts.—In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116. Also, to the extent that the amounts specified in § 1.652(a)-1 consist of "earned income" in the hands of the trust under the provisions of section 1348 such amount shall be treated under section 1348 as "earned income" in the hands of the beneficiary. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

§ 1.652(b)-2 Allocation of income items.—(a) The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of \$10,000, taxable interest of \$10,000, and tax-exempt interest of \$4,000. A will be deemed to have received \$5,000 of dividends, \$5,000 of taxable interest, and \$2,000 of tax-exempt interest; B and C will each be deemed to have received \$2,500 of dividends, \$2,500 of taxable interest, and \$1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or \$10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

§ 1.652(b)-3 Allocation of deductions.—Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)-1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is \$30,000 (after direct expenses), consisting equally of \$10,000 of dividends, tax-exempt interest, and rents, and income

commissions amount to \$3,000, one-third (\$1,000) of such commissions should be allocated to tax-exempt interest, but the balance of \$2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

§ 1.652(c)-1 Different taxable years.—If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652(a) and (b) is based on the income of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.652(c)-2 Death of individual beneficiaries.—If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

§ 1.652(c)-3 Termination of existence of other beneficiaries.—If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652(a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)-1 and 1.652(c)-2 as if the beneficiary were a deceased individual, except

that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.652(c)-4 Illustration of the provisions of sections 651 and 652.—The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	\$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents.....	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation.....	5,000

(b) The income of the trust for fiduciary accounting purposes is \$92,400, computed as follows:

Rents		\$25,000
Dividends		50,000
Tax-exempt interest.....		<u>25,000</u>
Total		100,000
Deductions: Expenses directly attributable to rental income.....		
	\$5,000	
Trustee's commissions allocable to income account	<u>2,600</u>	<u>7,600</u>
Income computed under section 643(b).....		92,400

One-half (\$46,200) of the income of \$92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is \$91,100, determined as follows (cents are disregarded in the computation):

Rents		\$25,000
Dividends		50,000
Tax-exempt interest.....	\$25,000	
Less: Expenses allocable thereto		
(25,000/100,000 × \$3,900)	<u>975</u>	<u>24,025</u>
Total		99,025
Deductions:		
Expenses directly attributable to rental income	\$5,000	

Trustee's commissions (\$3,900 less \$975 allocable to tax-exempt interest)	<u>2,925</u>	<u>7,925</u>
Distributable net income		91,100

In computing the distributable net income of \$91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50-percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of \$50 were included (section 643(a)(5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(h) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is \$67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c)).....		\$91,100
Less: Tax-exempt interest as adjusted ...	\$24,025	
Dividend exclusion	<u>50</u>	<u>24,075</u>
Distributable net income as determined under section 651(b)		67,025

Since the amount of the income (\$92,400) required to be distributed currently by the trust exceeds the distributable net income (\$67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of \$67,025.

(e) The taxable income of the trust is \$7,200 computed as follows:

Rents		\$25,000
Dividends (\$50,000 less \$50 exclusion)		49,950
Long-term capital gains		<u>15,000</u>
Gross income		89,950
Deductions:		
Rental expenses	\$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	<u>300</u>	<u>82,750</u>
Taxable income		7,200

The trust is not allowed a deduction for the portion (\$975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion (\$975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	Dividends	Tax-Exempt interest	Total
Income for trust accounting purposes.....	\$25,000	\$50,000	\$25,000	\$100,000
Less	5,000			5,000
Rental expenses	2,925			3,900
Trustee's commissions			975	
Total deductions	7,925	0	975	8,900
Character of amounts in the hands of the beneficiaries	17,075	50,000	24,025	¹ 91,100

1. Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of \$8,537.50, dividends of \$25,000, and tax-exempt interest of \$12,012.50. The dividends of \$25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of \$2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

§ 1.661(a)-1 Estates and trusts accumulating income or distributing corpus; general.—Subpart C, Part I, Subchapter J, Chapter 1 of the Code, is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of Subpart B of such Part I (relating to trusts which distribute current income only, or "simple" trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to Subpart B, and not Subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)-1 and 1.651(a)-3. A trust to which Subpart C is applicable is referred to as a "complex" trust in this part. Section 661 has no application to amounts excluded under section 663(a).

§ 1.661(a)-2 Deduction for distributions to beneficiaries.—(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of:

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year. However, the total amount deductible under section 661(a) cannot exceed the distributable net income as computed under section 643(a) and as modified by section 661(c). See § 1.661(c)-1.

(b) The term "income required to be distributed currently" includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651(a)-2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term "any other amounts properly paid, credited, or required to be distributed" includes all amounts properly paid, credited, or required to be distributed by an

estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663(a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661(a)(2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(d) The terms “income required to be distributed currently” and “any other amounts properly paid or credited or required to be distributed” also include any amount used to discharge or satisfy any person’s legal obligation as that term is used in § 1.662(a)-4.

(e) The terms “income required to be distributed currently” and “any other amounts properly paid or credited or required to be distributed” include amounts paid, or required to be paid, during the taxable year pursuant to a court order or decree or under local law, by a decedent’s estate as an allowance or award for the support of the decedent’s widow or other dependent for a limited period during the administration of the estate. The term any other amounts properly paid or credited or required to be distributed does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(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). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

§ 1.661(b)-1 Character of amounts distributed; in general.—In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of \$20,000, consisting of \$10,000 each of taxable interest and royalties and distributes \$10,000 to beneficiary A, the deduction of \$10,000 allowable under section 661(a) is deemed to consist of \$5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also § 1.661(c)-1.

§ 1.661(b)-2 Character of amounts distributed when charitable contributions are made.—In the application of the rule stated in § 1.661(b)-1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in § 1.652(b)-3, except that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are first ratably apportioned among each class of

items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of § 1.643(a)-5.

§ 1.661(c)-1 Limitation on deduction.—An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of \$20,000, which is deemed to consist of \$10,000 of dividends and \$10,000 of tax-exempt interest, and distributes \$10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to \$10,000 consisting of \$5,000 of dividends and \$5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is \$4,975, since no deduction is allowable for the \$5,000 of tax-exempt interest and the \$25 deemed distributed out of the \$50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

§ 1.661(c)-2 Illustration of the provisions of section 661.—The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, \$10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes \$10,000 to charity and in his discretion distributes \$15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	\$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses.....	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is \$40,000, computed as follows:

Dividends	\$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	<u>20,000</u>
Total	50,000
Less: Rental expenses	\$2,000
Depreciation.....	3,000
Trustee's commissions	<u>5,000</u>
Income as computed under section 643(b)	<u>40,000</u>

(c) The distributable net income of the trust as computed under section 643(a) is \$30,000, determined as follows:

Rents				\$20,000
Dividends				10,000
Partially tax-exempt interest				10,000
Fully tax-exempt interest				\$10,000
Less: Expenses allocable thereto (10,000/50,000 × \$5,000)				\$1,000
Charitable contributions allocable thereto (10,000/50,000 × \$10,000)	<u>2,000</u>	<u>3,000</u>	<u>7,000</u>	
Total				47,000
Deductions:				
Rental expenses.....				\$2,000
Depreciation of rental property				3,000
Trustee's commissions (\$5,000 less \$1,000 allocated to tax-exempt interest)				4,000
Charitable contributions (\$10,000 less \$2,000 allocated to tax-exempt interest)	<u>8,000</u>	<u>\$17,000</u>		
Distributable net income (section 643(a)).....				30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)-1 and 1.661(b)-2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental Income	Taxable Dividends	Excluded Dividends	Partially Dividends Tax Interest	Tax-Exempt Interest	Total
Trust income	\$20,000	\$9,950	\$50	\$10,000	\$10,000	\$50,000
Less:						
Charitable contributions	4,000	2,000		2,000	2,000	10,000
Rental expenses	2,000					2,000
Depreciation	3,000					3,000
Trustee's commissions	4,000				1,000	5,000
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each item of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is \$11,375 computed as follows:

Rental income		\$20,000
Dividends (\$10,000 less \$50 exclusion)		9,950
Partially tax-exempt interest		<u>10,000</u>
Gross income		39,950
Deductions: Rental expenses	\$2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	<u>100</u>	<u>28,575</u>
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction (\$2,000) and trustee's commissions (\$1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of \$4,000 deemed to have been distributed to A under section 661(a), \$25 (25/50ths of \$50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of \$3,500 rental income, \$3,975 of dividends, and \$4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of \$5,975 (\$9,950 less \$3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of \$6,000 (\$10,000 less \$4,000 deemed distributed to A) included in gross income.

(g) Dividends of \$4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 84.

§ 1.662(a)-1 Inclusion of amounts in gross income of beneficiaries of estates and complex trusts; general.—There is included in the gross income of a beneficiary of an estate or complex trust the sum of:

(a) Amounts of income required to be distributed currently to him, and

(b) All other amounts properly paid, credited, or required to be distributed to him by the estate or trust. The preceding sentence is subject to the rules contained in § 1.662(a)-2 (relating to currently distributable income), § 1.662(a)-3 (relating to other amounts distributed), and §§ 1.662(b)-1 and 1.662(b)-2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663(a).

§ 1.662(a)-2 Currently distributable income.—(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed with-

out taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase the amount of income for the taxable year required to be distributed currently includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently. The phrase the amount of income for the taxable year required to be distributed currently also includes any amount required to be paid during the taxable year in all events (either out of income or corpus) pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate to the extent there is income (as defined in section 643(b)) of the estate for the taxable year not paid, credited, or required to be distributed to other beneficiaries.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example 1. (1) Assume that under the terms of the trust instrument \$5,000 is to be paid to X charity out of income each year; that \$20,000 of income is currently distributable to A; and that an annuity of \$12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of \$30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total \$25,000 (\$20,000 to A and \$5,000 to B). Since the charitable contribution is out of income the amount of income available for B's annuity is only \$5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of \$5,000 as provided by section 661(a)(1), is \$30,000. Since the amounts treated as distributed currently of \$25,000 do not exceed the distributable net income (as modified) of \$30,000, A is required to include \$20,000 in his gross income and B is required to include \$5,000 in his gross income under section 662(a)(1).

Example 2. Assume the same facts as in paragraph (1) of example 1, except that the trust has, in addition, \$10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1) total \$25,000 (\$20,000 to A and \$5,000 to B), since trust income under section 643(b) remains the same as in example 1. Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contribu-

tions deduction of \$5,000 as provided by section 662(a)(1) is only \$20,000. Since the amounts treated as distributed currently of \$25,000 exceed the distributable net income (as so computed) of \$20,000, A is required to include \$16,000 (20,000/25,000 of \$20,000) in his gross income and B is required to include \$4,000 (5,000/25,000 of \$20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

§ 1.662(a)-3 Other amounts distributed.—(a) There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661(a)-2); (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year; and (6) an amount required to be paid during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate which is payable only out of corpus of the estate under the order or decree or local law.

(c) If the sum of the amounts of income required to be distributed currently (as determined under § 1.662(a)-2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643(a)), then such other amounts properly paid, credited, or required to be distributed are included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a) and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example. The terms of a trust require the distribution annually of \$10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has \$20,000 of income after the deduction of all expenses. Distributable net income is \$20,000. The trustee distributes \$10,000 of income to A. Of the remaining \$10,000 of income, he distributes \$3,000 each to B, C, and D, and also distributes an additional \$5,000 to A. A includes \$10,000 in income un-

der section 662(a)(1). The “other amounts distributed” amount of \$14,000, includible in the income of the recipients to the extent of \$10,000, distributable net income less the income currently distributable to A. A will include an additional \$3,571 ($5,000/14,000 \times \$10,000$) in income under this section, and B, C, and D will each include \$2,143 ($3,000/14,000 \times \$10,000$).

§ 1.662(a)-4 Amounts used in discharge of a legal obligation.—Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term legal obligation includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent’s own resources. For example, a parent has a “legal obligation” within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child’s support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent’s earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent’s earnings and resources are sufficient. In any event the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent’s obligation to support his child, to the extent that the parent’s legal obligation of support, including education, is determined under local law by the family’s station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

§ 1.662(b)-1 Character of amounts; when no charitable contributions are made.—In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

§ 1.662(b)-2 Character of amounts; when charitable contributions are made.—When a charitable contribution is made, the principles contained in §§ 1.652(b)-1 and 1.662(b)-1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642(c) is (in the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643(a)-5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example 1. (a) A trust instrument provides that \$30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has \$40,000 of taxable interest and \$10,000 of tax-exempt income, with no expenses. The trustee distributed \$30,000 to A, \$50,000 to charity X, and \$10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is \$30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of \$20,000, the difference between the income of the trust for the taxable year, \$50,000, and the amount required to be distributed currently, \$30,000).

(c) The charitable contributions deduction taken into account, \$20,000, is allocated proportionately to the items of income of the trust, \$16,000 to taxable interest and \$4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is \$30,000, which consists of the balance of these items, \$24,000 of taxable interest and \$6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

Example 2. The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During the taxable year the trust receives dividends of \$10,000 and realized a long-term capital gain of \$10,000, for which a long-term capital gain deduction of \$5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of \$10,000 are allocable to A.

§ 1.662(c)-1 Different taxable years.—If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662(a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.662(c)-2 Death of individual beneficiary.—If an amount specified in section 662(a)(1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be

distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

§ 1.662(c)-3 Termination of existence of other beneficiaries.—If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)-1 and 1.662(c)-2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.662(c)-4 Illustration of the provisions of sections 661 and 662.—The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	\$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is \$111,800, and the trustee distributes one-half (\$55,900) to W and in his discretion makes a contribution of one-quarter (\$27,950) to charity X and distributes the remaining one-quarter (\$27,950) to D. The total of the distributions to beneficiaries is \$83,850, consisting of (1) income required to be distributed currently to W of \$55,900 and (2) other amounts properly paid or credited to D of \$27,950. The income for trust accounting purposes of \$111,800 is determined as follows:

Rents	\$50,000
Dividends	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	<u>10,000</u>

Total	130,000
Less: Rental expenses	\$15,400
Trustee's commissions allocable to income account	2,800 <u>18,200</u>
Income as computed under section 643(b)	111,800

(c) The distributable net income of the trust as computed under section 643(a) is \$82,750, determined as follows:

Rents	\$50,000
Dividends	50,000
Partially tax-exempt interest	10,000
Tax-exempt interest	\$20,000
Less: Trustee's commissions allocable thereto (20,000/130,000 of \$3,900) \$600	
Charitable contributions allocable thereto (20,000/130,000 of \$27,950)	<u>4,300</u> <u>4,900</u> <u>15,100</u>
Total	\$125,100
Deductions: Rental expenses	15,400
Trustee's commissions (\$3,900 less \$600 allocated to tax-exempt interest)	3,300
Charitable deduction (\$27,950 less \$4,300 attributable to tax-exempt interest)	<u>23,650</u> <u>42,350</u>
Distributable net income	\$82,750

In computing the distributable net income of \$82,750, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of \$50 were included (section 643(a)(5) and (7)).

(d) Inasmuch as the distributable net income of \$82,750 as determined under section 643(a) is less than the sum of the amounts distributed to W and D of \$83,850, the deduction allowable to the trust under section 661(a) is such distributable net income as modified under section 661(c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income	\$82,750
Less: Tax-exempt interest (as adjusted for expenses and the charitable contributions)	\$15,100
Dividend exclusion allowable under section 116	<u>50</u> <u>15,150</u>
Deduction allowable under section 661(a)	\$67,600

(e) For the purpose of determining the character of the amounts deductible under section 642(c) and section 661(a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity.

	Rents	Taxable Dividends	Excluded Dividends	Tax-Exempt Interest	Partially Dividends Tax Interest	Total
Trust income	\$50,000	\$49,950	\$50	\$20,000	\$100,000	\$130,000
Less:						
Charitable contributions	10,750	10,750		4,3000	2,150	27,950
Rental expenses	15,400					15,400
Trustee's commissions	3,300			600		3,900
Total deductions	29,450	10,750	0	4,900	2,150	47,250
Amounts distributable to beneficiaries	20,550	39,200	50	15,100	7,850	82,750

The character of the charitable contribution is determined by multiplying the total charitable contribution (\$27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of \$10,750 ($50,000/130,000 \times \$27,950$).

(f) The taxable income of the trust is \$9,900 determined as follows:

Rental income	\$50,000	
Dividends (\$50,000 less \$50 exclusion)	49,950	
Partially tax-exempt interest	10,000	
Capital gains.....	<u>20,000</u>	
Gross income	129,950	
Deductions:		
Rental expenses.....	15,400	
Trustee's commissions	3,300	
Charitable contributions.....	23,650	
Capital gain deductions.....	10,000	
Distributions to beneficiaries	67,600	
Personal exemption.....	<u>100</u>	<u>120,050</u>
Taxable income	9,900	

(g) In computing the amount includible in W's gross income under section 662(a)(1), the \$55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this example):

Rents (20,550/82,750 × \$55,900)	\$13,882
Dividends (39,250/82,750 × \$55,900)	26,515
Partially tax-exempt interest (7,850/82,750 × \$55,900)	5,303
Tax-exempt interest (15,100/82,750 × \$55,900).....	<u>10,200</u>
Total	55,900

Accordingly, W will exclude \$10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or \$5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W (\$55,900) and the other amounts properly paid, credited, or required to be distributed to D (\$27,950) exceeds the distributable net income (\$82,750) of the trust as determined under section 643(a), D is deemed to have received \$26,850 (\$82,750 less \$55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750 × \$26,850)	\$6,668
Dividends (39,250/82,750 × \$26,850)	12,735
Partially tax-exempt interest (7,850/82,750 × \$26,850)	2,547
Tax-exempt interest (15,100/82,750 × \$26,850).....	<u>4,900</u>
Total	26,850

Accordingly, D will exclude \$4,900 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or \$2,500.

(i) [Reserved]

(j) The remaining \$2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence non-deductible by the trust, W, or D. (See § 1.642(e)-1.)

§ 1.663(a)-1 Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.—(a) In general. A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) Definition of a gift or bequest of a specific sum of money or of specific property. (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example 1. Under the terms of a will, a legacy of \$5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of \$25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of \$5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under section 663(a)(1).

Example 2. Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of \$50,000 for the taxable year. The estate distributed to A stock with a basis of \$40,000 and with a fair market value of \$40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property (\$40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see § 1.661(a)-2(c)).

Example 3. Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During the eleventh year, the trustee is to distribute \$10,000 to B, payable from income or corpus, and \$10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of \$10,000 when he reaches age 25, and \$10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments.* (1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments:

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)-2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of

payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment. For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, \$10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, \$10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, \$25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and \$50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The \$10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The \$10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive \$75,000 in installments of \$25,000, to be paid in alternate years. The trustee distributes \$25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of \$75,000 to each beneficiary are to be separately treated.

§ 1.663(a)-2 Charitable, etc., distributions.—Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an

estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

§ 1.663(a)-3 Denial of double deduction.—No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661(a) or 662(a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956 since it is deductible by the trust and includible in A's gross income for the taxable year 1955.

§ 1.663(b)-1 Distributions in first 65 days of taxable year; scope.—(a) Taxable years beginning after December 31, 1968—(1) General rule.—With respect to taxable years beginning after December 31, 1968, the fiduciary of a trust may elect under section (b) to 663 to treat any amount or portion thereof that is properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year.

(2) Effect of election.—(i) An election is effective only with respect to the taxable year for which the election is made. In the case of distributions made after May 8, 1972, the amount to which the election applies shall not exceed:

(a) The amount of income of the trust (as defined in § 1.643(b)-1) for the taxable year for which the election is made, or

(b) The amount of distributable net income of the trust (as defined in §§ 1.643(a)-1 through 1.643(a)-7) for such taxable year, if greater, reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year by reason of section 663(b) and this section. An election shall be made for each taxable year for which the treatment is desired. The application of this paragraph may be illustrated by the following example:

Example. X Trust, a calendar year trust, has \$1,000 of income (as defined in § 1.643(b)-1) and \$800 of distributable net income (as defined in §§ 1.643(a)-1 through 1.643(a)-7) in 1972. The trust properly pays \$550 to A, a beneficiary, on January 15, 1972, which the trustee elects to treat under section 663(b) as paid on December 31, 1971. The trust also properly pays to A \$600 on July 19, 1972, and \$450 on January 17, 1973. For 1972, the maximum amount that may be elected under this subdivision to be treated as properly paid or credited on the last day of 1972 is \$400 (\$1,000-\$600). The \$550 paid on January 15, 1972, does not reduce the maximum amount to which the election may apply, because that amount is treated as properly paid on December 31, 1971.

(ii) If an election is made with respect to a taxable year of a trust, this section shall apply only to those amounts which are properly paid or credited within the first 65 days following such year and which are so designated by the fiduciary in his election. Any amount considered under section 663(b) as having been distributed in the preceding taxable year shall be so treated for all purposes. For example, in determining the beneficiary's tax liability, such amount shall be considered as having been received

by the beneficiary in his taxable year in which or with which the last day of the preceding taxable year of the trust ends.

(b) Taxable years beginning before January 1, 1969.—With respect to taxable years of a trust beginning before January 1, 1969, the fiduciary of the trust may elect under section 663(b) to treat distributions within the first 65 days following such taxable year as amounts which were paid or credited on the last day of such taxable year, if:

(1) The trust was in existence prior to January 1, 1954;

(2) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(3) The fiduciary elects (as provided in § 1.663(b)-2) to have section 663(b) apply.

§ 1.663(b)-2 Election.—(a) Manner and time of election; irrevocability.—(1) When return is required to be filed.—If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

(2) When no return is required to be filed.—If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

(b) Elections under prior law.—Elections made pursuant to section 663(b) prior to its amendment by section 331(b) of the Tax Reform Act of 1969 (83 Stat. 598), which, under prior law, were irrevocable for the taxable year for which the election was made and all subsequent years, are not effective for taxable years beginning after December 31, 1968. In the case of a trust for which an election was made under prior law, the fiduciary shall make the election for each taxable year beginning after December 31, 1968, for which the treatment provided by section 663(b) is desired.

§ 1.663(c)-1 Separate shares treated as separate trusts or as separate estates; in general.—(a) If a single trust (or estate) has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts (or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts (or estates). In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust (or estate) instrument creates not one but several separate trusts (or estates), as opposed to separate shares in the same trust (or estate) within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:

(1) The filing of returns and payment of tax,

(2) The deduction of personal exemption under section 642(b), and

(3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust (or estate) is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust (or estate) instrument and the requirements of proper administration require different treatment.

§ 1.663(c)-2 Rules of administration.—(a) When separate shares come into existence.—A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

(b) Computation of distributable net income for each separate share.—(1) General rule.—The amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

(2) Section 643(b) income.—This paragraph (b)(2) governs the allocation of the portion of gross income includible in distributable net income that is income within the meaning of section 643(b). Such gross income is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

(3) Income in respect of a decedent.—This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

(4) Gross income not attributable to cash.—This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as section 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.

(5) Deductions and losses.—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.

(c) Computations and valuations.—For purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section.

§ 1.663(c)-3 Applicability of separate share rule to certain trusts.—(a) The applicability of the separate share rule provided by section 663(c) to trusts other than qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to: (1) Distribute, apportion, or accumulate income, or (2) distribute corpus to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) 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 separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) For taxable years ending before December 31, 1978, the separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remain-

der to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share; and for that purpose no account is taken of income and deductions allocable to the period after A's death.

§ 1.663(c)-4 Applicability of separate share rule to estates and qualified revocable trusts.—(a) General rule.—The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

(b) Special rule for certain types of beneficial interests.—Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

(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.

§ 1.663(c)-5 Examples.—Section 663(c) may be illustrated by the following examples:

Example 1. (i) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to be accumulated until he becomes 21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(ii) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year of 1955, the trust has income from royalties of \$20,000 and expenses of \$5,000. The trustee in his discretion distributes \$12,000 to A. Both A and the trust report on the calendar year basis.

(iii) The trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(iv) The distributable net income of each share of the trust is \$5,000 (\$6,667 less \$1,667). Since the amount (\$12,000) distributed to A during 1955 exceeds the distributable net income of \$5,000 allocated to his share, the trust is deemed to have distributed to him \$5,000 of 1955 income and \$7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of \$5,000 under section 661. The taxable income of the trust for 1955 is \$9,900, computed as follows:

Royalties	\$20,000	
Deductions:		
Expenses	\$5,000	
Distribution to A	5,000	
Personal exemption	<u>100</u>	<u>10,100</u>
Taxable income	9,900	

(v) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion (\$5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of \$7,000 made by the trust is subject to the throwback provisions of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code, and the regulations thereunder.

Example 2. (i) Facts. Testator, who dies in 2000, is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the executor makes a partial proportionate distribution of \$1,000,000, (\$600,000 to the surviving spouse and \$400,000 to the children's trust) and makes no other distributions. The estate receives dividend income of \$20,000, and pays expenses of \$8,000 that are deductible on the estate's federal income tax return.

(ii) Conclusion.—The fractional formula bequests to the surviving spouse and to the children's trust are separate shares. Because Testator's will provides for fractional formula residuary bequests, the income and any appreciation in the value of the estate assets are proportionately allocated between the marital share and the trust's share. Therefore, in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share. The distributable net income is \$7,200 (60% of income less 60% of expenses) for the marital share and \$4,800 (40% of income less 40% of expenses) for the trust's share. Because the amount distributed in partial satisfaction of each bequest exceeds the distributable net income of each share, the estate's distribution deduction under section 661 is limited to the sum of the distributable net income for both shares. The estate is allowed a distribution deduction of \$12,000 (\$7,200 for the marital share and \$4,800 for the trust's share). As a result, the estate has zero taxable income (\$20,000 income less \$8,000 expenses and \$12,000 distribution deduction). Under section 662, the surviving spouse and the trust must include in gross income \$7,200 and \$4,800, respectively.

Example 3. The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

Example 4. (i) Facts.—Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child of the largest amount that can pass free of Federal estate tax and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of \$200,000 and pays expenses of \$15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of \$350,000 and a fair market value of \$380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of \$30,000.

(ii) Conclusion.—The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the \$380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is \$214,400 (\$200,000 (dividend income) plus \$30,000 (capital gain) minus \$15,000 (expenses) and minus \$600 (personal exemption)).

Example 5. The facts are the same as in Example 4, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the

estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the \$380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

Example 6. The facts are the same as in Example 4, except that during 2000 the estate receives a distribution of \$900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire \$900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the \$900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the \$900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

Example 7. (i) Facts.—Testator, who dies in 2000, is survived by a spouse and three adult children. Testator's will divides the residue of the estate equally among the three children. The surviving spouse files an election under the applicable state's elective share statute. Under this statute, a surviving spouse is entitled to one-third of the decedent's estate after the payment of debts and expenses. 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. However, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the payment until the executor actually makes payment. During the estate's 2001 taxable year, the estate distributes to the surviving spouse \$5,000,000 in partial satisfaction of the elective share and pays \$200,000 of interest on the delayed payment of the elective share. During that year, the estate receives dividend income of \$3,000,000 and pays expenses of \$60,000 that are deductible on the estate's federal income tax return.

(ii) Conclusion.—The estate has four separate shares consisting of the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state law, none of the estate's gross income is allocated to the spouse's separate share for purposes of determining that share's distributable net income. Therefore, with respect to the \$5,000,000 distribution, the estate is allowed no deduction under section 661, and no amount is included in the spouse's gross income under section 662. The \$200,000 of interest paid to the spouse must be included in the spouse's gross income under section 61. Because no distributions were made to any other beneficiaries during the year, there is no need to compute the distributable net income of the other three separate shares. Thus, the taxable income of the estate for the 2000 taxable year is \$2,939,400 (\$3,000,000 (dividend income) minus \$60,000 (expenses) and \$600 (personal exemption)). The estate's \$200,000 interest payment is a nondeductible personal interest expense described in section 163(h).

Example 8. The will of Testator, who dies in 2000, directs the executor to distribute the X stock and all dividends therefrom to child A and the residue of the estate to child B. The estate has two separate shares consisting of the income on the X stock bequeathed to A and the residue of the estate bequeathed to B. The bequest of the X stock

meets the definition of section 663(a)(1) and therefore is not a separate share. If any distributions, other than shares of the X stock, are made during the year to either A or B, then for purposes of determining the distributable net income for the separate shares, gross income attributable to dividends on the X stock must be allocated to A's separate share and any other income must be allocated to B's separate share.

Example 9. The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is \$9,000,000. During 2000, the \$900,000 balance in Testator's individual retirement account is distributed to the estate. The entire \$900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of income in respect of a decedent must be allocated to A's share.

Example 10. The facts are the same as in Example 9, except that the will directs the executor to fund A's share first with X stock valued at \$3,000,000, rather than with the proceeds of the individual retirement account. The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of gross income attributable to the proceeds from the individual retirement account must be allocated between the two shares to the extent that they could potentially be funded with those proceeds. The maximum amount of A's share that could potentially be funded with the income in respect of decedent is \$1,500,000 (\$4,500,000 value of share less \$3,000,000 to be funded with stock) and the maximum amount of B's share that could potentially be funded with income in respect of decedent is \$4,500,000. Based upon the relative values of these amounts, the gross income attributable to the proceeds of the individual retirement account is allocated \$225,000 (or one-fourth) to A's share and \$675,000 (or three-fourths) to B's share.

Example 11. The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

§ 1.663(c)-6 Effective dates.—Sections 1.663(c)-1 through 1.663(c)-5 are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die on or after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see § 601.601(d)(2)(ii)(b) of this chapter). For trusts other than qualified revocable trusts, § 1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

§ 1.664-1 Charitable remainder trusts.—(a) In general—(1) Introduction—(i) General description of a charitable remainder trust.—Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain which is not less than 5 percent of the initial net fair market value of all property placed in trust (in the case of a charitable remainder annuity trust) or a fixed percentage which is not less than 5 percent of the net fair market value of the trust assets, valued annually (in the case of a charitable remainder unitrust). A trust created after July 31, 1969, which is a charitable remainder trust, is exempt from all of the taxes imposed by subtitle A of the Code for any taxable year of the trust, except for a taxable year beginning before January 1, 2007, in which it has unrelated business taxable income. For taxable years beginning after December 31, 2006, an excise tax, treated as imposed by chapter 42, is imposed on charitable remainder trusts that have unrelated business taxable income. See paragraph (c) of this section.

(ii) Scope.—This section provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries. For the application of certain foundation rules to charitable remainder trusts, see paragraph (b) of this section. If the trust has unrelated business taxable income, see paragraph (c) of this section. For the treatment of distributions to recipients, see paragraph (d) of this section. For the treatment of distributions to charity, see paragraph (e) of this section. For the time limitations for amendment of governing instruments, see paragraph (f) of this section. For transitional rules under which particular requirements are inapplicable to certain trusts, see paragraph (g) of this section. Section 1.664-2 provides rules relating solely to a charitable remainder annuity trust. Section 1.664-3 provides rules relating solely to a charitable remainder unitrust. Section 1.664-4 provides rules governing the calculation of the fair market value of the remainder interest in a charitable remainder unitrust. For rules relating to the filing of returns for a charitable remainder trust, see paragraph (a)(6) of § 1.6012-3 and section 6034 and the regulations thereunder.

(iii) Definitions.—As used in this section and §§ 1.664-2, 1.664-3, and 1.664-4:

(a) Charitable remainder trust. The term charitable remainder trust means a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522 and which meets the description of a charitable remainder annuity trust (as described in § 1.664-2) or a charitable remainder unitrust (as described in § 1.664-3).

(b) Annuity amount.—The term annuity amount means the amount described in paragraph (a)(1) of § 1.664-2 which is payable, at least annually, to the beneficiary of a charitable remainder annuity trust.

(c) Unitrust amount.—The term unitrust amount means the amount described in paragraph (a)(1) of § 1.664-3 which is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

(d) Recipient.—The term recipient means the beneficiary who receives the possession or beneficial enjoyment of the annuity amount or unitrust amount.

(e) Governing instrument.—The term governing instrument has the same meaning as in section 508(e) and the regulations thereunder.

(2) Requirement that the trust must be either a charitable remainder annuity trust or a charitable remainder unitrust. A trust is a charitable remainder trust only if it

is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. For example, a trust which provides for the payment each year to a noncharitable beneficiary of the greater of a sum certain or a fixed percentage of the annual value of the trust assets is not a charitable remainder trust inasmuch as the trust is neither a charitable remainder annuity trust (for the reason that the payment for the year may be a fixed percentage of the annual value of the trust assets which is not a “sum certain”) nor a charitable remainder unitrust (for the reason that the payment for the year may be a sum certain which is not a “fixed percentage” of the annual value of the trust assets).

(3) Restrictions on investments.—A trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. In the case of transactions with, or for the benefit of, a disqualified person, see section 4941(d) and the regulations thereunder for rules relating to the definition of self-dealing.

(4) Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation. In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.

(5) Rules applicable to testamentary transfers.—(i) Deferral of annuity or unitrust amount.—Notwithstanding subparagraph (4) of this paragraph and §§ 1.664-2 and 1.664-3, for purposes of sections 2055 and 2106 a charitable remainder trust shall be deemed created at the date of death of the decedent (even though the trust is not funded until the end of a reasonable period of administration or settlement) if the obligation to pay the annuity or unitrust amount with respect to the property passing in trust at the death of the decedent begins as of the date of death of the decedent, even though the requirement to pay such amount is deferred in accordance with the rules provided in this subparagraph. If permitted by applicable local law or authorized by the provisions of the governing instrument, the requirement to pay such amount may be deferred until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable period after such time, the trust must pay (in the case of an underpayment) or must receive from the recipient (in the case of an overpayment) the difference between:

(a) Any annuity or unitrust amounts actually paid, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, and

(b) The annuity or unitrust amounts payable, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually. The amounts payable shall be retroactively determined by using the taxable year, valuation method, and valuation dates which are ultimately adopted by the charitable remainder trust. See subdivision (ii) of this subparagraph for rules relating to retroactive determination of the amount payable under a charitable remainder unitrust. See paragraph (d)(4) of this section for rules relating to the year of in-

clusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient.

(ii) For purposes of retroactively determining the amount under subdivision (i)(b) of this subparagraph, the governing instrument of a charitable remainder unitrust may provide that the amount described in subdivision (i)(b) of this subparagraph with respect to property passing in trust at the death of the decedent for the period which begins on the date of death of the decedent and ends on the earlier of the date of death of the last recipient or the end of the taxable year of the trust in which occurs the complete funding of the trust shall be computed by multiplying:

(a) The sum of (1) the value, on the earlier of the date of death of the last recipient or the last day in such taxable year, of the property held in trust which is attributable to property passing to the trust at the death of the decedent, (2) any distributions in respect of unitrust amounts made by the trust or estate before such date, and (3) interest on such distributions computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, from the date of distribution to such date by:

(b)(1) In the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664-4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year.

(2) In the case of transfers for which the valuation date is after April 30, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664-4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year. The appropriate adjusted payout rate is determined by using the appropriate Table F contained in § 1.664-4(e)(6) for the section 7520 rate for the month of the valuation date.

(3) If the number of years between the date of death and the date of the earlier of the death of the last recipient or the last day of such taxable year is between periods for which factors are provided, a linear interpolation must be made.

(iii) Treatment of distributions.—The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664. In the case of a charitable remainder trust which is partially or fully funded during the period of administration of an estate or settlement of a trust (which is not a charitable remainder trust), the treatment of any amount paid, credited, or required to be distributed by the charitable remainder trust shall be governed by the rules of section 664.

(iv) Rate of interest.—The following rates of interest shall apply for purposes of paragraphs (a)(5)(i) through (ii) of this section:

(a) The section 7520 rate for the month in which the valuation date with respect to the transfer is (or one of the prior two months if elected under § 1.7520-2(b)) after April 30, 1989;

(b) 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) on or after August 9, 1984, and before May 1, 1989, and not subsequently amended;

(c) 6 percent or 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) after October 24, 1983, and before August 9, 1984; and

(d) 6 percent for instruments executed before October 25, 1983, and not subsequently amended (other than in the case of a reformation under section 2055(e)(3)).

(6) Examples. The application of the rules in paragraphs (a)(4) and (a)(5) of this section require the use of actuarial factors contained in §§ 1.664-4T(e) and 1.664-4A and may be illustrated by use of the following examples:

Example (1). On September 19, 1971, H transfers property to a trust over which he retains an inter vivos power of revocation. The trust is to pay W 5 percent of the value of the trust assets, valued annually, for her life, remainder to charity. The trust would satisfy all of the requirements of section 664 if it were irrevocable. For purposes of section 664, the trust is not deemed created in 1971 because H is treated as the owner of the entire trust under subpart E. On May 26, 1975, H predeceases W at which time the trust becomes irrevocable. For purposes of section 664, the trust is deemed created on May 26, 1975, because that is the earliest date on which H is not treated as the owner of the entire trust under subpart E. The trust becomes a charitable remainder trust on May 26, 1975, because it meets the definition of a charitable remainder trust from its creation.

Example (2). The facts are the same as in example (1), except that H retains the inter vivos power to revoke only one-half of the trust. For purposes of section 664, the trust is deemed created on September 19, 1971, because on that date the grantor is not treated as the owner of the entire trust under subpart E. Consequently, a charitable deduction is not allowable either at the creation of the trust or at H's death because the trust does not meet the definition of a charitable remainder trust from the date of its creation. The trust does not meet the definition of a charitable remainder trust from the date of its creation because the trust is subject to a partial power to revoke on such date.

Example (3). The facts are the same as in example (1), except that the residue of H's estate is to be paid to the trust and the trust is required to pay H's debts. The trust is not a charitable remainder trust at H's death because it does not function exclusively as a charitable remainder trust from the date of its creation which, in this case, is the date it becomes irrevocable.

Example (4). (i) In 1971, H transfers property to Trust A over which he retains an inter vivos power of revocation. Trust A, which is not a charitable remainder trust, is to provide income or corpus to W until the death of H. Upon H's death the trust is required by its governing instrument to pay the debts and administration expenses of H's estate, and then to terminate and distribute all of the remaining assets to a separate Trust B which meets the definition of a charitable remainder annuity trust.

(ii) Trust B will be charitable remainder trust from the date of its funding because it will function exclusively as a charitable remainder trust from its creation. For purposes of section 2055, Trust B will be deemed created at H's death if the obligation to pay the annuity amount begins on the date of H's death. For purposes of section 664, Trust B becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless Trust B has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by Trust A, including distributions to a recipient in respect of annuity amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (5). In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses. For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (6). (i) On January 1, 1974, H dies testate leaving the residue of his estate to a charitable remainder unitrust. The governing instrument provides that, beginning at H's death, the trustee is to make annual payments to W, on December 31 of each year of 5 percent of the net fair market value of the trust assets, valued as of December 31 of each year, for W's life and to pay the remainder to charity at the death of W. The governing instrument also provides that the actual payment of the unitrust amount need not be made until the end of the taxable year of the trust in which occurs the complete funding of the trust. The governing instrument also provides that the amount payable with respect to the period between the date of death and the end of such taxable year shall be computed under the special method provided in subparagraph (5)(ii) of this paragraph. The governing instrument provides that, within a reasonable period after the end of the taxable year of the trust in which occurs the complete funding of the trust, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between the unitrust amounts paid (plus interest at 6 percentage compounded annually) and the amount computed under the special method. The trust is completely funded on September 20, 1976. No amounts were paid before June 30, 1977. The trust adopts a fiscal year of July 1 to June 30. The net fair market value of the trust assets on June 30, 1977, is \$100,000.

(ii) Because no amounts were paid prior to the end of the taxable year in which the trust was completely funded, the amount payable at the end of such taxable year is equal to the net fair market value of the trust assets on the last day of such taxable year (June 30, 1977) multiplied by a factor equal to 1.0 minus the factor in Table D corresponding to the number of years in the period between the date of death and the end of such taxable year. The adjusted payout rate (determined under § 1.664-4A(c)) is 5 percent. Because the last day of the taxable year in which the trust is completely funded is June 30, 1977, there are 3 181/365 years in such period. Because there is no factor given in Table D for such a period, a linear interpolation must be made:

1.0 minus 0.814506 (factor at 5 percent for 4 years).....	0.185494
1.0 minus 0.857375 (factor at 5 percent for 3 years).....	.142625
Difference .....	.042869
$181 / 365 = X / 0.042869$ $X = 0.021258$	
1.0 minus 0.857375 (factor at 5 percent for 3 years).....	.142625
Plus: X.....	.021258
Interpolated factor.....	.163883

Thus, the amount payable for the period from January 1, 1974, to June 30, 1977, is \$16,388.30 ($\$100,000 \times 0.163883$). Thereafter, the trust assets must be valued on December 31 of each year and 5 percent of such value paid annually to W for her life.

(7) Valuation of unmarketable assets—(i) In general.—If unmarketable assets are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under section 170, 2055, 2106, or 2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is—

(a) Performed exclusively by an independent trustee; or

(b) Determined by a current qualified appraisal, as defined in § 1.170A-13(c)(3), from a qualified appraiser, as defined in § 1.170A-13(c)(5).

(ii) Unmarketable assets.—Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

(iii) Independent trustee. An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of section 672(c) and the applicable regulations).

(b) Application of certain foundation rules to charitable remainder trusts. See section 4947(a)(2) and section 4947(b)(3)(B) and the regulations thereunder for the application to charitable remainder trusts of certain provisions relating to private foundations. See section 508(e) for rules relating to required provisions in governing instruments prohibiting certain activities specified in section 4947(a)(2).

(c) Excise tax on charitable remainder trusts.—(1) In general. For each taxable year beginning after December 31, 2006, in which a charitable remainder annuity trust or a charitable remainder unitrust has any unrelated business taxable income, an excise tax is imposed on that trust in an amount equal to the amount of such unrelated business taxable income. For this purpose, unrelated business taxable income is as defined in section 512, determined as if part III, subchapter F, chapter 1, subtitle A of the Internal Revenue Code applied to such trust. Such excise tax is treated as imposed by chapter 42 (other than subchapter E) and is reported and payable in accordance with the appropriate forms and instructions. Such excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary. (See paragraph (d)(2) of this section.) The charitable remainder trust income that is unrelated business taxable income constitutes income of the trust for purposes of determining the character of the distribution made to the beneficiary. Income of the charitable remainder trust is allocated among the charitable remainder trust income categories in paragraph (d)(1) of this section without regard to whether any part of that income constitutes unrelated business taxable income under section 512.

(2) Examples. The application of the rules in this paragraph (c) may be illustrated by the following examples:

Example 1. For 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, has \$60,000 of ordinary income, including \$10,000 of gross income from a partnership that constitutes unrelated business taxable income to the trust. The trust has no deductions that are directly connected with that income. For that same year, the trust has administration expenses (deductible in computing taxable income) of \$16,000, resulting in net ordinary income of \$44,000. The amount of unre-

lated business taxable income is computed by taking gross income from an unrelated trade or business and deducting expenses directly connected with carrying on the trade or business, both computed with modifications under section 512(b). Section 512(b)(12) provides a specific deduction of \$1,000 in computing the amount of unrelated business taxable income. Under the facts presented in this example, there are no other modifications under section 512(b). The trust, therefore, has unrelated business taxable income of \$9,000 (\$10,000 minus the \$1,000 deduction under section 512(b)(12)). Undistributed ordinary income from prior years is \$12,000 and undistributed capital gains from prior years are \$50,000. Under the terms of the trust agreement, the trust is required to pay an annuity of \$100,000 for year 2007 to the noncharitable beneficiary. Because the trust has unrelated business taxable income of \$9,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, \$9,000. The character of the \$100,000 distribution to the noncharitable beneficiary is as follows: \$56,000 of ordinary income (\$44,000 from current year plus \$12,000 from prior years), and \$44,000 of capital gains. The \$9,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories of income under paragraph (d)(1) of this section. At the beginning of year 2008, the amount of undistributed capital gains is \$6,000, and there is no undistributed ordinary income.

Example 2. During 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, sells real estate generating gain of \$40,000. Because the trust had obtained a loan to finance part of the purchase price of the asset, some of the income from the sale is treated as debt-financed income under section 514 and thus constitutes unrelated business taxable income under section 512. The unrelated debt-financed income computed under section 514 is \$30,000. Assuming the trust receives no other income in 2007, the trust will have unrelated business taxable income under section 512 of \$29,000 (\$30,000 minus the \$1,000 deduction under section 512(b)(12)). Except for section 512(b)(12), no other exceptions or modifications under sections 512-514 apply when calculating unrelated business taxable income based on the facts presented in this example. Because the trust has unrelated business taxable income of \$29,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, \$29,000. The \$29,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories of income under paragraph (d)(1) of this section. Regardless of how the trust's income might be treated under sections 511-514, the entire \$40,000 is capital gain for purposes of section 664 and is allocated accordingly to and within the second of the categories of income under paragraph (d)(1) of this section.

(3) Effective/applicability date. This paragraph (c) is applicable for taxable years beginning after December 31, 2006. The rules that apply with respect to taxable years beginning before January 1, 2007, are contained in Sec. 1.664-1(c) as in effect prior to June 24, 2008. (See 26 CFR part 1, Sec. 1.664-1(c)(1) revised as of April 1, 2007.)

(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 in-

come 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 cat-

egory, 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 (\$10 from 2004 and \$30 carried forward from 2003).....	40
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.....	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 gain 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.....	0
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.

(2) Allocation of deductions.—Items of deduction of the trust for a taxable year of the trust which are deductible in determining taxable income (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) which are directly attributable to one or more classes of items within a category of income (determined under paragraph (d)(1)(i)(a) of this section) or to corpus shall be allocated to such classes of items or to corpus. All other allowable deductions for such taxable year which are not directly attributable to one or more classes of items within a category of income or to corpus (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) shall be allocated among the classes of items within the category (excluding classes of items with net losses) on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto under the first sentence of this subparagraph, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two sentences (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) may be allocated in any manner. All taxes imposed by chapter 42 of the Code (including without limitation taxes treated under section 664(c)(2) as imposed by chapter 42) and, for taxable years beginning prior to January 1, 2007, all taxes imposed by subtitle A of the Code for which the trust is liable because it has unrelated business taxable income, shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of items described in paragraph (d)(1)(i)(a)(3) of this section shall be allocated to corpus. The deductions allowable to a trust under sections 642(b), 642(c), 661, and 1202 are not allowed in determining the amount or character of any class of items within a category of income described in paragraph (d)(1)(i)(a) of this section or to corpus.

(3) Allocation of income among recipients.—If there are two or more recipients, each will be treated as receiving his pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

Example. X transfers \$40,000 to a charitable remainder annuity trust which is to pay \$3,000 per year to X and \$2,000 per year to Y for a term of 5 years. During the first taxable year the trust has \$3,000 of ordinary income, \$500 of capital gain, and \$500 of tax-exempt income after allocation of all expenses. X is treated as receiving ordinary income of \$1,800 ($\$3,000/\$5,000 \times \$3,000$), capital gain of \$300 ($\$3,000/\$5,000 \times \500), tax exempt income of \$300 ($\$3,000/\$5,000 \times \500), and corpus of \$600 ($\$3,000/\$5,000 \times [\$5,000 - \$4,000]$). Y is treated as receiving ordinary income of \$1,200 ($\$2,000/\$5,000 \times \$3,000$), capital gain of \$200 ($\$2,000/\$5,000 \times \500), tax exempt income of \$200 ($\$2,000/\$5,000 \times \500), and corpus of \$400 ($\$2,000/\$5,000 [\$5,000 - \$4,000]$).

(4) Year of inclusion.—(i) General rule.—To the extent required by this paragraph, the annuity or unitrust amount is includible in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income to the extent required by this paragraph shall be included in his taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed.

(ii) Payments resulting from incorrect valuations.—Notwithstanding subdivision (i) of this subparagraph, any payments which are made or required to be distributed by a charitable remainder trust pursuant to paragraph (a)(5) of this section, under paragraph (f)(3) of this section because of an amendment to the governing instrument, or under paragraphs (a)(1) of §§ 1.664-2 and 1.664-3 because of an incorrect valuation, shall, to the extent required by this paragraph, be included in the gross income of the recipient in his taxable year in which or with which ends the taxable year of the trust in which the amount is paid, credited, or required to be distributed. For rules relating to required adjustments of underpayments and overpayments of the annuity or unitrust amounts in respect of payments made prior to the amendment of a governing instrument, see paragraph (f)(3) of this section. There is allowable to a recipient a deduction from gross income for any amounts repaid to the trust because of an overpayment during the reasonable period of administration or settlement or until the trust is fully funded, because of an amendment, or because of an incorrect valuation, to the extent such amounts were included in his gross income. See section 1341 and the regulations thereunder for rules relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right.

(iii) Rules applicable to year of recipient's death.—If the taxable year of the trust does not end with or within the last taxable year of the recipient because of the recipient's death, the extent to which the annuity or unitrust amount required to be distributed to him is included in the gross income of the recipient for his last taxable year, or in the gross income of his estate, is determined by making the computations required under this paragraph for the taxable year of the trust in which his last taxable year ends. (The last sentence of subdivision (i) of this subparagraph does not apply to such amounts.) The gross income for the last taxable year of a recipient on the cash basis includes (to the extent required by this paragraph) amounts actually distributed to the recipient before his death. Amounts required to be distributed which are distributed to his estate, are included (to the extent required by this paragraph) in the gross income of the estate as income in respect of a decedent under section 691.

(5) Distributions in kind.—The annuity or unitrust amount may be paid in cash or in other property. In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed. The application of these rules may be illustrated by the following example:

Example. On January 1, 1971, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive \$5,000 per year. During 1971, the trust receives \$500 of ordinary income. On December 31, 1971, the trust distributed cash of \$500 and a capital asset of the trust having a fair market value of \$4,500 and a basis of \$2,200. The trust is deemed to have realized a capital gain of \$2,300. X treats the distribution of \$5,000 as being ordinary income of \$500, capital gain of \$2,300 and trust corpus of \$2,200. The basis of the distributed property is \$4,500 in the hands of X.

(e) Other distributions.—(1) Character of distributions.—An amount distributed by the trust to an organization described in section 170(c) other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified in paragraph (d)(1)(i)(a) of this section in an order inverse to that prescribed in such paragraph. The character of such amount shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined.

(2) Distributions in kind.—In the case of a distribution of an amount to which subparagraph (1) of this paragraph applies, no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed.

(f) Effective date.—(1) General rule.—The provisions of this section are effective with respect to transfers in trust made after July 31, 1969. Any trust created (within the meaning of applicable local law) prior to August 1, 1969, is not a charitable remainder trust even if it otherwise satisfies the definition of a charitable remainder trust.

(2) Transfers to pre-1970 trusts.—Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust, shall, for purposes of subparagraphs (1) and (3) of this paragraph, be deemed transferred to a trust created on the date of such transfer provided that the transfer occurs after July 31, 1969, and prior to October 18, 1971, and the transferred property and any undistributed income therefrom is severed and placed in a separate trust before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings begun before December 31, 1972, which are required to sever such property, become final.

(3) Amendment of post-1969 trusts.—A trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, which is not a charitable remainder trust at the date of its creation, may be treated as a charitable remainder trust from the date it would be deemed created under § 1.664-1(a)(4) and (5)(i) for all purposes: Provided, That all the following requirements are met:

(i) At the time of the creation of the trust, the governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust.

(ii) The governing instrument of the trust is amended so that the trust will meet the definition of a charitable remainder trust and, if applicable, will meet the requirement of paragraph (a)(5)(i) of this section that obligation to make payment of the annuity or unitrust amount with respect to property passing at death begin as of the date of death, before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. In the case of a trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, the provisions of section 508(d)(2)(A) shall not apply if the governing instrument of the trust is amended so as to comply with the requirements of section 508(e) before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. Notwithstanding the provisions of paragraphs (a)(3) and (a)(4) of §§ 1.664-2 and 1.664-3, the governing instrument may grant to the trustee a power to amend the governing instrument for the sole purpose of complying with the requirements of this section and § 1.664-2 or § 1.664-3: Provided, That at the creation of the trust, the governing instrument (a) provides for the payment of a unitrust amount described in § 1.664-3(a)(1)(i) or an annuity which meets the requirements of paragraph (a)(2) of § 1.664-2 or § 1.664-3, (b) designates the recipients of the trust and the period for which the amount described in (a) of this subdivision (ii) is to be paid, and (c) provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust. The mere granting of such a power is not sufficient to meet the requirements of this sub-

paragraph that the governing instrument be amended in the manner and within the time limitations of this subparagraph.

(iii)(a) Where the amount of the distributions which would have been made by the trust to a recipient if the amended provisions of such trust had been in effect from the time of creation of such trust exceeds the amount of the distributions made by the trust prior to its amendment, the trust pays an amount equal to such excess to the recipient.

(b) Where the amount of distributions made to the recipient prior to the amendment of the trust exceeds the amount of the distributions which would have been made by such trust if the amended provisions of such trust had been in effect from the time of creation of such trust, such excess is repaid to the trust by the recipient. See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient. A deduction for a transfer to a charitable remainder trust shall not be allowed until the requirements of this paragraph are met and then only if the deduction is claimed on a timely filed return (including extensions) or on a claim for refund filed within the period of limitations prescribed by section 6511(a).

(4) Valuation of unmarketable assets.—The rules contained in paragraph (a)(7) of this section are applicable for trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit a valuation method that satisfies the requirements of paragraph (a)(7) of this section for taxable years beginning on or after December 10, 1998.

(g) Transitional effective date.—Notwithstanding any other provision of this section, § 1.664-2 or § 1.664-3, the requirement of paragraph (a)(5)(i) of this section that interest accrue on overpayments and underpayments, the requirement of paragraph (a)(5)(ii) of this section that the unitrust amount accruing under the formula provided therein cease with the death of the last recipient, and the requirement that the governing instrument of the trust contain the provisions specified in paragraph (a)(1)(iv) of § 1.664-2 (relating to computation of the annuity amount in certain circumstances), paragraph (a)(1)(v) of § 1.664-3 (relating to computation of the unitrust amount in certain circumstances), paragraphs (b) of §§ 1.664-2 and 1.664-3 (relating to additional contributions), and paragraph (a)(1)(iii) of § 1.664-3 (relating to incorrect valuations), paragraphs (a)(6)(iv) of §§ 1.664-2 and 1.664-3 (relating to alternative remaindermen) shall not apply to:

(1) A will executed on or before December 31, 1972, if:

(i) The testator dies before December 31, 1975, without having republished the will after December 31, 1972, by codicil or otherwise.

(ii) The testator at no time after December 31, 1972, had the right to change the provisions of the will which pertain to the trust, or

(iii) The will is not republished by codicil or otherwise before December 31, 1975, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, or

(2) A trust executed on or before December 31, 1972, if:

(i) The grantor dies before December 31, 1975, without having amended the trust after December 31, 1972,

(ii) The trust is irrevocable on December 31, 1972, or

(iii) The trust is not amended before December 31, 1975, and the grantor is on such date and at all times thereafter under a mental disability to change the terms of the trust.

§ 1.664-2 Charitable remainder annuity trust.—(a) Description.—A charitable remainder annuity trust is a trust which complies with the applicable provisions of § 1.664-1 and meets all of the following requirements:

(1) Required payment of annuity amount—(i) Payment of sum certain at least annually. The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section.

(a) General rule applicable to all trusts.—A trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire annuity amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(1) The trust pays the annuity amount by distributing property (other than cash) that it owned at the close of the taxable year to pay the annuity amount, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due;

(2) The trust pays the annuity amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(3) The trust pays the annuity amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the annuity amount is due.

(b) Special rule for trusts created before December 10, 1998.—In addition to the circumstances described in paragraph (a)(1)(i)(a) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the sum certain to be paid each year as the annuity amount is 15 percent or less of the initial net fair market value of the property irrevocably passing in trust as determined for federal tax purposes.

(c) Reasonable time.—For this paragraph (a)(1)(i), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, “Split-Interest Trust Information Return,” (including extensions) for the taxable year.

(d) Example.—The following example illustrates the rules in paragraph (a)(1)(i)(a) of this section:

Example. X is a charitable remainder annuity trust described in section 664(d)(1) that was created after December 10, 1998. The prorated annuity amount payable from X for Year 1 is \$100. The trustee does not pay the annuity amount to the recipient by the close of Year 1. At the end of Year 1, X has only \$95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to \$95 in cash, the trustee distributes to the recipient of the annuity a capital asset with a \$5 fair market value and a \$2 adjusted basis to pay the \$100 annuity amount due for Year 1. The trust owned the asset at the end of Year 1. Under § 1.664-1(d)(5), the distribution is treated as a sale by X, resulting in X recognizing a \$3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under § 1.664-1(d)(1), the character of the annuity amount for Year 1 in the recipient's hands is \$95 of ordinary income, \$3 of capital gain income, and \$2 of trust corpus. For Year 1, X satisfied paragraph (a)(1)(i)(a) of this section.

(e) Effective date.—This paragraph (a)(1)(i) is applicable for taxable years ending after April 18, 1997. However, paragraphs (a)(1)(i)(a)(2) and (3) of this section apply only to distributions made on or after January 5, 2001.

(ii) Definition of sum certain.—A sum certain is a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period. For example, a provision for an amount which is the same every year to A until his death and concurrently an amount which is the same every year to B until his death, with the amount to each recipient to terminate at his death, would satisfy the above rule. Similarly, provisions for an amount to A and B for their joint lives and then to the survivor would satisfy the above rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the stated amount payable after such a distribution: Provided, That:

(a) The reduced amount payable is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) Sum certain stated as a fraction or percentage.—The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes. If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of § 1.664-1. See paragraph (d)(4) of § 1.664-1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to future contributions. For rules relating to required adjustments for underpayments or overpayments of the amount described in this paragraph in respect of payments made during a reasonable period of administra-

tion, see paragraph (a)(5) of § 1.664-1. The application of the rule permitting the stated dollar amount to be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes may be illustrated by the following example:

Example. The will of X provides for the transfer of one-half of his residuary estate to a charitable remainder annuity trust which is required to pay to W for life an annuity equal to 5 percent of the initial net fair market value of the interest passing in trust as finally determined for Federal tax purposes. The annuity is to be paid on December 31 of each year computed from the date of X's death. The will also provides that if such initial net fair market value is incorrectly determined, the trust shall pay to W, in the case of an undervaluation, or be repaid by W, in the case of an overvaluation, an amount equal to the difference between the amount which the trust should have paid if the correct value were used and the amount which the trust actually paid. X dies on March 1, 1971. The executor files an estate tax return showing the value of the residuary estate as \$250,000 before reduction for taxes and expenses of \$50,000. The executor paid to W \$4,192 ($[\$250,000 - \$50,000] \times 1/2 \times 5 \text{ percent} \times 306/365$) on December 31, 1971. On January 1, 1972, the executor transfers one-half of the residue of the estate to the trust. The trust adopts the calendar year as its taxable year. The value of the residuary estate is finally determined for Federal tax purposes to be \$240,000 ($\$290,000 - \$50,000$). Accordingly, the amount which the executor should have paid to W is \$5,030 ($[\$290,000 - \$50,000] \times 1/2 \times 5 \text{ percent} \times 306/365$). Consequently, an additional amount of \$838 ($\$5,030 - \$4,192$) must be paid to W within a reasonable period after the final determination of value for Federal tax purposes.

(iv) Computation of annuity amount in certain circumstances.—(a) Short taxable years.—The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount determined under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(b) Last taxable year of period.—The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount which must be distributed under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator). See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the annuity amount with the regular payment next preceding the termination of the period specified therein.

(2) Minimum annuity amount.—(i) General rule.—The total amount payable under subparagraph (1) of this paragraph is not less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes.

(ii) Reduction of annuity amount in certain cases.—A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the stated amount payable upon the death of a recipient or the expiration of a term of years provided that:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total amounts payable each year under subparagraph (1) of this paragraph after such distribution are not less than a stated dollar amount which bears the same ratio to 5 percent of the initial net fair market value of the trust assets as the net fair market value of the trust assets immediately after such distribution bears to the net fair market value of the trust assets immediately before such distribution.

(iii) Rule applicable to inter vivos trust which does not provide for payment of minimum annuity amount. In the case where the grantor of an inter vivos trust underestimates in good faith the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes and specifies a fixed dollar amount for the annuity which is less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes, the trust will be deemed to have met the 5 percent requirement if the grantor or his representative consents, by appropriate agreement with the District Director, to accept an amount equal to 20 times the annuity as the fair market value of the property placed in trust for purposes of determining the appropriate charitable contributions deduction.

(3) Permissible recipients.—(i) General rule.—The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of the creation of the trust. A named person or persons may include members of a named class provided that, in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the annuity amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that an amount shall be paid to his children living at his death.

(ii) Power to alter amount paid to recipients.—A trust is not a charitable remainder annuity trust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the annuity among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) Other payments.—No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted ba-

sis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) Period of payment of annuity amount.—(i) General rules.—The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of an annuity amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of an annuity amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) Relationship to 5 percent requirement.—The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A and B for their joint lives and then to the survivor for his life;

(b) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for a term of years not longer than 20 years and then to B for life (provided B was living at the date of creation of the trust);

(d) An amount to A for his life and concurrently an amount to B for his life (the amount to each recipient to terminate at his death) if the amount given to each individual is not less than 5 percent of the initial net fair market value of the property placed in trust; or

(e) An amount to A for his life and concurrently an equal amount to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c), if the total of the

amounts given to A and B is not less than 5 percent of the initial net fair market value of the property placed in trust.

(6) Permissible remaindermen.—(i) General rule.—At the end of the period specified in subparagraph (5) of this paragraph the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) Treatment of trust.—If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as sections 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) Concurrent or successive remaindermen.—Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) Alternative remaindermen.—The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of one or more alternative organizations which are described in section 170(c) at such time or retained for such use. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) Additional contributions.—A trust is not a charitable remainder annuity trust unless its governing instrument provides that no additional contributions may be made to the charitable remainder annuity trust after the initial contribution. For purposes of this section, all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution.

(c) Calculation of the fair market value of the remainder interest of a charitable remainder annuity trust.—For purposes of sections 170, 2055, 2106, and 2522, the fair market value of the remainder interest of a charitable remainder annuity trust (as described in this section) is the net fair market value (as of the appropriate valuation date) of the property placed in trust less the present value of the annuity. For purposes of this section, valuation date means, in general, the date on which the property is transferred to the trust by the donor regardless of when the trust is created. In the case of transfers to a charitable remainder annuity trust for which the valuation date is after April 30, 1989, if an election is made under section 7520 and § 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the transfer is made, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. For purposes of section 2055 or 2106, the valuation date is the date of death unless the alternate valuation date is elected in accordance with section 2032, in which event, and

within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and § 1.7520-2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. The present value of an annuity is computed under § 20.2031-7T(d) for transfers for which the valuation date is on or after May 1, 2009, or under § 20.2031-7A(a) through (f), whichever is applicable, for transfers for which the valuation date is before May 1, 2009. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances).

(d) Deduction for transfers to a charitable remainder annuity trust.—For rules relating to a deduction for transfers to a charitable remainder annuity trust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. Any claim for deduction on any return for the value of a remainder interest in a charitable remainder annuity trust must be supported by a full statement attached to the return showing the computation of the present value of such interest. The deduction allowed by section 170 is limited to the fair market value of the remainder interest of a charitable remainder annuity trust regardless of whether an organization described in section 170(c) also receives a portion of the annuity. For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or 170(e)(1)(B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

§ 1.664-3 Charitable remainder unitrust.—(a) Description.—A charitable remainder unitrust is a trust which complies with the applicable provisions of § 1.664-1 and meets all of the following requirements:

(1) Required payment of unitrust amount.—(i) Payment of fixed percentage at least annually.—(a) General rule.—The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. This paragraph (a)(1)(i)(a) is applicable for taxable years ending after April 18, 1997.

(b) Income exception.—Instead of the amount described in (a) of this subdivision (i), the governing instrument may provide that the trust shall pay for any year either the amount described in (1) or the total of the amounts described in (1) and (2) of this subdivision (b).

(1) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(a) of this section.

(2) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under paragraph (a)(1)(i)(a) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(b)(1) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(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, notwithstanding any contrary provision in

applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(4) The rules in paragraph (a)(1)(i)(b)(1) and (2) of this section are applicable for taxable years ending after April 18, 1997. The rule in the first sentence of paragraph (a)(1)(i)(b)(3) is applicable for taxable years ending after April 18, 1997. The rules in the second, fourth, and fifth sentences of paragraph (a)(1)(i)(b)(3) are applicable for taxable years ending after January 2, 2004. The rule in the third sentence of paragraph (a)(1)(i)(b)(3) is applicable for sales or exchanges that occur after April 18, 1997. The rule in the sixth sentence of paragraph (a)(1)(i)(b)(3) is applicable for trusts created after January 2, 2004.

(c) *Combination of methods.*—Instead of the amount described in paragraph (a)(1)(i)(a) or (b) of this section, the governing instrument may provide that the trust will pay not less often than annually the amount described in paragraph (a)(1)(i)(b) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(a) of this section (calculated using the same fixed percentage) for the remaining years of the trust only if the governing instrument provides that—

(1) The change from the method prescribed in paragraph (a)(1)(i)(b) of this section to the method prescribed in paragraph (a)(1)(i)(a) of this section is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons;

(2) The change from the method prescribed in paragraph (a)(1)(i)(b) of this section to the method prescribed in paragraph (a)(1)(i)(a) of this section occurs at the beginning of the taxable year that immediately follows the taxable year during which the date or event specified under paragraph (a)(1)(i)(c)(1) of this section occurs; and

(3) Following the trust's conversion to the method described in paragraph (a)(1)(i)(a) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(a) of this section and not any amount described in paragraph (a)(1)(i)(b) of this section.

(d) *Triggering event.*—For purposes of paragraph (a)(1)(i)(c)(1) of this section, a triggering event based on the sale of unmarketable assets as defined in § 1.664-1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.

(e) *Examples.* The following examples illustrate the rules in paragraph (a)(1)(i)(c) of this section. For each example, assume that the governing instrument of charitable remainder unitrust Y provides that Y will initially pay not less often than annually the amount described in paragraph (a)(1)(i)(b) of this section and then pay the amount described in paragraph (a)(1)(i)(a) of this section (calculated using the same fixed percentage) for the remaining years of the trust and that the requirements of

paragraphs (a)(1)(i)(c)(2) and (3) of this section are satisfied. The examples are as follows:

Example 1. Y is funded with the donor's former personal residence. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the trust sells the residence. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 2. Y is funded with cash and an unregistered security for which there is no available exemption permitting public sale under the Securities and Exchange Commission rules. The governing instrument of Y provides that the change in method for computing the annual unitrust amount is triggered on the earlier of the date when the stock is sold or at the time the restrictions on its public sale lapse or are otherwise lifted. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 3. Y is funded with cash and with a security that may be publicly traded under the Securities and Exchange Commission rules. The governing instrument of Y provides that the change in method for computing the annual unitrust amount is triggered when the stock is sold. Y does not provide for a combination of methods that satisfies the requirements of paragraph (a)(1)(i)(c) of this section because the sale of the publicly-traded stock is within the discretion of the trustee.

Example 4. S establishes Y for her granddaughter, G, when G is 10 years old. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which G turns 18 years old. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 5. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the donor is married. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 6. The governing instrument of Y provides that if the donor divorces, the change in method for computing the annual unitrust amount will occur as of the first day of the year following the year of the divorce. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 7. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's first child is born. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 8. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's father dies. Y provides for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 9. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's financial advisor determines that the beneficiary should begin receiving payments under the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, Y does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

Example 10. The governing instrument of Y provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary submits a request to the trustee that the trust convert to the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, Y does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(c) of this section.

(f) Effective date.—(1) General rule.—Paragraphs (a)(1)(i)(c), (d), and (e) of this section are applicable for charitable remainder trusts created on or after December 10, 1998.

(2) General rule regarding reformations of combination of method unitrusts. If a trust is created on or after December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(c) of this section, the trust will qualify as a charitable remainder unitrust only if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust, or is reformed in accordance with paragraph (a)(1)(i)(f)(3) of this section. If a trust was created before December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(c) of this section, the trust may be reformed to use the initial method for computing the unitrust amount throughout the term of the trust without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664-1(a)(4), or may be reformed in accordance with paragraph (a)(1)(i)(f)(3) of this section. Except as provided in paragraph (a)(1)(i)(f)(3) of this section, a qualified charitable remainder unitrust will not continue to qualify as a charitable remainder unitrust if it is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(3) Special rule for reformations of trusts that begin by June 8, 1999. Notwithstanding paragraph (a)(1)(i)(f)(2) of this section, if a trust either provides for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(c) of this section, or provides for payment of the unitrust amount under only the method prescribed in paragraph (a)(1)(i)(b) of this section, then the trust may be reformed to allow for a combination of methods permitted under paragraph (a)(1)(i)(c) of this section without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664-1(a)(4) or to engage in an act of self-dealing under section 4941 if the trustee begins legal proceedings to reform by June 8, 1999. The triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust, except for situations in which the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(c) of this section and the triggering event occurred prior to the reformation.

(g) Payment under general rule for fixed percentage trusts.—When the unitrust amount is computed under paragraph (a)(1)(i)(a) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire unitrust amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or

(3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(1) The trust pays the unitrust amount by distributing property (other than cash) that it owned at the close of the taxable year, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the unitrust amount is due;

(2) The trust pays the unitrust amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(3) The trust pays the unitrust amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the unitrust amount is due.

(h) Special rule for fixed percentage trusts created before December 10, 1998. When the unitrust amount is computed under paragraph (a)(1)(i)(a) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the fixed percentage to be paid each year as the unitrust amount is 15 percent or less of the net fair market value of the trust assets as determined under paragraph (a)(1)(iv) of this section.

(i) Example.—The following example illustrates the rules in paragraph (a)(1)(i)(g) of this section:

Example. X is a charitable remainder unitrust that calculates the unitrust amount under paragraph (a)(1)(i)(a) of this section. X was created after December 10, 1998. The prorated unitrust amount payable from X for Year 1 is \$100. The trustee does not pay the unitrust amount to the recipient by the end of the Year 1. At the end of Year 1, X has only \$95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to \$95 in cash, the trustee distributes to the unitrust recipient a capital asset with a \$5 fair market value and a \$2 adjusted basis to pay the \$100 unitrust amount due for Year 1. The trust owned the asset at the end of Year 1. Under § 1.664-1(d)(5), the distribution is treated as a sale by X, resulting in X recognizing a \$3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under § 1.664-1(d)(1), the character of the unitrust amount for Year 1 in the recipient's hands is \$95 of ordinary income, \$3 of capital gain income, and \$2 of trust corpus. For Year 1, X satisfied paragraph (a)(1)(i)(g) of this section.

(j) Payment under income exception.—When the unitrust amount is computed under paragraph (a)(1)(i)(b) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year.

(k) Reasonable time.—For paragraphs (a)(1)(i)(g), (h), and (j) of this section, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, “Split-Interest Trust Information Return,” (including extensions) for the taxable year.

(l) Effective date.—Paragraphs (a)(1)(i)(g), (h), (i), (j), and (k) of this section are applicable for taxable years ending after April 18, 1997. Paragraphs (a)(1)(i)(g)(2) and (3) apply only to distributions made on or after January 5, 2001.

(ii) Definition of fixed percentage.—The fixed percentage may be expressed either as a fraction or as a percentage and must be payable each year in the period specified in subparagraph (5) of this paragraph. A percentage is fixed if the percentage is the same either as to each recipient or as to the total percentage payable each year of such period. For example, provision for a fixed percentage which is the same every year to A until his death and concurrently a fixed percentage which is the same every year to B until his death, the fixed percentage to each recipient to terminate at his death, would satisfy the rule. Similarly, provision for a fixed percentage to A and B for their joint lives and then to the survivor would satisfy the rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the fixed percentage payable after such distribution Provided That:

(a) The reduced fixed percentage is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) Rules applicable to incorrect valuations.—The governing instrument provides that in the case where the net fair market value of the trust assets is incorrectly determined by the fiduciary, the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of § 1.664-1. See paragraph (d)(4) of § 1.664-1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to additional contributions.

(iv) Rules applicable to valuation. In computing the net fair market value of the trust assets there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking the average of valuations made on more than one date during the taxable year of the trust, so long as the same valuation date or dates and valuation methods are used each year. If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, “Split-Interest Trust Information Return,” that the trust must file. The amount described in subdivision (i)(a) of this subparagraph which must be paid each year must be based upon the valuation for such year.

(v) Computation of unitrust amount in certain circumstances—(a) Short taxable years.—The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(1) The amount determined under subdivision (i)(a) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(2) The amount determined under subdivision (i)(b) of this subparagraph shall be computed by using the amount determined under subdivision (a)(1) of this subdivision (v), and

(3) If no valuation date occurs before the end of the taxable year of the trust, the trust assets shall be valued as of the last day of the taxable year of the trust.

(b) Last taxable year of period. (1) The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(i) The unitrust amount which must be distributed under subdivision (i)(a) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(ii) The amount determined under subdivision (i)(b) of this subparagraph shall be computed by using the amount determined under (b)(1)(i) of this subdivision (v), and

(iii) If no valuation date occurs before the end of such period, the trust assets shall be valued as of the last day of such period.

(2) See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the unitrust amount with the regular payment next preceding the termination of the period specified therein.

(2) Minimum unitrust amount.—(i) General rule.—The fixed percentage described in subparagraph (1)(i) of this paragraph with respect to all beneficiaries taken together is not less than 5 percent.

(ii) Reduction of unitrust amount in certain cases.—A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the fixed percentage payable upon the death of a recipient or the expiration of a term of years Provided That:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total of the percentage payable under subparagraph (1) of this paragraph after such distribution is not less than 5 percent.

(3) Permissible recipients.—(i) General rule.—The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of creation of the trust. A

named person or persons may include members of a named class except in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the unitrust amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that the required amount shall be paid to his children living at his death.

(ii) Power to alter amount paid to recipients.—A trust is not a charitable remainder unitrust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) Other payments.—No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) Period of payment of unitrust amount—(i) General rules.—The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of a unitrust amount to A for his life and then to B for

a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of a unitrust amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) Relationship to 5 percent requirement.—The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) A fixed percentage of at least 5 percent to A and B for their joint lives and then to the survivor for his life;

(b) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years and then to B for life (provided B was living at the creation of the trust);

(d) A fixed percentage to A for his life and concurrently a fixed percentage to B for his life (the percentage to each recipient to terminate at his death) if the percentage given to each individual is not less than 5 percent;

(e) A fixed percentage to A for his life and concurrently an equal percentage to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c) if the total of the percentages is not less than 5 percent for the entire period described in this subparagraph.

(6) Permissible remaindermen.—(i) General rule.—At the end of the period specified in subparagraph (5) of this paragraph, the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) Treatment of trust.—If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as section 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) Concurrent or successive remaindermen.—Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) Alternative remaindermen.—The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of or retained for the use of one or more alternative organizations which are described in section 170(c) at such time. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) Additional contributions. A trust is not a charitable remainder annuity trust unless its governing instrument either prohibits additional contributions to the trust after the initial contribution or provides that for the taxable year of the trust in which the additional contribution is made:

(1) Where no valuation date occurs after the time of the contribution and during the taxable year in which the contribution is made, the additional property shall be valued as of the time of contribution; and

(2) The amount described in paragraph (a)(1)(i)(a) of this section shall be computed by multiplying the fixed percentage by the sum of (i) the net fair market value of the trust assets (excluding the value of the additional property and any earned income from and any appreciation on such property after its contribution), and (ii) that proportion of the value of the additional property (that was excluded under subdivision (i) of this paragraph), which the number of days in the period which begins with the date of contribution and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section bears to the number of days in the period which begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section. For purposes of this section, all property passing to a charitable remainder unitrust by reason of death of the grantor shall be considered one contribution. The application of the preceding rules may be illustrated by the following examples:

Example 1. On March 2, 1971, X makes an additional contribution of property to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is January 1 of each year. For purposes of computing the required payout with respect to the additional contribution for the year of contribution, the additional contribution is valued on March 2, 1971, the time of contribution. The property had a value on that date of \$5,000. Income from such property in the amount of \$250 was received on December 31, 1971. The required payout with respect to the additional contribution for the year of contribution is \$208 (5 percent \times \$5,000 \times 305/365). The income earned after the date of the contribution and after the regular valuation date does not enter into the computation.

Example 2. On July 1, 1971, X makes an additional contribution of \$10,000 to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is December 31 of each year. The fixed percentage is 5 percent. Between July 1, 1971, and December 31, 1971, the additional property appreciates in value to \$12,500 and earns \$500 of income. Because the regular valuation date for the year of contribution occurs after the date of the additional contribution, the additional contribution including income earned by it is valued on the regular valuation date. Thus, the required payout with respect to the additional contribution is \$325.87 (5 percent \times [\$12,500 + \$500] \times 183/365).

(c) Calculation of the fair market value of the remainder interest of a charitable remainder unitrust.—See § 1.664-4 for rules relating to the calculation of the fair market value of the remainder interest of a charitable remainder unitrust.

(d) Deduction for transfers to a charitable remainder unitrust.—For rules relating to a deduction for transfers to a charitable remainder unitrust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. The deduction allowed by section 170 for transfers to charity is limited to the fair market value of the remainder interest of a charitable remainder unitrusts regardless of whether an organization described in section 170(c) also receives a portion of the amount described in § 1.664-3(a)(1). For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or (B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

§ 1.664-4 Calculation of the fair market value of the remainder interest in a charitable remainder unitrust.—(a) Rules for determining present value.—For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664-3) is its present value determined under paragraph (d) of this section. The present value determined under this section shall be computed on the basis of—

(1) Life contingencies determined as to each life involved, from the values of lx set forth in Table 90CM contained in § 20.2031-7(d)(7) of this chapter in the case of transfers for which the valuation date is after April 30, 1999; or from Table 80CNSMT contained in § 20.2031-7A(e)(4) of this chapter in the case of transfer for which the valuation date is after April 30, 1989, and before May 1, 1999. See § 20.2031-7A(a) through (d) of this chapter, whichever is applicable, for transfers for which the valuation date is before May 1, 1989;

(2) Interest at the section 7520 rate in the case of transfers for which the valuation date is after April 30, 1989, or 10 percent in the case of transfers to charitable remainder unitrusts made after November 30, 1983, for which the valuation date is before May 1, 1989. See § 20.2031-7A(a) through (c) of this chapter, whichever is applicable, for transfers for which the valuation date is before December 1, 1983; and

(3) The assumption that the amount described in § 1.664-3(a)(1)(i)(a) is distributed in accordance with the payout sequence described in the governing instrument. If the governing instrument does not prescribe when the distribution is made during the period for which the payment is made, for purposes of this section, the distribution is considered payable on the first day of the period for which the payment is made.

(b) Actuarial Computations by the Internal Revenue Service.—The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520-1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (See § 601.601(d)(2)(ii)(b) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) Statement supporting deduction required.—Any claim for a deduction on any return for the value of a remainder interest in a charitable remainder unitrust must be

supported by a full statement attached to the return showing the computation of the present value of such interest.

(d) Valuation.—The fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664-3) for transfers for which the valuation date is after April 30, 1999, is its present value determined under paragraph (e) of this section. The fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664-3) for transfers for which the valuation date is before May 1, 1999, is its present value determined under the following sections:

Valuation Dates		
<i>After</i>	<i>Before</i>	<i>Applicable Regulations</i>
	01-01-52	1.664-4A(a)
12-31-51	01-01-71	1.664-4A(b)
12-31-70	12-01-83	1.664-4A(c)
11-30-83	05-01-89	1.664-4A(d)
04-30-89	05-01-99	1.664-4A(e)

(e) Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after April 30, 1999—(1) In general.—Except as otherwise provided in paragraph (e)(2) of this section, in the case of transfers for which the valuation date is after April 30, 1999, the present value of a remainder interest is determined under paragraphs (e)(3) through (e)(7) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under § 1.664-3(a)(1)(v) if the taxable year of the trust were to end on such date. See, however, § 1.7520-3(b) (relating to exceptions to the use of the prescribed tables under certain circumstances).

(2) Transitional rules for valuation of charitable remainder unitrusts.—(i) For purposes of sections 2055, 2106, or 2624, if on May 1, 1999, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1999, without having regained competency to dispose of the decedent’s property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1999, the present value of a remainder interest under this section is determined as if the valuation date with respect to the decedent’s gross estate is either before May 1, 1999, or after April 30, 1999, at the option of the decedent’s executor.

(ii) For purposes of sections 170, 2055, 2106, 2522, or 2624, in the case of transfers to a charitable remainder unitrust for which the valuation date is after April 30, 1999, and before July 1, 1999, the present value of a remainder interest based on one or more measuring lives is determined under this section by use of the section 7520 interest rate for the month in which the valuation date occurs (see §§ 1.7520-1(b) and 1.7520-2(a)(2)) and the appropriate actuarial tables under either paragraph (e)(7) of this section or § 1.664-4A(e)(6), at the option of the donor or the decedent’s executor, as the case may be.

(iii) For purposes of paragraphs (e)(2)(i) and (ii) of this section, where the donor or decedent’s executor is given the option to use the appropriate actuarial tables under either paragraph (e)(7) of this section or § 1.664-4A(e)(6), the donor or de-

cedent's executor must use the same actuarial table with respect to each individual transaction and with respect to all transfers occurring on the valuation date (for example, gift and income tax charitable deductions with respect to the same transfer must be determined based on the same tables, and all assets includible in the gross estate and/or estate tax deductions claimed must be valued based on the same tables).

(3) Adjusted payout rate.—For transfers for which the valuation date is after April 30, 1989, the adjusted payout rate is determined by using the appropriate Table F in paragraph (e)(6) of this section, for the section 7520 interest rate applicable to the transfer. If the interest rate is between 4.2 and 14 percent, see paragraph (e)(6) of this section. If the interest rate is below 4.2 percent or greater than 14 percent, see paragraph (b) of this section. The adjusted payout rate is determined by multiplying the fixed percentage described in § 1.664-3(a)(1)(i)(a) by the factor describing the payout sequence of the trust and the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution or distributions shall be made during the taxable year of the trust, see paragraph (a) of this section. In the case of a trust having a payout sequence for which no figures have been provided by the appropriate table, and in the case of a trust that determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see paragraph (b) of this section.

(4) Period is a term of years.—If the period described in § 1.664-3(a)(5) is a term of years, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after November 30, 1983, is the factor under the appropriate adjusted payout rate in Table D of paragraph (e)(6) of this section corresponding to the number of years in the term. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph. For purposes of this section, the valuation date is, in the case of an inter vivos transfer, the date on which the property is transferred to the trust by the donor. However, if an election is made under section 7520 and § 1.7520-2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the date of transfer falls, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. In the case of a testamentary transfer under section 2055, 2106, or 2624, the valuation date is the date of death, unless the alternate valuation date is elected under section 2032, in which event, and within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and § 1.7520-2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. The application of this paragraph (e)(4) may be illustrated by the following example:

Example. D transfers \$100,000 to a charitable remainder unitrust on January 1. The trust instrument requires that the trust pay 8 percent of the fair market value of the trust assets as of January 1st for a term of 12 years to D in quarterly payments (March 31, June 30, September 30, and December 31). The section 7520 rate for January (the month that the transfer occurred) is 9.6 percent. Under Table F(9.6) in paragraph(e)(6) of this section, the appropriate adjustment factor is .944628 for quarterly payments payable at the end of each quarter. The adjusted payout rate is $7.557 (8\% \times$

.944628). Based on the remainder factors in Table D in paragraph(e)(6) of this section, the present value of the remainder interest is \$38,950.30, computed as follows:

Factor at 7.4 percent for 12 years.....	.397495
Factor at 7.6 percent for 12 years.....	<u>.387314</u>
Difference .....	.010181

Interpolation adjustment:

$$\frac{7.557\% - 7.4\%}{0.2\%} = \frac{X}{.010181}$$

$$X = .007992$$

Factor at 7.4 percent for 12 years.....	.397495
Less: Interpolation adjustment.....	<u>.007992</u>
Interpolated factor.....	.389503

Present value of remainder interest:

$$(\$100,000 \times .389503) \dots\dots\dots \$38,950.30$$

(5) Period is the life of one individual. If the period described in § 1.664-3(a)(5) is the life of one individual, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1999, is the factor in Table U(1) in paragraph (e)(7) of this section under the appropriate adjusted payout. For purposes of the computations described in this paragraph, the age of an individual is the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in the appropriate table, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the valuation date as determined in paragraph (e)(4) of this section) of the property placed in trust by the factor determined under this paragraph (e)(5). If the adjusted payout rate is between 4.2 and 14 percent, see paragraph (e)(7) of this section. If the adjusted payout rate is below 4.2 percent or greater than 14 percent, see paragraph (b) of this section. The application of this paragraph (e)(5) may be illustrated by the following example:

Example. A, who is 44 years and 11 months old, transfers \$100,000 to a charitable remainder unitrust on January 1st. The trust instrument requires that the trust pay to A semiannually (on June 30 and December 31) 9 percent of the fair market value of the trust assets as of January 1st during A's life. The section 7520 rate for January is 9.6 percent. Under Table F(9.6) in paragraph (e)(6) of this section, the appropriate adjustment factor is .933805 for semiannual payments payable at the end of the semiannual period. The adjusted payout rate is 8.404 (9% × .933805). Based on the remainder factors in Table U(1) in paragraph (e)(7) of this section, the present value of the remainder interest is \$10,109.00, computed as follows:

Factor at 8.4 percent at age 45 .....	.10117
Factor at 8.6 percent at age 45	<u>.09715</u>
Difference .....	.00402

Interpolation adjustment:

$$\frac{8.404\% - 8.4\%}{0.2\%} = \frac{X}{.00008}$$

$$X = .007992$$

Factor at 8.4 percent at age 45 .....	.10117
Less: Interpolation adjustment .....	.00008
Interpolated Factor	<u>.10109</u>

Present value of remainder interest:

$$(\$100,000 \times .10109) = \$10,109.00$$

(6) Actuarial Table D and F (4.2 through 14.0) for transfers for which the valuation date is after April 30, 1989. For transfers for which the valuation date is after April 30, 1989, the present value of a charitable remainder unitrust interest that is dependent upon a term of years is determined by using the section 7520 rate and the tables in this paragraph (e)(6). For transfers for which the valuation date is after April 30, 1999, where the present value of a charitable remainder unitrust interest is dependent on the termination of a life interest, see paragraph (e)(5) of this section. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, "Actuarial Values, Book Beth," (1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(7) Actuarial Table U.—(1) for transfers for which the valuation date is after April 30, 1999. For transfers for which the valuation date is after April 30, 1999, the present value of a charitable remainder unitrust interest that is dependent on the termination of a life interest is determined by using the section 7520 rate, Table U(1) in this paragraph (e)(7), and Table F(4.2) through (14.0) in paragraph (e)(6) of this section. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, "Actuarial Values, Book Beth," (7-1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(f) Effective dates.—This section applies after April 30, 1999.

§ 1.664-4A Valuation of charitable remainder interests for which the valuation date is before May 1, 1999.—(a) Valuation of charitable remainder interests for which the valuation date is before January 1, 1952. There was no provision for the qualification of a charitable remainder unitrust under section 664 until 1969. See § 20.2031-7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable interest for which the valuation date is before January 1, 1952.

(b) Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971. No charitable deduction is allowable for a transfer to a unitrust for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the unitrust meets the requirements of section 664. See § 20.2031-7A(b) of this chapter (Estate Tax Regulations) for the determination of the

present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after December 31, 1970, and before December 1, 1983. For the determination of the present value of a charitable remainder unitrust for which the valuation date is after December 31, 1970, and before December 1, 1983, see § 20.2031-7A(c) of this chapter (Estate Tax Regulations) and former § 1.664-4(d) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989—(1) In general.—Except as otherwise provided in paragraph (d)(2) of this section, in the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of a remainder interest that is dependent on a term of years or the termination of the life of one individual is determined under paragraphs (d)(3) through (d)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under § 1.664-3(a)(1)(v) if the taxable year of the trust were to end on such date. The present value of the remainder interest in the trust is determined by computing the adjusted payout rate (as defined in paragraph (d)(3) of this section) and following the procedure outlined in paragraph (d)(4) or (d)(5) of this section, whichever is applicable. The present value of a remainder interest that is dependent on a term of years is computed under paragraph (d)(4) of this section. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed under paragraph (d)(5) of this section. See paragraph (d)(2) of this section for testamentary transfers for which the valuation date is after November 30, 1983, and before August 9, 1984.

(2) Rules for determining the present value for testamentary transfers where the decedent dies after November 30, 1983, and before August 9, 1984.—For purposes of section 2055 or 2106, if—

(i) The decedent dies after November 30, 1983, and before August 9, 1984; or

(ii) On December 1, 1983, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after November 30, 1983, without regaining competency to dispose of the decedent's property, or died within 90 days of the date on which the decedent first regained competency, the present value determined under this section of a remainder interest is determined in accordance with paragraph (d)(1) and paragraphs (d)(3) through (d)(6) of this section, or § 1.664-4A(c), at the option of the taxpayer.

(3) Adjusted payout rate.—The adjusted payout rate is determined by multiplying the fixed percentage described in paragraph (a)(1)(i)(a) of § 1.664-3 by the figure in column (2) of Table F(1) which describes the payout sequence of the trust opposite the number in column (1) of Table F(1) which corresponds to the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution shall be made during the taxable year of the trust, see § 1.664-4(a). In the case of a trust having a payout sequence for which no figures have been provided by Table F(1) and in the case of a trust which determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see § 1.664-4(b).

(4) Period is a term of years.—If the period described in § 1.664-3(a)(5) is a term of years, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in Table D in § 1.664-4(e)(6) that corresponds to the number of years in the term. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (d)(4). For purposes of this section, the term appropriate valuation date means the date on which the property is transferred to the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. If the adjusted payout rate is greater than 14 percent, see § 1.664-4(b). The application of this paragraph (d)(4) may be illustrated by the following example:

Example. D transfers \$100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to D semiannually (on June 30 and December 31) 10 percent of the fair market value of the trust assets as of June 30th for a term of 15 years. The adjusted payout rate is 9.767 percent (10% × 0.976731). The present value of the remainder interest is \$21,404.90, computed as follows:

Factor at 9.6 percent for 15 years.....	0.220053
Factor at 9.8 percent for 15 years.....	.212862
Difference .....	.007191

$$\frac{9.767\% - 9.6\%}{0.2\%} = \frac{X}{.007191}$$

$$X = .00604$$

Factor at 9.6 percent for 15 years.....	0.220053
Less: X .....	.006004
Interpolated factor .....	.214049
Present value of remainder interest =	

$$\$100,000 \times 0.214049 = \$21,404.90$$

(5) Period is the life of one individual.—If the period described in paragraph (a)(5) of § 1.664-3 is the life of one individual, the factor that is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table E in paragraph (d)(6) of this section opposite the number in column (1) that corresponds to the age of the individual whose life measures the period. For purposes of the computations described in this paragraph (b)(5), the age of an individual is to be taken as the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided for in Table E, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (b)(5). If the adjusted payout rate is greater than 14 percent, see § 1.664-4(b). The application of this paragraph may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers \$100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to A at the end of each taxable year of the trust 10 percent of the fair market value of the trust assets as of the beginning of each taxable year of the trust. The adjusted payout rate is 9.091 percent (10 percent \times .909091). The present value of the remainder interest is \$15,259.00 computed as follows:

Factor at 9 percent at age 50	0.15472
Factor at 9.2 percent at age 50 .....	.15003
Difference .....	.00469

$$\frac{9.091\% - 9\%}{0.2\%} = \frac{X}{.000469}$$

$$X = .00213$$

Factor at 9 percent at age 50 .....	.15472
Less: X .....	.00213
Interpolated factor .....	.15259

Present value of remainder interest =
 $\$100,000 \times 0.15259 = \$15,259.00$

(6) Actuarial tables for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989. Table D in § 1.664-4(e)(6) and the following tables shall be used in the application of the provisions of this section:

(e) Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999—
 (1) In general. Except as otherwise provided in paragraph (e)(2) of this section, in the case of transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a remainder interest is determined under paragraphs (e)(3) through (e)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under § 1.664-3(a)(1)(v) if the taxable year of the trust were to end on such date. See, however, § 1.7520-3(b) (relating to exceptions to the use of the prescribed tables under certain circumstances).

(2) Transitional rules for valuation of charitable remainder unitrusts.—(i) If the valuation date of a transfer to a charitable remainder unitrust is after April 30, 1989, and before June 10, 1994, a transferor can rely upon Notice 89-24, 1989-1 C.B. 660, or Notice 89-60, 1989-1 C.B. 700, in valuing the transferred interest. (See § 601.601(d)(2)(ii)(b) of this chapter.)

(ii) For purposes of sections 2055, 2106, or 2624, if on May 1, 1989, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1989, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1989, the present value of a remainder interest determined under this section is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1989, or after April 30, 1989, at the option of the decedent's executor.

(3) Adjusted payout rate.—For transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the adjusted payout rate is determined by using the appropriate Table F, contained in § 1.664-4(e)(6), for the section 7520 interest rate applicable to the transfer. If the interest rate is between 4.2 and 14 percent, see § 1.664-4(e)(6). If the interest rate is below 4.2 percent or greater than 14 percent, see § 1.664-4(b). See § 1.664-4(e) for rules applicable in determining the adjusted payout rate.

(4) Period is a term of years.—If the period described in § 1.664-3(a)(5) is a term of years, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, is the factor under the appropriate adjusted payout rate in Table D in § 1.664-4(e)(6) corresponding to the number of years in the term. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph. Generally, for purposes of this section, the valuation date is, in the case of an inter vivos transfer, the date on which the property is transferred to the trust by the donor, and, in the case of a testamentary transfer under sections 2055, 2106, or 2624, the valuation date is the date of death. See § 1.664-4(e)(4) for additional rules regarding the valuation date. See § 1.664-4(e)(4) for an example that illustrates the application of this paragraph (e)(4).

(5) Period is the life of one individual.—If the period described in § 1.664-3(a)(5) is the life of one individual, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, is the factor in Table U(1) in paragraph (e)(6) of this section under the appropriate adjusted payout. For purposes of the computations described in this paragraph (e)(5), the age of an individual is the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in the appropriate table, a linear interpolation must be made. The rules provided in § 1.664-4(e)(5) apply for determining the present value of the remainder interest. See § 1.664-4(e)(5) for an example illustrating the application of this paragraph (e)(5)(using current actuarial tables).

(6) Actuarial tables for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999. For transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a charitable remainder unitrust interest that is dependent on a term of years or the termination of a life interest is determined by using the section 7520 rate and Table D, Tables F(4.2) through F(14.0) in § 1.664-4(e)(6) and Table U(1) of this paragraph (e)(6), as applicable. See, however, § 1.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, "Actuarial Values, Beta Volume," (8-89). Publication 1458 is no longer available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. However, pertinent factors in this publication may be obtained by a written request to: CC:DOM:CORP:R (IRS Publication 1458), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

§ 1.665(a)-0 Excess distributions by trusts; scope of subpart D.—Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Internal Revenue Code, in the case of trusts other than foreign trusts created by U.S. persons, is designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries.

In the case of a foreign trust created by a U.S. person, Subpart D is designed to prevent certain other tax avoidance possibilities. To accomplish these ends, Subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex trust (subject to Subpart C (section 661 and following) of such Part I) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665(b) or (c). An accumulation distribution, in the case of a trust other than a foreign trust created by a U.S. person, is “thrown back” to each of the 5 preceding years in inverse order. In the case of a foreign trust created by a U.S. person such an accumulation distribution is “thrown back,” in inverse order, to each of the preceding years to which the Internal Revenue Code of 1954 applies. That is, an accumulation distribution will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, with respect to a distribution by a trust other than a foreign trust created by a U.S. person, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amount thrown back to previous years had they been included in gross income of the beneficiaries in those years. In the case of a foreign trust created by a U.S. person, the resulting tax is computed under the provisions of section 669. To prevent double taxation, both in the case of a foreign trust created by a U.S. person, and a trust other than a foreign trust created by a U.S. person, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back and which are creditable under the provisions of Chapter 1 of the Internal Revenue Code. Subpart D does not apply to any estate.

§ 1.665(a)-1 Undistributed net income.—(a) The term undistributed net income means for any taxable year the distributable net income of the trust for that year as determined under section 643(a), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on the trust, as defined in § 1.665(d)-1

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, \$10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of \$30,100 derived from royalties and the trustee made distributions of \$20,000 to A. The taxable income of the trust is \$10,000 on which a tax of \$2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is \$7,460 computed as follows:

Distributable net income	\$30,100
Less: Income currently distributable to A.....	\$10,000
Other amounts distributed to A	10,000
Taxes imposed on the trust (see § 1.665(d)-1).....	<u>2,640</u>
	<u>22,640</u>
Undistributed net income	7,460

See also paragraphs (e)(1) and (f)(1) of § 1.668(b)-2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)-6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on such trust by Chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income. For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust (for any taxable year), by Chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to the provisions of section 871 which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)-1. The amount of taxes imposed pursuant to the provisions of section 871 is the difference between the total tax imposed pursuant to the provisions of that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money or property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that \$7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1963 the trust had income of \$10,000 from dividends of a U.S. corporation (on which Federal income taxes of \$3,000 were imposed pursuant to the provisions of section 871 and withheld under section 1441 resulting in the receipt by the trust of cash in the amount of \$7,000), \$20,000 in capital gains from the sale of stock of a Country Y corporation, and \$30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. The trustee did not file a U.S. income tax return for the taxable year 1963. The distributable net income of the trust before distributions to the beneficiary for 1963 is \$60,000 (\$57,000 of which is cash). During 1963 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income or \$30,000. Thus, the U.S. beneficiary is treated as having had distributed to him \$5,000 (composed of \$3,500 as a cash distribution and \$1,500 as the tax imposed pursuant to the provisions of section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; \$10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and \$15,000 in cash, representing one-half of the income from Country X sources for a total of \$30,000. The undistributed net income of the trust at the close of taxable year 1963 is \$28,500 computed as follows:

Distributable net income.....	\$60,000
Less: (1) Amounts distributed to the beneficiary—	
Income currently distributed to the beneficiary	\$7,000
Other amounts distributed to the beneficiary.....	21,500
Taxes under sec. 871	
deemed distributed to the beneficiary	<u>1,500</u>
Total amounts distributed to the beneficiary.....	30,000

(2) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)-1).....	1,500
Total	<u>31,500</u>
Undistributed net income.....	28,500

Example 2. The facts are the same as in example (1) except that property has been transferred to the trust by a person other than a U.S. person, and during 1963 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X in 1963.

(1) The undistributed net income of the foreign trust created by a U.S. person for 1963 is \$17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):	
60% of \$10,000 U.S. dividends	\$6,000
60% of \$20,000 Country X capital gains.....	12,000
60% of \$30,000 Country X dividends	<u>18,000</u>
Total	36,000
Less: (i) Amounts distributed to the beneficiary—	
Income currently distributed to the beneficiary (60% of \$7,000)	\$4,200
Other amounts distributed to the beneficiary (60% of \$21,500)	12,900
Taxes under sec. 871 deemed distributed to the beneficiary (60% of \$1,500)	<u>900</u>
Total amounts distributed to the beneficiary.....	18,000
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)-1) (60% of \$1,500).....	
Total	<u>\$900</u>
Undistributed net income.....	17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1963 is \$11,400, computed as follows:

Distributed net income (40% of each item of gross income of entire trust)	
40% of \$10,000 U.S. dividends	\$4,000
40% of \$20,000 Country X capital gains.....	8,000
40% of Country X dividends	<u>12,000</u>
Total	24,000
Less: (i) Amounts distributed to the beneficiary—	
Income currently distributed to the beneficiary (40% of \$7,000)	\$2,800
Other amounts distributed to the beneficiary (40% of \$21,500)	8,600
Taxes under sec. 871 deemed distributed to the beneficiary (40% of \$1,500)	<u>600</u>

Total amounts distributed to the beneficiary.....	12,000
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)-1) (40% of \$1,500).....	<u>\$600</u>
Total	<u>\$12,600</u>
Undistributed net income.....	11,400

(c) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665(b), or which are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (f)(5) of § 1.668(b)-2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

§ 1.665(b)-1 Accumulation distributions of trusts other than certain foreign trusts; in general.—(a) Subject to the limitations set forth in § 1.665(b)-2, in the case of a trust other than a foreign trust created by a U.S. person, the term accumulation distribution for any taxable year means an amount (if in excess of \$2,000), by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person’s legal obligation as that term is used in § 1.662(a)-4.) If the distribution as so computed is \$2,000 or less, it is not an accumulation distribution within the meaning of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. If the distribution exceeds \$2,000, then the full amount is an accumulation distribution for the purposes of Subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, in the case of a trust other than a foreign trust created by a U.S. person, the provisions of Subpart D will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in § 1.665(b)-2 do not apply):

Example 1. A trustee properly makes a distribution to a beneficiary of \$20,000 during the taxable year 1956, of which \$10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is \$15,000. There is an accumulation distribution of \$5,000 computed as follows:

Total distribution	\$20,000
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Less: Income required to be distributed currently (section 661(a)(1))	10,000
Other amounts distributed (section 661(a)(2)).....	10,000
Distributable net income	\$15,000
Less: Income required to be distributed currently	<u>10,000</u>
Balance of distributable net income.....	<u>5,000</u>
Accumulation distribution.....	5,000

Example 2. Under the terms of the trust instrument, an annuity of \$15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of \$18,000, as defined in section 643(b), and expenses allocable to corpus of \$5,000. Distributable net income amounted to \$13,000. The trustee distributed \$15,000 of income to A and in the exercise of his discretion, paid \$5,000 to B. There is an accumulation distribution of \$5,000 computed as follows:

Total distribution	\$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))	<u>15,000</u>
Other amounts distributed (section 661(a)(2)).....	5,000
Distributable net income	\$13,000
Less: Income required to be distributed currently to A.....	<u>15,000</u>
Balance of distributable net income.....	<u>0</u>
Accumulation distribution to B.....	5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of \$22,000 and expenses of \$5,000 allocable to corpus. Distributable net income amounts to \$17,000. The trustee distributed \$10,000 each to A and B during the taxable year. There is an accumulation distribution of \$3,000 computed as follows:

Total distribution	\$20,000
Less: income required to be distributed currently.....	<u>0</u>
Other amounts distributed (section 661(a)(2)).....	20,000
Distributable net income	<u>17,000</u>
Accumulation distribution.....	3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

§ 1.665(b)-2 Exclusions from accumulation distributions in the case of trusts (other than a foreign trust created by a U.S. person).—(a) In the case of a trust other than a foreign trust created by a U.S. person, certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under Subpart C (section 661 and following) of such Part I of the beneficiary’s tax liability for the year of distribution.

Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) Distributions from accumulations while a beneficiary is under 21.—(i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However, all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited, or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665(b)(2), (3), and (4) do not apply):

(a) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed to him. The distribution is not an accumulation distribution.

(b) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(c) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(d) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(e) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(f) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663(c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

(g) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) Emergency distributions.—The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstances causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) Certain distributions at specified ages.—The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages; provided, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; and (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) Certain final distributions.—(i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term last transfer to such trust includes only transfers, whether by the original grantor or by a third person, made with a donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665(b)(4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of \$100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from \$100,000 of donated principal, accumulated income of \$30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of \$3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the \$3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in subpart C. However, the balance of the distribution will qualify as an exclusion from the provisions of subpart D.

§ 1.665(b)-3 Exclusions under section 663(a)(1).—Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, has no application to an amount

§ 1.665(c)-1 Accumulation distributions of certain foreign trusts; in general.—(a) In the case of a foreign trust created by a U.S. person, the term accumulation distribution for any taxable year means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under circumstances specified in section 677(b) and section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.)

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of Subpart D will not apply unless there is undistributed net income in at least one of the preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the examples provided in paragraph (c) of § 1.665(b)-1.

§ 1.665(c)-2 Indirect payments to the beneficiary.—(a) In general.—Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in

the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) Limitation. In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

§ 1.665(d)-1 Taxes imposed on the trust.—(a) For the purpose of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, the term taxes imposed on the trust means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust which reports on the calendar year basis the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of \$20,000 from royalties, long-term capital gains of \$10,000, and expenses of \$2,000. The trustee in his discretion made a distribution of \$10,000 to A. The taxes imposed on the trust for the purposes of this subpart are \$2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is \$18,000 (royalties of \$20,000 less expenses of \$2,000). The total taxes paid by the trust are \$3,787, computed as follows:

Royalties	\$20,000
Capital gains.....	<u>10,000</u>
Gross income	30,000
Deductions:	
Expenses	\$2,000
Distributions to A.....	10,000
Capital gain deduction	5,000
Personal exemption.....	<u>100</u>

	<u>17,100</u>
Taxable Income	12,900
Total income taxes	3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income (\$18,000) of the trust been distributed to A, is \$1,074, computed as follows:

Taxable income of the trust	\$12,900
Less: Undistributed portion of distributable net income (\$18,000 – \$10,000)	<u>8,000</u>
Balance of taxable income	4,900
Income taxes on \$4,900	1,074

(4) the amount of taxes imposed on the trust as defined in this paragraph is \$2,713, computed as follows:

Total taxes	\$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	<u>1,074</u>
Taxes imposed on the trust as defined in this paragraph.....	2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph (f)(4) of § 1.668(b)-2 for an illustration of the application of this paragraph.

§ 1.665(e)-1 Preceding taxable year.—For purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term preceding taxable year does not include any taxable year to which such part I does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of such subpart D may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under such subpart D to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) Simple trusts subject to subpart D. An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under subpart B (section 651 and following) of such part I). In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which subpart C (section 661 and following) of such part I applies. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinarily dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)-4. The trust would qualify for treatment under such subpart C for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of

the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, in the case of a trust other than a foreign trust created by a U.S. person, the distribution would qualify as an accumulation distribution for the purposes of such subpart D if in excess of \$2,000 and not excepted under section 665(b) and the regulations thereunder. In the case of a foreign trust created by a U.S. person, the distribution, regardless of the amount, would qualify as an accumulation distribution for the purposes of subpart D. For the purposes only of such subpart D, the trust would be treated as subject to the provisions of such subpart C for the preceding taxable year in which the extraordinary or taxable stock dividends were received and in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

§ 1.665(e)-2 Application of separate share rule.—In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, subpart D (section 665 and following), part I, subchapter J, of the Code, is applied as if each share were a separate trust. Thus, “undistributed net income” and the amount of an “accumulation distribution” are computed separately for each share. The “taxes imposed on the trust” are allocated as follows:

(a) There is first allocated to each separate share that portion of the “taxes imposed on the trust”, computed before the allowance of credits under section 642(a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a)(5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the “taxes imposed on the trust” which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of § 1.665(d)-1.

§ 1.665(a)-0A Excess distributions by trusts; scope of subpart D.—(a) In general.—(1) Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code as amended by the Tax Reform Act of 1969, is designed to tax the beneficiary of a trust that accumulates, rather than distributes, all or part of its income currently (i.e., an accumulation trust), in most cases, as if the income had been currently distributed to the beneficiary instead of accumulated by the trusts. Accordingly, subpart D provides

special rules for the treatment of amounts paid, credited, or required to be distributed by a complex trust (one that is subject to subpart C (section 661 and following) of such part I) in any year in excess of “distributable net income” (as defined in section 643(a)) for that year. Such an excess distribution is an “accumulation distribution” (as defined in section 665(b)). The special rules of subpart D are generally inapplicable to amounts paid, credited, or required to be distributed by a trust in a taxable year in which it qualifies as a simple trust (one that is subject to subpart B (section 651 and following) of such part I). However, see § 1.665(e)-1A(b) for rules relating to the treatment of a simple trust as a complex trust.

(2) An accumulation distribution is deemed to consist of, first, “undistributed net income” (as defined in section 665(a)) of the trust from preceding taxable years, and, after all the undistributed net income for all preceding taxable years has been deemed distributed, “undistributed capital gain” (as defined in section 665(f)) of the trust for all preceding taxable years commencing with the first year such amounts were accumulated. An accumulation distribution of undistributed capital gain is a “capital gain distribution” (as defined in section 665(g)). To the extent an accumulation distribution exceeds the “undistributed net income” and “undistributed capital gain” so determined, it is deemed to consist of corpus.

(3) The accumulation distribution is “thrown back” to the earliest “preceding taxable year” of the trust, which, in the case of distributions made for a taxable year beginning after December 31, 1973, from a trust (other than a foreign trust created by a U.S. person), is any taxable year beginning after December 31, 1968. Special transitional rules apply for distributions made in taxable years beginning before January 1, 1974. In the case of a foreign trust created by a U.S. person, a “preceding taxable year” is any year of the trust to which the Code applies.

(4) A distribution of undistributed net income (included in an accumulation distribution) and a capital gain distribution will be included in the income of the beneficiary in the year they are actually paid, credited, or required to be distributed to him. The tax on the distribution will be approximately the amount of tax the beneficiary would have paid with respect to the distribution had the income and capital gain been distributed to the beneficiary in the year earned by the trust. An additional amount equal to the “taxes imposed on the trust” for the preceding year is also deemed distributed. To prevent double taxation, however, the beneficiary receives a credit for such taxes.

(b) Effective dates.—All regulations sections under subpart D (sections 665 through 669) which have an “A” suffix (such as § 1.665(a)A and § 1.666(b)-1A) are applicable to taxable years beginning on or after January 1, 1969, and all references therein to sections 665 through 669 are references to such sections as amended by the Tax Reform Act of 1969. Sections without the “A” suffix (such as § 1.666(b)-1) are applicable only to taxable years beginning before January 1, 1969, and all references therein to sections 665 through 669 are references to such sections before amendment by the Tax Reform Act of 1969.

(c) Examples.—Where examples contained in the regulations under subpart D refer to tax rates for years after 1968, such tax rates are not necessarily the actual rates for such years, but are only used for example purposes.

(d) Applicability to estates.—Subpart D does not apply to any estate.

§ 1.665(a)-1A Undistributed net income.—(a) Domestic trusts.—The term undistributed net income, in the case of a trust (other than a foreign trust created by a U.S. person) means, for any taxable year beginning after December 31, 1968, the distributable net income of the trust for that year (as determined under section 643(a)), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on the trust attributable to such distributable net income, as defined in § 1.665(d)-1A. The application of the rule in this paragraph to a taxable year of a trust in which income is accumulated may be illustrated by the following example:

Example. Under the terms of the trust, \$10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1971 the trust had distributable net income of \$30,100 derived from royalties and the trustee made distributions of \$20,000 to A. The taxable income of the trust is \$10,000 on which a tax of \$2,190 is paid. The undistributed net income of the trust for the taxable year 1971 is \$7,910, computed as follows:

Distributable net income	\$30,100
Less: Income currently distributable to A	\$10,000
Other amounts distributed to A	10,000
Taxes imposed on the trust attributable to the undistributed net income (see § 1.665(d)-1A)	<u>2,190</u>
Total	<u>22,190</u>
Undistributed net income	7,910

(b) Foreign trusts. The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)-6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income. For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust for any taxable year by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to section 871 (relating to tax on non-resident alien individuals) which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)-1A. The amount of taxes imposed pursuant to section 871 is the difference between the total tax imposed pursuant to that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that \$7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1973 the trust had income of \$10,000 from dividends of a U.S. corporation (on which Federal income taxes of \$3,000 were imposed pursuant to section 871 and withheld under section 1441, resulting in the receipt by the trust of cash in the amount of \$7,000), \$20,000 in capital gains from the sale of stock of a Country Y cor-

poration and \$30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. No income taxes were required to be paid to Country X or Country Y in 1973. The trustee did not file a U.S. income tax return for the taxable year 1973. The distributable net income of the trust before distributions to the beneficiary for 1973 is \$60,000 (\$57,000 of which is cash). During 1973 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income. Thus, the U.S. beneficiary is treated as having had distributed to him \$5,000 (composed of \$3,500 as a cash distribution and \$1,500 as the tax imposed pursuant to section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; \$10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and \$15,000 in cash, representing one-half of the income from Country X sources for a total of \$30,000. The undistributed net income of the trust at the close of taxable year 1973 is \$28,500 computed as follows:

Distributable net income	\$60,000
Less:	
Amounts distributed to the beneficiary:	
Income currently distributed to the beneficiary	\$7,000
Other amounts distributed to the beneficiary	21,500
Taxes under sec. 871 deemed distributed to the beneficiary	<u>1,500</u>
Total amounts distributed to the beneficiary	30,000
Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665(d)-1A)	
\$3,000 less \$1,500)	<u>\$1,500</u>
Total	<u>\$31,500</u>
Undistributed net income	28,500

Example 2. The facts are the same as in example 1 except that property has been transferred to the trust by a person other than a U.S. person, and during 1973 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X or Country Y in 1973.

(1) The undistributed net income of the portion of the entire trust which is a foreign trust created by a U.S. person for 1973 is \$17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):	
60% of \$10,000 U.S. dividends	\$6,000
60% of \$20,000 Country X capital gains	12,000
60% of \$30,000 Country X dividends	<u>18,000</u>
Total	36,000
Less:	
(i) Amounts distributed to the beneficiary—	
Income currently distributed to the beneficiary (60% of \$7,000)	\$4,200
Other amounts distributed to the beneficiary (60% of \$21,500)	12,900

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Taxes under sec. 871 deemed distributed to the beneficiary (60% of \$1,500)	<u>900</u>
Total amounts distributed to the beneficiary	18,000
(ii) Amount of taxes imposed on the trust under chapter of the Code attributable to the undistributed net income (see § 1.665(d)-1A) (60% of \$1,500).....	<u>900</u>
Total	<u>18,900</u>
Undistributed net income	17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1973 is \$11,400, computed as follows:

Distributable net income (40% of each item of gross income of entire trust)	
40% of \$10,000 U.S. dividends	\$4,000
40% of \$20,000 Country X capital gains	8,000
40% of \$30,000 Country X dividends	<u>12,000</u>
Total	24,000

Less:

(i) Amounts distributed to the beneficiary—	
Income currently distributed to the beneficiary	
(40% of \$7,000)	\$2,800
Other amounts distributed to the beneficiary	
(40% of \$21,500)	8,600
Taxes under sec. 871 deemed distributed to the beneficiary	
(40% of \$1,500)	<u>600</u>
Total amounts distributed to the beneficiary	12,000
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665(d)-1A) (40% of \$1,500).....	
	600
Total	<u>12,600</u>
Undistributed net income	11,400

(c) Effect of prior distributions.—The undistributed net income for any year to which an accumulation distribution for a later year may be thrown back will be reduced by accumulation distributions in intervening years that are required to be thrown back to such year. For example, if a trust has undistributed net income for 1975, and an accumulation distribution is made in 1980, there must be taken into account the effect on undistributed net income for 1975 of any accumulation distribution made in 1976, 1977, 1978, or 1979. However, undistributed net income for any year will not be reduced by any distributions in any intervening years that are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (d) of § 1.666(a)-1A for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

(d) Distributions made in taxable years beginning before January 1, 1974. For special rules relating to accumulation distributions of undistributed net income made in taxable years of the trust beginning before January 1, 1974, see § 1.665(b)-2A.

§ 1.665(b)-1A Accumulation distributions.—(a) In general.—(1) For any taxable year of a trust the term accumulation distribution means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) (i.e., all amounts properly paid, credited, or required to be distributed to the beneficiary other than income required to be distributed currently within the meaning of section 661(a)(1)) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. To the extent provided in section 663(b) and the regulations thereunder, distributions made within the first 65 days following a taxable year may be treated as having been distributed on the last day of such taxable year.

(2) An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year of the trust by reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year. No accumulation distribution is deemed to be made solely because the grantor or any other person is treated as owner of a portion of the trust by reason of an unexercised power to appoint, distribute, consume, or withdraw corpus or accumulated income of the trust. Nor will an accumulation distribution be deemed to have been made by reason of the exercise of a power that may affect only taxable income previously attributed to the holders of such power under subpart E (section 671 and following). See example 4 of paragraph (d) of this section for an example of an accumulation distribution occurring as a result of the exercise of a power of withdrawal.

(3) Although amounts properly paid or credited under section 661(a) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if the amounts properly paid or credited under section 661(a)(2) exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently under section 661(a)(1). This may occur, for example, when expenses, interest, taxes, or other items allocable to corpus are taken into account in determining taxable income and hence causing distributable net income to be less than the trust's income.

(b) Payments that are accumulation distributions.—The following are some instances in which an accumulation distribution may arise:

(1) One trust to another.—A distribution from one trust to another trust is generally an accumulation distribution. See § 1.643(c)-1. This general rule will apply regardless of whether the distribution is to an existing trust or to a newly created trust and regardless of whether the trust to which the distribution is made was created by the same person who created the trust from which the distribution is made or a different person. However, a distribution made from one trust to a second trust will be deemed an accumulation distribution by the first trust to an ultimate beneficiary of the second trust if the primary purpose of the distribution to the second trust is to avoid the capital gain distribution provisions (see section 669 and the regulations thereunder). An amount passing from one separate share of a trust to another separate share of the same trust is not an accumulation distribution. See § 1.665(g)-2A. For rules relating to the computation of the beneficiary's tax under section 668 by reason of an accumulation distribution from the second trust, see paragraphs (b)(1) and (c)(1)(i) of § 1.668(b)-1A and paragraphs (b)(1) and (c)(1)(i) of § 1.669(b)-1A.

(2) Income accumulated during minority.—A distribution of income accumulated during the minority of the beneficiary is generally an accumulation distribution. For example, if a trust accumulates income until the beneficiary's 21st birthday, and

then distributes the income to the beneficiary, such a distribution is an accumulation distribution. However, see § 1.665(b)-2A for rules governing income accumulated in taxable years beginning before January 1, 1969.

(3) Amounts paid for support.—To the extent that amounts forming all or part of an accumulation distribution are applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) or are used to discharge or satisfy any person’s legal obligation as that term is used in § 1.662(a)-4, such amounts will be considered as having been distributed directly to the person whose obligation is being satisfied.

(c) Payments that are not accumulation distributions.—(1) Gifts, bequests, etc., described in section 663(a)(1). A gift or bequest of a specific sum of money or of specific property described in section 663(a)(1) is not an accumulation distribution.

(2) Charitable payments.—Any amount paid, permanently set aside, or used for the purposes specified in section 642(c) is not an accumulation distribution, even though no charitable deduction is allowed under such section with respect to such payment.

(3) Income required to be distributed currently.—No accumulation distribution will arise by reason of a payment of income required to be distributed currently even though such income exceeds the distributable net income of the trust because the payment is an amount specified in section 661(a)(1).

(d) Examples.—The provisions of this section may be illustrated by the following examples:

Example 1. A trustee properly makes a distribution to a beneficiary of \$20,000 during the taxable year 1976, of which \$10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is \$15,000. There is an accumulation distribution of \$5,000 computed as follows:

Total distribution	\$20,000
Less: Income required to be distributed currently (section 661(a)(1))	10,000
Other amounts distributed (section 661(a)(2)).....	10,000
Distributable net income	\$15,000
Less: Income required to be distributed currently	<u>10,000</u>
Balance of distributable net income.....	<u>5,000</u>
Accumulation distribution.....	5,000

Example 2. Under the terms of the trust instrument, an annuity of \$15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of \$18,000, as defined in section 643(b), and expenses allocable to corpus of \$5,000. Distributable net income amounted to \$13,000. The trustee distributed \$15,000 of income to A and, in the exercise of his discretion, paid \$5,000 to B. There is an accumulation distribution of \$5,000 computed as follows:

Total distribution	\$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))	<u>15,000</u>
Other amounts distributed (section 661(a)(2)).....	5,000
Distributable net income	\$13,000

Less: Income required to be distributed currently to A	15,000
Balance of distributable net income	<u>0</u>
Accumulation distribution to B	5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of \$22,000 and expenses of \$5,000 allocable to corpus. Distributable net income amounts to \$17,000. The trustee distributed \$10,000 each to A and B during the taxable year. There is an accumulation distribution of \$3,000 computed as follows:

Total distribution	\$20,000
Less: Income required to be distributed currently	0
Other amounts distributed (section 661(a)(2))	20,000
Distributable net income	\$17,000
Less: Income required to be distributed currently	<u>0</u>
Balance of distributable net income	<u>17,000</u>
Accumulation distribution	3,000

Example 4. A dies in 1974 and bequeaths one-half the residue of his estate in trust. His widow, W, is given a power, exercisable solely by her, to require the trustee to pay her each year of the trust \$5,000 from corpus. W's right to exercise such power was exercisable at any time during the year but was not cumulative, so that, upon her failure to exercise it before the end of any taxable year of the trust, her right as to that year lapsed. The trust's taxable year is the calendar year. During the calendar years 1975 and 1976, W did not exercise her right and it lapsed as to those years. In the calendar years 1977 and 1978, in which years the trust had no distributable net income, she exercised her right and withdrew \$4,000 in 1977 and \$5,000 in 1978. No accumulation distribution was made by the trust in the calendar years 1975 and 1976. An accumulation distribution of \$4,000 was made in 1977 and an accumulation distribution of \$5,000 was made in 1978. The accumulation distribution for the years 1977 and 1978 is not reduced by any amount of income of the trust attributable to her under section 678 by reason of her power of withdrawal.

§ 1.665(b)-2A Special rules for accumulation distributions made in taxable years beginning before January 1, 1974.—(a) General rule.—Section 331(d)(2)(A) of the Tax Reform Act of 1969 excludes certain accumulated income from the tax imposed by section 668(a)(2) by providing certain exceptions from the definition of an “accumulation distribution.” Any amount paid, credited, or required to be distributed by a trust (other than a foreign trust created by a U.S. person) during a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, shall not be subject to the tax imposed by section 668(a)(2) to the extent of the portion of such amount that (1) would be allocated under section 666(a) to a preceding taxable year of the trust beginning before January 1, 1969, and (2) would not have been deemed an accumulation distribution because of the provisions of paragraphs (1), (2), (3), or (4) of section 665(b) as in effect on December 31, 1968, had the trust distributed such amounts on the last day of its last taxable year beginning before January 1, 1969. However, the \$2,000 de minimis exception formerly in section 665(b) does not apply in the case of any distribution made in a taxable year of a trust beginning after December 31, 1968. Amounts to which this exclusion applies shall reduce the undistributed net income of the trust for the preceding taxable year or years to which such amounts would

be allocated under section 666(a). However, since section 668(a)(2) does not apply to such amounts, no amount of taxes imposed on the trust allocable to such undistributed net income is deemed distributed under section 666(b) and (c).

(b) Application of general rule.—The rule expressed in paragraph (a) of this section is applied to the exceptions formerly in section 665(b) as follows:

(1) Distributions from amounts accumulated while beneficiary is under 21. (i) Paragraph (1) of section 665(b) as in effect on December 31, 1968, provided that amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21 were not to be considered to be accumulation distributions. If an accumulation distribution is made in a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) to the extent the income earned by the trust for such preceding taxable year would be deemed under § 1.665(b)-2(b)(1) to have been accumulated before the beneficiary's birth or before his 21st birthday. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on the calendar year basis was established on January 1, 1965, to accumulate the income during the minority of B, and to pay the accumulated income over to B upon his attaining the age of 21. B's 21st birthday is January 1, 1973. On January 2, 1973, the trustee pays over to B all the accumulated income of the trust. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)-1A). To the extent the distribution is allocated to 1968, no tax is imposed under section 668(a)(2).

(ii) As indicated in paragraph (a) of this section, a distribution of an amount excepted from the tax otherwise imposed under section 668(a)(2) will reduce undistributed net income for the purpose of determining the effect of a future distribution. Thus, under the facts of the example in subdivision (i) of this subparagraph, the undistributed net income for the trust's taxable year 1968 would be reduced by the amount of the distribution allocated to that year under section 666(a).

(2) Emergency distributions.—Paragraph (2) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary to meet his emergency needs. Therefore, if an accumulation distribution is made from a trust in a taxable year beginning before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) if such distribution would have been considered an emergency distribution under § 1.665(b)-2(b)(2) had it been made in a taxable year of the trust beginning before January 1, 1969. For example, assume a trust on a calendar year basis in 1972 makes an accumulation distribution which under § 1.665(b)-2(b)(2) would be considered an emergency distribution and under section 666(a) the distribution would be allocated to the years 1967, 1968, and 1969. To the extent such amount is allocated to 1967 and 1968, no tax would be imposed under section 668(a)(2).

(3) Certain distributions at specified ages.—Paragraph (3) of section 665(b) as in effect on December 31, 1968, provided an exclusion (in the case of certain trusts created before January 1, 1954) from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary upon his attaining a specified age or ages, subject to certain restrictions (see § 1.665(b)-2(b)(3)). Therefore, a distribution from a trust in a taxable year beginning after December 31, 1968, will not be subject to

the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such distribution would have qualified under the provisions of § 1.665(b)-2(b)(3) had it been made in a taxable year of the trust to which such section was applicable.

(4) Certain final distributions.—Paragraph (4) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution was made more than 9 years after the date of the last transfer to such trust. Therefore, amounts properly paid or credited to a beneficiary as a final distribution of a trust in a taxable year of a trust beginning after December 31, 1968, and before January 1, 1974, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such final distribution was made more than 9 years after the date of the last transfer to such trust. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on a calendar year basis was established on January 1, 1958, and no additional transfers were made to it. On January 1, 1973, the trustee terminates the trust and on the same day he makes a final distribution to the beneficiary, B. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)-1A). Because more than 9 years elapsed between the date of the last transfer to the trust and the date of final distribution, the distribution is not taxed under section 668(a)(2) to the extent it would be allocated to 1968 under section 666(a).

§ 1.665(c)-1A Special rule applicable to distributions by certain foreign trusts.—(a) In general.—Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) Limitation.—In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

§ 1.665(d)-1A Taxes imposed on the trust.—(a) In general.—(1) For purposes of subpart D, the term taxes imposed on the trust means the amount of Federal income taxes properly imposed for any taxable year on the trust that are attributable to the un-

distributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. Except as provided in paragraph (c)(2) of this section, the minimum tax for tax preferences imposed by section 56 is not a tax attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. See section 56 and the regulations thereunder.

(2) In the case of a trust that has received an accumulation distribution from another trust, the term taxes imposed on the trust also includes the amount of taxes deemed distributed under §§ 1.666(b)-1A, 1.666(c)-1A, 1.669(d)-1A, and 1.669(e)-1A (whichever are applicable) as a result of such accumulation distribution, to the extent that they were taken into account under paragraphs (b)(2) or (c)(1)(vi) of § 1.668(b)-1A and (b)(2) or (c)(1)(vi) of § 1.669(b)-1A in computing the partial tax on such accumulation distribution. For example, assume that trust A, a calendar year trust, makes an accumulation distribution in 1975 to trust B, also on the calendar year basis, in connection with which \$500 of taxes are deemed under § 1.666(b)-1A to be distributed to trust B. The partial tax on the accumulation distribution is computed under paragraph (b) of § 1.668(b)-1A (the exact method) to be \$600 and all of the \$500 is used under paragraph (b)(2) of § 1.668(b)-1A to reduce the partial tax to \$100. The taxes imposed on trust B for 1975 will, in addition to the \$100 partial tax, also include the \$500 used to reduce the partial tax.

(b) Taxes imposed on the trust attributable to undistributed net income.—(1) For the purpose of subpart D, the term taxes imposed on the trust attributable to the undistributed net income means the amount of Federal income taxes for the taxable year properly allocable to the undistributed portion of the distributable net income for such taxable year. This amount is (i) an amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax for tax preferences imposed by section 56), computed after the allowance of credits under section 642(a), as (a) the taxable income of the trust, other than the capital gains not included in distributable net income less their share of section 1202 deduction, bears to (b) the total taxable income of the trust for such year or, (ii) if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, an amount equal to such total taxes less the amount of the alternative tax imposed on the trust and attributable to the capital gain. Thus, for the purposes of subpart D, in determining the amount of taxes imposed on the trust attributable to the undistributed net income, that portion of the taxes paid by the trust attributable to capital gain allocable to corpus is excluded. The rule stated in this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1974, the trust had income of \$20,000 from royalties, long-term capital gains of \$10,000, and expenses of \$2,000. The trustee in his discretion made a distribution of \$10,000 to A. The taxes imposed on the trust for such year attributable to the undistributed net income are \$2,319, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is \$18,000 (royalties of \$20,000 less expenses of \$2,000). The total taxes paid by the trust are \$3,787, computed as follows:

Royalties	\$20,000
Capital gain allocable to corpus	<u>10,000</u>
Gross income	30,000

Deductions:	
Expenses	\$2,000
Distributions to A.....	10,000
Capital gain deduction	5,000
Personal exemption.....	<u>100</u>
	<u>17,100</u>
Taxable income	12,900
Total income taxes	3,787

(3) Taxable income other than capital gains less the section 1202 deduction is \$7,900 (\$12,900 – (\$10,000 – \$5,000)). Therefore, the amount of taxes imposed on the trust attributable to the undistributed net income is \$2,319, computed as follows:

\$3,787 (total taxes) × \$7,900	
(taxable income other than capital gains	
not included in d.n.i. less the 1202 deduction)	
divided by \$12,900 (taxable income).....	\$2,319

(2) If in any taxable year an accumulation distribution of undistributed net income is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed net income of such prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 666(b) or (c). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1975 the trust makes an accumulation distribution, of which an amount of undistributed net income is deemed distributed in 1974. Taxes imposed on the trust (in the amount of \$1,000) attributable to the undistributed net income are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust subsequent to the 1975 distribution attributable to the remaining undistributed net income are \$1,319 (\$2,319 less \$1,000).

(c) Taxes imposed on the trust attributable to undistributed capital gain.—(1) Regular tax.—For the purpose of subpart D the term taxes imposed on the trust attributable to undistributed capital gain means the amount of Federal income taxes for the taxable year properly attributable to that portion of the excess of capital gains over capital losses of the trust that is allocable to corpus for such taxable year. Such amount is the total of:

(i) The amount computed under subparagraph (2) of this paragraph (the minimum tax), plus

(ii) The amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax), computed after the allowance of credits under section 642(a), as (a) the excess of capital gains over capital losses for such year that are not included in distributable net income, computed after its share of the deduction under section 1202 (relating to the deduction for capital gains) has been taken into account, bears to the greater of (b) the total taxable income of the trust for such year, or (c) the amount of capital gains computed under (a) of this subdivision. However, if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, the amount is the amount of the alternative tax imposed on the trust and attributable to the capital gain. The application of this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. Assume the same facts as in the example in paragraph (b)(1). The capital gains not included in d.n.i. are \$10,000, and the deduction under section 1202 is \$5,000. The amount of taxes imposed on the trust attributable to undistributed capital gain is \$1,468, computed as follows:

\$3,787 (total taxes) × \$5,000
 (capital gains not included in d.n.i. less
 section 1202 deductions)
 divided by \$12,900 (taxable income)..... \$1,468

(2) Minimum tax.—The term taxes imposed on the trust attributable to the undistributed capital gain also includes the minimum tax for tax preferences imposed on the trust by section 56 with respect to the undistributed capital gain. The amount of such minimum tax so included bears the same relation to the total amount of minimum tax imposed on the trust by section 56 for the taxable year as one-half the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) from such taxable year bears to the sum of the items of tax preference of the trust for such taxable year which are apportioned to the trust in accordance with § 1.58-3(a)(1).

(3) Reduction for prior distribution.—If in any taxable year a capital gain distribution is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed capital gain of the prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 669(d) or (e). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1976, the trust makes a capital gain distribution, of which an amount of undistributed capital gain is deemed distributed in 1974. Taxes imposed on the trust (in the amount of \$500) attributable to the undistributed capital gain are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust attributable to the remaining undistributed capital gain are \$968 (\$1,468 less \$500).

§ 1.665(e)-1A Preceding taxable year.—(a) Definition—(1) Domestic trusts—(i) In general.—For purposes of subpart D, in the case of a trust other than a foreign trust created by a U.S. person, the term preceding taxable year serves to identify and limit the taxable years of a trust to which an accumulation distribution consisting of undistributed net income or undistributed capital gain may be allocated (or “thrown back”) under section 666(a) and 669(a). An accumulation distribution consisting of undistributed net income or undistributed capital gain may not be allocated or “thrown back” to a taxable year of a trust if such year is not a “preceding taxable year.”

(ii) Accumulation distributions.—In the case of an accumulation distribution consisting of undistributed net income made in a taxable year beginning before January 1, 1974, any taxable year of the trust that precedes by more than 5 years the taxable year of the trust in which such accumulation distribution was made is not a “preceding taxable year.” Thus, for a domestic trust on a calendar year basis, calendar year 1967 is not a “preceding taxable year” with respect to an accumulation distribution made in calendar year 1973, whereas calendar year 1968 is a “preceding taxable year.” In the case of an accumulation distribution made during a taxable year beginning after December 31, 1973, any taxable year of the trust that begins before January 1, 1969, is not a “preceding taxable year.” Thus, for a domestic trust on a calendar year basis, calendar year 1968 is not a “preceding taxable year” with respect to an accumulation distribution made in calendar year 1975, whereas calendar year 1969 is a “preceding taxable year.”

(iii) Capital gain distributions.—In the case of an accumulation distribution that is a capital gain distribution, any taxable year of the trust that (a) begins before January 1, 1969, or (b) is prior to the first year in which income is accumulated, whichever occurs later, is not a “preceding taxable year.” Thus, for the purpose of capital gain distributions and section 669, only taxable years beginning after December 31, 1968, can be “preceding taxable years.” See § 1.688(a)-1A(c).

(2) Foreign trusts created by U.S. persons.—For purposes of Subpart D, in the case of a foreign trust created by a U.S. person, the term “preceding taxable year” does not include any taxable year to which Part I of Subchapter J does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of Subpart D may not, in the case of a foreign trust created by a U.S. person, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a foreign trust created by a U.S. person (reporting on the calendar year basis) makes a distribution during the calendar year 1970 of income accumulated during prior years, the earliest year of the trust to which the accumulation distribution may be allocated under such Subpart D is 1954, but it may not be allocated to 1953 and prior years, since the Internal Revenue Code of 1939 applies to those years.

(b) Simple trusts.—A taxable year of a trust during which the trust was a simple trust (that is, was subject to Subpart B) for the entire year shall not be considered a “preceding taxable year” unless during such year the trust received “outside income” or unless the trustee did not distribute all of the income of the trust that was required to be distributed currently for such year. In such event, undistributed net income for such year shall not exceed the greater of the “outside income” or income not distributed during such year. For purposes of this paragraph, the term outside income means amounts that are included in distributable net income of the trust for the year but that are not “income” of the trust as that term is defined in § 1.643(b)-1. Some examples of “outside income” are:

- (1) Income taxable to the trust under section 691;
- (2) Unrealized accounts receivable that were assigned to the trust; and
- (3) Distributions from another trust that include distributable net income or undistributed net income of such other trust.

The term outside income, however, does not include amounts received as distributions from an estate, other than income specified in (1) and (2), for which the estate was allowed a deduction under section 661(a). The application of this paragraph may be illustrated by the following examples:

Example 1. By his will D creates a trust for his widow W. The terms of the trust require that the income be distributed currently (i.e., it is a simple trust), and authorize the trustee to make discretionary payments of corpus to W. Upon W’s death the trust corpus is to be distributed to D’s then living issue. The executor of D’s will makes a \$10,000 distribution of corpus to the trust that carries out estate income consisting of dividends and interest to the trust under section 662(a)(2). The trust reports this income as its only income on its income tax return for its taxable year in which ends the taxable year of the estate in which the \$10,000 distribution was made, and pays a tax thereon of \$2,106. Thus, the trust has undistributed net income of \$7,894 (\$10,000-\$2,106). Several years later the trustee makes a discretionary corpus payment of \$15,000 to W. This payment is an accumulation distribution under section 665(b). However, since the trust had no “outside income” in the year of the estate distribution, such year is not a preceding taxable year. Thus, W is not treated as receiving undistributed net income of \$7,894 and taxes thereon of \$2,106 for the purpose of including the same in her gross income under section 668. The result would be the same if the invasion power were not exer-

cised and the accumulation distribution occurred as a result of the distribution of the corpus to D's issue upon the death of W.

Example 2. Trust A, a simple trust on the calendar year basis, received in 1972 extraordinary dividends or taxable stock dividends that the trustee in good faith allocated to corpus, but that are determined in 1974 to have been currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)-4. Trust A would qualify for treatment under Subpart C for 1974, the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and is treated as another amount properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, the distribution in 1974 qualifies as an accumulation distribution for the purposes of Subpart D. For purposes only of such Subpart D, trust A would be treated as subject to the provisions of such Subpart C for 1972, the preceding taxable year in which the extraordinary or taxable stock dividends were received, and, in computing undistributed net income for 1972, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in 1974 was made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

§ 1.665(f)-1A Undistributed capital gain.—(a) Domestic trusts.—(1) The term undistributed capital gain means (in the case of a trust other than a foreign trust created by a U.S. person), for any taxable year of the trust beginning after December 31, 1968, the gains in excess of losses for that year from the sale or exchange of capital assets of the trust less:

(i) The amount of such gains that are included in distributable net income under section 643(a)(3) and § 1.643(a)-3,

(ii) The amount of taxes imposed on the trust for such year attributable to such gains, as defined in § 1.665(d)-1A, and

(iii) In the case of a trust that does not use the alternative method for computing taxes on capital gains of the taxable year, the excess of deductions (other than deductions allowed under section 642(b) relating to personal exemption or section 642(c) relating to charitable contributions) over distributable net income for such year to the extent such excess deductions are properly allowable in determining taxable income for such year. For purposes of computing the amount of capital gain under this paragraph, no deduction under section 1202, relating to deduction for excess of capital gains over capital losses, shall be taken into account. The application of this subparagraph may be illustrated by the following example:

Example. Under the terms of the trust, the trustee must distribute all income currently and has discretion to distribute capital gain to A or to allocate it to corpus. During the taxable year 1971 the trust recognized capital gain in the amount of \$15,000, and capital losses of \$5,000, and had interest income (after expenses) of \$6,000. The trustee distributed \$8,000 to A, consisting of \$6,000 of interest and \$2,000 of capital gain. The \$2,000 of gain distributed to A is included in the computation of distributable net income under § 1.643(a)-3. The balance of the capital gain is not included in distributable net income since it is allocated to corpus and not paid, credited, or required to be distributed to any beneficiary. The trust paid taxes of \$671, all of which are attributable under § 1.665(d)-1A to the undistributed capital gain. The amount of undistributed capital gain of the trust for 1971 is therefore \$7,329, computed as follows:

Total capital gains	\$15,000
Less:	

Capital losses	5,000	
Gains in excess of losses.....		10,000
Less:		
Amount of capital gain included in distributable net income.....	2,000	
Taxes imposed on the trust attributable to the undistributed capital gain (see § 1.665(d)-1A)	<u>671</u>	
		<u>2,671</u>
Undistributed capital gain		7,329

(2) For purposes of subparagraph (1) of this paragraph, the term losses for that year includes losses of the trusts from the sale or exchange of capital assets in preceding taxable years not included in the computation of distributable net income of any year, reduced by such losses taken into account in a subsequent preceding taxable year in computing undistributed capital gain but not reduced by such losses taken into account in determining the deduction under section 1211. See section 1212(b)(2) and the regulations thereunder. For example, assume that a trust had a net long-term capital loss in 1970 of \$5,000. During the years 1971 through 1975, the trust had no capital gains or capital losses. In 1976, it has a long-term capital gain of \$8,000, which it allocates to corpus and does not distribute to a beneficiary, but has no taxes attributable to such gain. The undistributed capital gain for 1976 is \$8,000 – \$5,000, or \$3,000, even though all or a part of the \$5,000 loss was claimed under section 1211 as a deduction in years 1970 through 1975.

(b) Foreign trusts.—Distributable net income for a taxable year of a foreign trust created by a U.S. person includes capital gains in excess of capital losses for such year (see § 1.643(a)-6(a)(3)). Thus, a foreign trust created by a U.S. person can never have any undistributed capital gain.

§ 1.665(g)-1A Capital gain distribution.—For any taxable year of a trust, the term capital gain distribution means, to the extent of the undistributed capital gain of the trust, that portion of an accumulation distribution that exceeds the amount of such accumulation distribution deemed under section 666(a) to be undistributed net income of the trust for all preceding taxable years. See § 1.665(b)-1A for the definition of “accumulation distribution”. For any such taxable year the undistributed capital gain includes the total undistributed capital gain for all years of the trust beginning with the first taxable year beginning after December 31, 1968, in which income (as determined under section 643(b)) is accumulated, and ending before such taxable year. See § 1.665(g)-2A for application of the separate share rule. The application of this section may be illustrated by the following example:

Example. A trust on the calendar year basis made the following accumulations.—For purposes of this example, the undistributed net income is the same as income under applicable local law. No income was accumulated prior to 1970.

Year	Undistributed net income	Undistributed capital gain
1969	None	\$10,000
1970	\$1,000	3,000
1971	None	4,000

The trust has distributable net income in 1972 of \$2,000 and recognizes capital gains of \$4,500 that are allocable to corpus. On December 31, 1972, the trustee makes a distribution of \$20,000 to the beneficiary. There is an accumulation distribution of \$18,000 (\$20,000 distribution less \$2,000 d.n.i.) that consists of undistributed net income of \$1,000 (see § 1.666(a)-1A) and a capital gain distribution of \$7,000. The capital gain distribution is computed as follows:

Accumulation distribution.....	\$18,000	
Less: Undistributed net income	<u>1,000</u>	
Balance.....		17,000
Capital gain distribution (undistributed capital gain of the trust for 1972 ((\$3,000 from 1970 and \$4,000 from 1971)).....		<u>7,000</u>
Balance (corpus)		10,000

No undistributed capital gain is deemed distributed from 1969 because 1969 is a year prior to the first year in which income is accumulated (1970). The accumulation distribution is not deemed to consist of any part of the capital gains recognized in 1972.

§ 1.665(g)-2A Application of separate share rule.—(a) In general.—If the separate share rule of section 663(c) is applicable for any taxable year of a trust, Subpart D is applied as if each share were a separate trust except as provided in paragraph (c) of this section and in § 1.668(a)-1A(c). Thus, the amounts of an “accumulation distribution”, “undistributed net income”, “undistributed capital gain”, and “capital gain distribution” are computed separately for each share.

(b) Allocation of taxes—undistributed net income. The “taxes imposed on the trust attributable to the undistributed net income” are allocated as follows:

(1) There is first allocated to each separate share that portion of the “taxes imposed on the trust attributable to the undistributed net income” (as defined in § 1.665(d)-1A(b)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(i) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a)(5), (6), and (7); and

(ii) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the “taxes imposed on the trust” that bears the same relation to the total of such credits that the items of distributable net income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust.

(c) Allocation of taxes.—undistributed capital gain.—The “taxes imposed on the trust attributable to undistributed capital gain” are allocated as follows:

(1) There is first allocated to each separate share that portion of the “taxes imposed on the trust attributable to undistributed capital gain” (as defined in § 1.665(d)-1A(c)), computed before the allowance of any credits under section 642(a), that bears

the same relation to the total of such taxes that the undistributed capital gain (prior to the deduction of taxes under section 665(c)(2)) of the separate share bears to the total such undistributed capital gain of the trust.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the “taxes imposed on the trust” that bears the same relation to the total of such credits that the capital gain allocable to the separate share with respect to which the credit is allowed bear to the total of such capital gain of the trust.

(d) Termination of a separate share.—(1) If upon termination of a separate share, an amount is properly paid, credited, or required to be distributed by the trust under section 661(a)(2) to a beneficiary from such share, an accumulation distribution will be deemed to have been made to the extent of such amount. In determining the distributable net income of such share, only those items of income and deduction for the taxable year of the trust in which such share terminates, properly allocable to such share, shall be taken into consideration.

(2) No accumulation distribution will be deemed to have been made upon the termination of a separate share to the extent that the property constituting such share, or a portion thereof, continues to be held as a part of the same trust. The undistributed net income, undistributed capital gain, and the taxes imposed on the trust attributable to such items, if any, for all preceding taxable years (reduced by any amounts deemed distributed under sections 666(a) and 669(a) by reason of any accumulation distribution of undistributed net income or undistributed capital gain in prior years or the current taxable year), which were allocable to the terminating share, shall be treated as being applicable to the trust itself. However, no adjustment will be made to the amounts deemed distributed under sections 666 and 669 by reason of an accumulation distribution of undistributed net income or undistributed capital gain from the surviving share or shares made in years prior to the year in which the terminating share was added to such surviving share or shares.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. A trust was established under the will of X for the benefit of his wife and upon her death the property was to continue in the same trust for his two sons, Y and Z. The separate share rule is applicable to this trust. The trustee had discretion to pay or accumulate the income to the wife, and after her death was to pay each son’s share to him after he attained the age of 25. When the wife died, Y was 23 and Z was 28.

(1) Upon the death of X’s widow, there is no accumulation distribution. The entire trust is split into two equal shares, and therefore the undistributed net income and the undistributed capital gain of the trust are split into two shares.

(2) The distribution to Z of his share after his mother’s death is an accumulation distribution of his separate share of one-half of the undistributed net income and undistributed capital gain.

§ 1.666(a)-1A Amount allocated.—(a) In general.—In the case of a trust that is subject to subpart C of part I of subchapter J of chapter 1 of the Code (relating to estates and trusts that may accumulate income or that distribute corpus), section 666(a) prescribes rules for determining the taxable years from which an accumulation distribution will be deemed to have been made and the extent to which the accumulation distribution is considered to consist of undistributed net income. In general, an accumulation distribution made in taxable years beginning after December 31, 1969, is deemed to have been made first from the earliest preceding taxable year of the trust for which

there is undistributed net income. An accumulation distribution made in a taxable year beginning before January 1, 1970, is deemed to have been made first from the most recent preceding taxable year of the trust for which there is undistributed net income. See § 1.665(e)-1A for the definition of “preceding taxable year.”

(b) Distributions by domestic trusts.—(1) Taxable years beginning after December 31, 1973. An accumulation distribution made by a trust (other than a foreign trust created by a U.S. person) in any taxable year beginning after December 31, 1973, is allocated to the preceding taxable years of the trust (defined in § 1.665(e)-1A(a)(1)(ii) as those beginning after December 31, 1968) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first to be allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1977, a domestic trust reporting on the calendar year basis makes an accumulation distribution of \$33,000. Therefore, years before 1969 are ignored. In 1969, the trust had \$6,000 of undistributed net income; in 1970, \$4,000; in 1971, none; in 1972, \$7,000; in 1973, \$5,000; in 1974, \$8,000; in 1975, \$6,000; and \$4,000 in 1976. The accumulation distribution is deemed distributed \$6,000 in 1969, \$4,000 in 1970, none in 1971, \$7,000 in 1972, \$5,000 in 1973, \$8,000 in 1974, and \$3,000 in 1975.

(2) Taxable years beginning after December 31, 1969, and before January 1, 1974. If a trust (other than a foreign trust created by a U.S. person) makes an accumulation distribution in a taxable year beginning after December 31, 1969, and before January 1, 1974, the distribution will be deemed distributed in the same manner as accumulation distributions qualifying under subparagraph (1) of this paragraph, except that the first year to which the distribution may be thrown back cannot be earlier than the fifth taxable year of the trust preceding the year in which the accumulation distribution is made. Thus, for example, in the case of an accumulation distribution made in the taxable year of a domestic trust which begins on January 1, 1972, the taxable year of the trust beginning on January 1, 1967, would be the first year in which the distribution was deemed made, assuming that there was undistributed net income for 1967. See also § 1.665(e)-1A(a)(1). The provisions of this subparagraph may be illustrated by the following example:

Example. In 1973, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of \$25,000. In 1968, the fifth year preceding 1973, the trust had \$7,000 of undistributed net income; in 1969, none; in 1970, \$12,000; in 1971, \$4,000; in 1972, \$4,000. The accumulation distribution is deemed distributed in the amounts of \$7,000 in 1968, none in 1969, \$12,000 in 1970, \$4,000 in 1971, and \$2,000 in 1972.

(3) Taxable years beginning after December 31, 1968, and before January 1, 1970. Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)-1.

(c) Distributions by foreign trusts.—(1) Foreign trusts created solely by U.S. persons.—(i) Taxable years beginning after December 31, 1969. If a foreign trust created

by a U.S. person makes an accumulation distribution in any taxable year beginning after December 31, 1969, the distribution is allocated to the trust's preceding taxable years (defined in § 1.665(e)-1A(a)(2) as those beginning after Dec. 31, 1953, and ending after Aug. 16, 1954) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subdivision may be illustrated by the following example:

Example. In 1971, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of \$50,000. In 1961, the trust had \$12,000 of undistributed net income; in 1962, none; in 1963, \$10,000; in 1964, \$8,000; in 1965, \$5,000; in 1966, \$14,000; in 1967, none; in 1968, \$3,000; in 1969, \$2,000; and in 1970, \$1,000. The accumulation distribution is deemed distributed in the amounts of \$12,000 in 1961, none in 1962, \$10,000 in 1963, \$8,000 in 1964, \$5,000 in 1965, \$14,000 in 1966, none in 1967, and \$1,000 in 1968.

(ii) Taxable years beginning after December 31, 1968, and before January 1, 1970. Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)-1.

(2) Foreign trusts created partly by U.S. persons—(i) Taxable years beginning after December 31, 1969.—If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1969, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the earliest preceding taxable year, as defined in § 1.665(e)-1A(a), of the applicable foreign trusts, to the extent of the undistributed net income for the such trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the earliest accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year beginning after December 31, 1969, the distribution is included in the beneficiary's income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after Decem-

ber 31, 1953, and ended after August 16, 1954. The provisions of this subdivision may be illustrated by the following example:

Example. A trust is created in 1962 under the laws of Country X by the transfer to a trustee in Country X of property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1974, the trust makes an accumulation distribution of \$150,000 to the beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of § 1.643(d)-1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of § 1.665(a)-1A. For taxable years 1962 through 1973, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income— portion of the trust created by a U.S. person	Undistributed net of income— portion of the trust created by a person other than a U.S. person
1962	\$7,000	\$4,000
1963	12,000	7,000
1964	None	None
1965	11,000	5,000
1966	8,000	3,000
1967	None	None
1968	4,000	2,000
1969	17,000	8,000
1970	16,000	9,000
1971	None	None
1972	25,000	12,000
1973	20,000	10,000
Totals	120,000	60,000

The accumulation distribution in the amount of \$150,000 is deemed to have been distributed in the amount of \$100,000 ($120,000/180,000 \times \$150,000$) from the portion of the trust which is a foreign trust created by a U.S. person and in the amount of \$39,000, which is less than \$50,000 ($60,000/180,000 \times \$150,000$), from the portion of the trust

which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1962	\$7,000	None
1963	12,000	None
1964	None	None
1965	11,000	None
1966	8,000	None
1967	None	None
1968	4,000	None
1969	17,000	\$8,000
1970	16,000	9,000
1971	None	None
1972	25,000	\$12,000
1973	None	10,000
Totals	100,000	39,000

Pursuant to this paragraph, the accumulation distribution in the amount of \$100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's income for 1974, as the amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of \$50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's income for 1974 to the extent of the undistributed net income of the trust for the preceding years beginning after December 31, 1968. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person, only the undistributed net income for the years 1969 through 1973, which totals \$39,000, is includible in the beneficiary's income for 1974. Thus, of the \$150,000 distribution made in 1974, the beneficiary is required to include a total of \$139,000 in his income for 1974. The balance of \$11,000 is deemed to represent a distribution of corpus.

(ii) Taxable years beginning after December 31, 1968, and before January 1, 1970. Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)-1.

(3) Foreign trusts created by non-U.S. persons.—To the extent that a foreign trust is a foreign trust created by a person other than a U.S. person, an accumulation

distribution is included in the beneficiary's income for the year paid, credited, or required to be distributed to the extent provided under paragraph (b) of this section.

(d) Reduction of undistributed net income for prior accumulation distributions.—For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is reduced by the amount from such year deemed distributed in any accumulation distribution of undistributed net income made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust has undistributed net income for 1974 and makes accumulation distributions during the taxable years 1978 and 1979, in determining that part of the 1979 accumulation distribution that is thrown back to 1974 the undistributed net income for 1974 is first reduced by the amount of the undistributed net income for 1974 deemed distributed in the 1978 accumulation distribution.

(e) Rule when no undistributed net income.—If, before the application of the provisions of subpart D to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is undistributed net income deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed net income for 1970, then no portion of the 1975 accumulation distribution is undistributed net income deemed distributed on the last day of 1970.

§ 1.666(b)-1A Total taxes deemed distributed.—(a) If an accumulation distribution is deemed under § 1.666(a)-1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the “taxes imposed on the trust attributable to the undistributed net income” (as defined in § 1.665(d)-1A(b)) for such preceding taxable year is also deemed distributed under section 661(a)(2). For example, a trust has undistributed net income of \$8,000 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed net income are \$3,032. During the taxable year 1977, an accumulation distribution of \$8,000 is made to the beneficiary, which is deemed under § 1.666(a)-1A to have been distributed on the last day of 1974. The 1977 accumulation distribution is not less than the 1974 undistributed net income. Accordingly, the taxes of \$3,032 imposed on the trust attributable to the undistributed net income for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of \$11,032 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)-1A.

§ 1.666(c)-1A Pro rata portion of taxes deemed distributed.—(a) If an accumulation distribution is deemed under § 1.666(a)-1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is also deemed distributed under section 661(a)(2). The additional amount is equal to the “taxes imposed on the trust attributable to the undistributed net income” (as defined in § 1.665(a)-1A(b)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the accumulation distribution allocated to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year. See

paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.666(c)-2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)-1A and paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.666(c)-2A.

§ 1.666(c)-2A Illustration of the provisions of section 666(a), (b), and (c).— The application of the provisions of §§ 1.666(a)-1A, 1.666(b)-1A, and 1.666(c)-1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes accumulation distributions as follows:

1979.....	\$7,000
1980.....	26,000

For 1974 through 1978, the undistributed portion of distributable net income, taxes imposed on the trust attributable to the undistributed net income, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust attributable to the undistributed net income	Undistributed net income
1974	\$12,100	\$3,400	\$8,700
1975	16,100	5,200	10,900
1976	6,100	1,360	4,740
1977	None	None	None
1978	10,100	2,640	7,460

The trust has no undistributed capital gain.

(b) Since the entire amount of the accumulation distribution for 1979 (\$7,000) is less than the undistributed net income for 1974 (\$8,700), an additional amount of \$2,736 ($7,000/8,700 \times \$3,400$) is deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1980, the amount of undistributed net income for 1974 will reflect the accumulation distribution for 1979. The undistributed net income for 1974 will then be \$1,700 and the taxes imposed on the trust for 1974 will be \$664, determined as follows:

Undistributed net income as of the close of 1974.....	\$8,700
Less: Accumulation distribution (1979).....	7,000
Balance (undistributed net income as of the close of 1979).....	1,700

Taxes imposed on the trust attributable to the undistributed net income as of the close of 1979
 $(1,700/8,700 \times \$3,400)$ 664

(d) The accumulation distribution of \$26,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of \$24,800, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, \$9,864, the total taxes imposed on the trust attributable to the undistributed net income for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed Net Income	Taxes imposed on the trust
1974	\$1,700	\$664
1975	10,900	5,200
1976	4,740	1,360
1977	None	None
1978	7,460	2,640
1979	None	None

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1974 was accumulated. The distributable net income of the trust for the taxable year 1974 is \$20,100 and the income taxes paid by the trust for 1974 attributable to the undistributed net income are \$7,260. All of the income for 1975 and 1976 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of \$5,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1974, is \$12,840, computed as follows:

Distributable net income \$20,100
 Less: Taxes imposed on the trust attributable to the undistributed net income 7,260
 Undistributed net income as of the close of 1974 12,840

(c) The accumulation distribution of \$5,420 made during the taxable year 1975 is deemed under section 666(a) to have been made on December 31, 1974. Since this accumulation distribution is less than the 1974 undistributed net income of \$12,840, a portion of the taxes imposed on the trust for 1974 is also deemed under section 666(c) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974 is \$8,484, computed as follows:

Accumulation distribution \$5,420
 Taxes deemed distributed $(5,420/12,840 \times \$7,260)$ 3,064
 Total 8,484

(d) After the application of the provisions of subpart D to the accumulation distribution of 1975, the undistributed net income of the trust for 1974 is \$7,420, computed as follows:

Undistributed net income as of the close of 1974.....	\$12,840
Less: 1975 accumulation distribution deemed distributed on December 31, 1974 (paragraph (c) of this example).....	<u>5,420</u>
Undistributed net income for 1974 as of the close of 1975	7,420

(e) The taxes imposed on the trust attributable to the undistributed net income for the taxable year 1974, as adjusted to give effect to the 1975 accumulation distribution, amount to \$4,196, computed as follows:

Taxes imposed on the trust attributable to undistributed net income as of the close of 1974.....	\$7,260
Less: Taxes deemed distributed in 1974	<u>3,064</u>
Taxes attributable to the undistributed net income determined as of the close of 1975	4,196

(f) The accumulation distribution of \$5,420 made during the taxable year 1976 is, under section 666(a), deemed a distribution to X on December 31, 1974, within the meaning of section 661(a)(2). Since the accumulation distribution is less than the 1974 adjusted undistributed net income of \$7,420, the trust is deemed under section 666(c) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the accumulation distribution made in 1976, is \$8,484, computed as follows:

Accumulation distribution.....	\$5,420
Taxes deemed distributed ($5,420/7,420 \times \$4,196$).....	<u>3,064</u>
Total	8,484

(g) After the application of the provisions of subpart D to the accumulation distribution of 1976, the undistributed net income of the trust for 1974 is \$2,000, computed as follows:

Undistributed net income for 1974 as of the close of 1975	\$7,420
Less: 1976 accumulation distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	<u>5,420</u>
Undistributed net income for 1974 as of the close of 1976	2,000

(h) The taxes imposed on the trust attributable to the undistributed net income of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to \$1,132 (\$4,196 less \$3,064).

§ 1.666(d)-1A Information required from trusts.—(a) Adequate records required.—For all taxable years of a trust, the trustee must retain copies of the trust’s income tax return as well as information pertaining to any adjustments in the tax shown as due on the return. The trustee shall also keep the records of the trust required to be retained by section 6001 and the regulations thereunder for each taxable year as to

which the period of limitations on assessment of tax under section 6501 has not expired. If the trustee fails to produce such copies and records, and such failure is due to circumstances beyond the reasonable control of the trustee or any predecessor trustee, the trustee may reconstruct the amount of corpus, accumulated income, etc., from competent sources (including, to the extent permissible, Internal Revenue Service records). To the extent that an accurate reconstruction can be made for a taxable year, the requirements of this paragraph shall be deemed satisfied for such year.

(b) Rule when information is not available.—(1) Accumulation distributions.—If adequate records (as required by paragraph (a) of this section) are not available to determine the proper application of subpart D to an accumulation distribution made in a taxable year by a trust, such accumulation distribution shall be deemed to consist of undistributed net income earned during the earliest preceding taxable year (as defined in § 1.665(e)-1A) of the trust in which it can be established that the trust was in existence. If adequate records are available for some years, but not for others, the accumulation distribution shall be allocated first to the earliest preceding taxable year of the trust for which there are adequate records and then to each subsequent preceding taxable year for which there are adequate records. To the extent that the distribution is not allocated in such manner to years for which adequate records are available, it will be deemed distributed on the last day of the earliest preceding taxable year of the trust in which it is established that the trust was in existence and for which the trust has no records. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust makes a distribution in 1975 of \$100,000. The trustee has adequate records for 1973, 1974, and 1975. The records show that the trust is on the calendar year basis, had distributable net income in 1975 of \$20,000, and undistributed net income in 1974 of \$15,000, and in 1973 of \$16,000. The trustee has no other records of the trust except for a copy of the trust instrument showing that the trust was established on January 1, 1965. He establishes that the loss of the records was due to circumstances beyond his control. Since the distribution is made in 1975, the earliest “preceding taxable year”, as defined in § 1.665(e)-1A, is 1969. Since \$80,000 of the distribution is an accumulation distribution, and \$31,000 thereof is allocated to 1974 and 1973, \$49,000 is deemed to have been distributed on the last day of 1969.

(2) Taxes.—(i) If an amount is deemed under this paragraph to be undistributed net income allocated to a preceding taxable year for which adequate records are not available, there shall be deemed to be “taxes imposed on the trust” for such preceding taxable year an amount equal to the taxes that the trust would have paid if the deemed undistributed net income were the amount remaining when the taxes were subtracted from taxable income of the trust for such year. For example, assume that an accumulation distribution in 1975 of \$100,000 is deemed to be undistributed net income from 1971, and that the taxable income required to produce \$100,000 after taxes in 1971 would be \$284,966. Therefore the amount deemed to be “taxes imposed on the trust” for such preceding taxable year is \$184,966.

(ii) The credit allowed by section 667(b) shall not be allowed for any amount deemed under this subparagraph to be “taxes imposed on the trust.”

§ 1.666(a)-1 Amount allocated.—(a)(1) If a trust other than a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary’s gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accu-

mulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(2) If a foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. It is therefore necessary to determine the extent to which there is undistributed net income for such preceding taxable years. For this purpose, an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(3) If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income for the applicable foreign trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the most recently accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. If the foreign trust created by a person other than a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years.

(b) If, before the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term 5 preceding taxable years includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I (section 641 and following) of such subchapter J even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1964, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of \$25,000. In 1963, the trust had \$7,000 of undistributed net income; in 1962, none; in 1961, \$12,000; in 1960, \$4,000; in 1959, \$4,000. The accumulation distribution is deemed distributed \$7,000 in 1963, none in 1962, \$12,000 in 1961, \$4,000 in 1960, and \$2,000 in 1959.

Example 2. In 1964, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of \$50,000. In 1963, the trust had \$12,000 of undistributed net income; in 1962, none; in 1961, \$10,000; in 1960, \$8,000; in 1959, \$5,000; in 1958, \$14,000; in 1957, none; in 1956, \$3,000; in 1955, \$2,000; and in 1954, \$1,000. The accumulation distribution is deemed distributed \$12,000 in 1963, none in 1962, \$10,000 in 1961, \$8,000 in 1960, \$5,000 in 1959, \$14,000 in 1958, none in 1957, \$1,000 in 1956.

Example 3. A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1964, the trust makes an accumulation distribution of \$150,000 to the U.S. beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of § 1.643(d)-1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of § 1.665(a)-1. For the taxable years 1952 through 1963, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income— portion of the trust created by a U.S. person	Undistributed net income— portion of the trust created by a person other than a U.S. person
1963	\$20,000	\$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	11,000	5,000
1954	None	None

Year	Undistributed net income— portion of the trust created by a U.S. person	Undistributed net income— portion of the trust created by a person other than a U.S. person
1953	12,000	7,000
1952	7,000	4,000
Totals	120,000	60,000

The accumulation distribution in the amount of \$150,000 is deemed to have been distributed in the amount of \$100,000 ($120,000/180,000 \times \$150,000$) from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of \$50,000 ($60,000/180,000 \times \$150,000$) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1963	\$20,000	\$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	10,000	5,000
1954	None	None
1953	None	1,000
1952	None	None
Totals	100,000	50,000

Pursuant to paragraph (a)(3) of this section, the accumulation distribution in the amount of \$100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's gross income for 1964, as this amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribu-

tion in the amount of \$50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1964 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person only the undistributed net income for the years 1959 through 1963 which totals \$39,000 is includible in the beneficiary's gross income for 1964. Thus, of the \$150,000 distribution made in 1964, the beneficiary is required to include a total of \$139,000 in his gross income for 1964.

Example 4. Assume the same facts as in example 3 and, in addition, that by December 31, 1964, the undistributed net income for 1964 is determined to be \$20,000, and that in accordance with the provisions of paragraph (b)(3) of § 1.643(d)-1 and paragraph (b) of § 1.665(a)-1, \$10,000 is allocated to the portion of the trust which is a foreign trust created by a U.S. person and \$10,000 is allocated to the portion of the trust which is a foreign trust created by a person other than a U.S. person. On March 31, 1965, the trust makes an accumulation distribution of \$25,000 to the U.S. beneficiary. For the taxable years 1952 through 1964, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income— portion of the trust created by a U.S. person	Undistributed net income— portion of the trust created by a person other than a U.S. person
1964	\$10,000	\$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	12,000	6,000
1952	7,000	4,000
Totals	30,000	20,000

The accumulation distribution is deemed to have been distributed in the amount of \$15,000 ($30,000/50,000 \times \$25,000$), from the portion of the trust which is a foreign trust

created by a U.S. person, and in the amount of \$10,000 ($20,000/50,000 \times \$25,000$) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1964	\$10,000	\$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	4,000	None
1952	None	None
Totals	15,000	10,000

Pursuant to paragraph (a)(3) of this section, only \$11,000 of the accumulation distribution in the amount of \$15,000 from the portion of the trust which is a foreign trust created by a U.S. person is includible in the beneficiary's gross income for 1965 as the \$11,000 amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of \$10,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1965 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, the entire \$10,000 (representing the undistributed net income for the year 1964) is includible in the beneficiary's gross income for 1965. Thus, of the \$25,000 distribution made in 1965, the beneficiary is required to include a total of \$21,000 in his gross income for 1965.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable

year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

§ 1.666(b)-1 Total taxes deemed distributed.—(a) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the “taxes imposed on the trust” (as defined in § 1.665(d)-1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of \$11,032 (not including any capital gains) and undistributed net income of \$8,000 for the taxable year 1954. The taxes imposed on the trust are \$3,032. During the taxable year 1955, an accumulation distribution of \$8,000 is made to the beneficiary, which is deemed under § 1.666(a)-1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of \$3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of \$11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of \$8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)-1 and paragraphs (f)(5) and (g)(1) of § 1.668(b)-2.

§ 1.666(c)-1 Pro rata portion of taxes deemed distributed.—(a) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in § 1.665(d)-1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.666(c)-2, and paragraph (f)(2) of § 1.668(b)-2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)-1, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.666(c)-2 and paragraph (f)(5)(iii) of § 1.668(b)-2.

§ 1.666(c)-2 Illustration of the provisions of section 666.—The application of the provisions of §§ 1.666(a)-1, 1.666(b)-1, and 1.666(c)-1 may be illustrated by the following examples:

Example 1. (a) A trust makes accumulation distributions as follows:

1959.....	\$7,000
1960.....	25,000

For 1954 through 1958, the undistributed portion of distributable net income taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	\$12,100	\$3,400	\$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 (\$7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 (\$8,700), an additional amount of \$2,736 ($7,000/8,700 \times \$3,400$) is likewise deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be \$1,906; and the taxes imposed on the trust for 1958 will then be \$458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958	\$12,100
Less: Accumulation distribution (1959).....	\$7,000
Taxes deemed distributed under section 666(c) ($7,000/8,700 \times \$3,400$)	<u>2,736</u>
	9,736
Balance (undistributed portion of distributable net income as of the close of 1959).....	2,364
Less: Personal exemption	<u>100</u>
Balance.....	2,264
Taxes imposed on the trust (income taxes on \$2,264)	<u>458</u>
Undistributed portion of distributable net income as of the close of 1959	2,364
Less: Income taxes attributable thereto.....	<u>458</u>
Undistributed net income for 1958 as of the close of 1959	1,906

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(d) The accumulation distribution of \$25,000 for 1960 is deemed to have been made on the last day of the 5 preceding taxable years of the trust to the extent of \$17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, \$7,018, the total taxes imposed on the trust for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	\$1,906	\$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is \$20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are \$7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of \$6,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1954, is \$12,840, computed as follows:

Distributable net income	\$20,100
Less: Taxes imposed on the trust	<u>7,260</u>
Undistributed net income as of the close of 1954.....	12,840

(c) The accumulation distribution of \$6,420 made during the taxable year 1955 is deemed under section 666(a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of \$12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666(c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is \$10,050, computed as follows:

Accumulation distribution.....	\$6,420
Taxes deemed distributed (6,420/12,840 × \$7,260).....	3,630
Total	10,050

(d) After the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is \$10,050, and the taxes imposed with respect thereto are \$2,623, computed as follows:

Distributable net income as of the close of 1954.....	\$20,100
---	----------

Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c) of this example).....	<u>10,050</u>
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955	10,050
Less: Personal exemption	<u>100</u>
Balance.....	9,950
Income taxes on \$9,950	2,623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is \$7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	\$10,050
Less: Income taxes applicable thereto	<u>2,623</u>
Undistributed net income determined as of the close of 1955	7,427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of \$6,420 made during the taxable year 1956 is, under section 666(a), deemed a distribution to X on December 31, 1954, within the meaning of section 661(a)(2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of \$7,427, the trust is deemed under section 666(c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31, 1954, with respect to the accumulation distribution made in 1956, is \$8,687, computed as follows:

Accumulation distribution.....	\$6,420
Taxes deemed distributed $(6,420/7,427 \times \$2,623)$	<u>2,267</u>
Total	8,687

(g) After the application of the provisions of subpart D to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is \$1,363, and the taxes imposed on the trust with respect thereto are \$253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	\$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f) of this example)	<u>8,687</u>
Undistributed portion of distributable net income as of the close of 1956	1,363
Less: Personal exemption	<u>100</u>
Balance.....	1,263
Income taxes on \$1,263	253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is \$1,110 (\$1,363 less \$253).

§ 1.667-1 Denial of refund to trusts.—(a) If an amount is deemed under section 666 to be an amount paid, credited, or required to be distributed on the last day of a pre-

ceding taxable year, the trust is not allowed a refund or credit of the amount of “taxes imposed on the trust”, as defined in § 1.665(d)-1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions in the preceding taxable year. The amount of taxes which may not be refunded or credited to the trust under this paragraph and which are allowed as a credit under section 668(b) against the tax of the beneficiaries, is an amount equal to the excess of:

(1) The taxes imposed on the trust (as defined in section 665(d) and § 1.655(d)-1) for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over

(2) The amount of taxes for such preceding taxable year which would be imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, on account of the accumulation distribution determined for the taxable year.

It should be noted that the credit under section 667 is computed by the use of a different ratio from that used for computing the amount of taxes deemed distributed under section 666(c).

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example 1. In 1954, a trust of which A is the sole beneficiary has taxable income of \$20,000 (including capital gains of \$5,100 allocable to corpus less a personal exemption of \$100), on which a tax of \$7,260 is paid.

The undistributed portion of distributable net income is \$15,000, to which \$6,160 of the tax is allocable under section 665. The undistributed net income is therefore \$8,840 (\$15,000 minus \$6,160). In 1955, the trust makes an accumulation distribution of \$8,840. Under section 666(b), the total taxes for 1954 attributable to the undistributed net income are deemed distributed, so \$15,000 is deemed distributed. The amount of the tax which may not be refunded to the trust under section 667 and the credit to which A is entitled under section 668(b) is the excess of \$6,160 over zero, since after the distribution and the application of subpart D there is no remaining undistributed portion of distributable net income for 1954.

Example 2. The same trust as in example 1 of this paragraph distributes \$5,000 in 1955, rather than \$8,840. The amount of the tax which may not be refunded to the trust but which is available to A as a credit is \$4,044, computed as follows:

Accumulation distribution in 1955.....	\$5,000
Taxes deemed distributed under section 666(c) (5,000/8,840 × \$6,160)	<u>3,484</u>
Total amount deemed distributed out of the undistributed portion of distributable net income.....	<u>8,484</u>
Tax attributable to the undistributed portion of distributable net income (\$15,000) before 1955 distribution (see example (1) of this paragraph)	6,160
Tax on \$11,516 (taxable income of \$20,000 minus \$8,484, amount deemed distributed).....	\$3,216
Tax on \$5,000 (capital gains of \$5,100, less personal exemption of \$100, allocable to corpus)	<u>1,100</u>

Tax attributable to undistributed portion of distributable net income after 1955 distribution	<u>2,116</u>
Refund disallowed to the trust and credit available to A in 1955	4,044

§ 1.667(a)-1A Denial of refund to trusts.—If an amount is deemed under section 666 or 669 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of “taxes imposed on the trust”, as defined in § 1.665(d)-1A. However, such taxes imposed on the trust are allowed as a credit under section 667(b) against the tax of certain beneficiaries who are treated as having received the distributions in the preceding taxable year.

§ 1.667(b)-1A Authorization of credit to beneficiary for taxes imposed on the trust.—(a) Determination of credit—(1) In general.—Section 667(b) allows under certain circumstances a credit (without interest) against the tax imposed by subtitle A of the Code on the beneficiary for the taxable year in which the accumulation distribution is required to be included in income under section 668(a). In the case of an accumulation distribution consisting only of undistributed net income, the amount of such credit is the total of the taxes deemed distributed to such beneficiary under section 666(b) and (c) as a result of such accumulation distribution for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.668(b)-1A. In the case of an accumulation distribution consisting only of undistributed capital gain, the amount of such credit is the total of the taxes deemed distributed as a result of the accumulation distribution to such beneficiary under section 669(d) and (e) for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.669(b)-1A. In the case of an accumulation distribution consisting of both undistributed net income and undistributed capital gain, a credit will not be available unless the total taxes deemed distributed to the beneficiary for all preceding taxable years as a result of the accumulation distribution exceeds the beneficiary’s partial tax determined under §§ 1.668(b)-1A and 1.669(b)-1A without reference to the taxes deemed distributed. A credit is not allowed for any taxes deemed distributed as a result of an accumulation distribution to a beneficiary by reason of sections 666(b) and (c) or sections 669(d) and (e) for a preceding taxable year of the trust before the beneficiary was born or created. However, if as a result of an accumulation distribution the total taxes deemed distributed under sections 668(a)(2) and 668(a)(3) in preceding taxable years before the beneficiary was born or created exceed the partial taxes attributable to amounts deemed distributed in such years, such excess may be used to offset any liability for partial taxes attributable to amounts deemed distributed as a result of the same accumulation distribution in preceding taxable years after the beneficiary was born or created.

(2) Exact method.—In the case of the tax computed under the exact method provided in §§ 1.668(b)-1A(b) and 1.669(b)-1A(b), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, whichever are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(ii) Compute the total of the amounts of tax determined under § 1.668(b)-1A(b)(1) or § 1.669(b)-1A(b)(1), whichever is appropriate, for the prior taxable years of the beneficiary in which he was in being. If the amount determined under

subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable.

If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph, the credit allowable is the lesser of the amount of such excess or the amount of taxes deemed distributed to the beneficiary for all preceding taxable years to the extent that such taxes are not used in § 1.668(b)-1A(b)(2) or § 1.669(b)-1A(b)(2) in determining the beneficiary's partial tax under section 668(a)(2) or 668(a)(3). The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution made in 1975 is deemed distribution in 1973 and 1974, years in which the beneficiary was in being.

The taxes deemed distributed in such years are \$4,000 and \$2,000, respectively, totaling \$6,000. The amounts of tax computed under § 1.668(b)-1A(b)(1) attributable to the amounts thrown back are \$3,000 and \$2,000, respectively, totaling \$5,000. The credit allowable under this subparagraph is therefore \$1,000 (\$6,000 less \$5,000).

(3) Short-cut method.—In the case of the tax computed under the short-cut method provided in § 1.668(b)-1A(c) or § 1.669(b)-1A(c), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed in all preceding taxable years of the trust under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, whichever are appropriate.

(ii) Compute the beneficiary's partial tax determined under either § 1.668(b)-1A(c)(1)(v) or § 1.669(b)-1A(c)(1)(v), whichever is appropriate.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable.

If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph,

(iii) Compute the total taxes deemed distributed under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, which are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(iv) Multiply the amount by which subdivision (i) of this subparagraph exceeds subdivision (ii) of this subparagraph by a fraction, the numerator of which is the amount determined under subdivision (iii) of this subparagraph and the denominator of which is the amount determined under subdivision (i) of this subparagraph.

The result is the allowable credit. The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution that consists only of undistributed net income is made in 1975. The taxes deemed distributed in the preceding years under §§ 1.666(b)-1A and 1.666(c)-1A are \$15,000. The amount determined under § 1.668(b)-1A(c)(1)(v) is \$12,000. The beneficiary was in being on the last day of all but one preceding taxable year in which the accumulation distribution was deemed made, and the taxes deemed distributed in those years was \$10,000. Therefore, the excess of the subdivision (i) amount over the subdivision (ii) amount is \$3,000, and is multiplied by 10,000/15,000, resulting in an answer of \$2,000, which is the credit allowable when computed under the short-cut method.

(b) Year of credit.—The credit to which a beneficiary is entitled under this section is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the income of the beneficiary under section 668(a). Any excess over the total tax liability of the beneficiary for such year is treated as an overpayment of tax by the beneficiary. See section 6401(b) and the regulations thereunder.

§ 1.668(a)-1A Amounts treated as received in prior taxable years; inclusion in gross income.—(a) Section 668(a) provides that the total of the amounts treated under sections 666 and 669 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the income of the beneficiary or beneficiaries receiving them. The total of such amounts is includable in the income of each beneficiary to the extent the amounts would have been included under section 662(a)(2) and (b) as if the total had actually been an amount properly paid by the trust under section 661(a)(2) on the last day of such preceding taxable year. The total is included in the income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder.

(b) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(c) For purposes of applying section 668(a)(3), a trust shall be considered to be other than a "trust which is not required to distribute all of its income currently" for each taxable year prior to the first taxable year beginning after December 31, 1968, and ending after November 30, 1969, in which income is accumulated. Income will not be deemed to have been accumulated for purposes of applying section 668(a)(3) in a year if the trustee makes a determination, as evidenced by a statement on the return, to distribute all of the trust's income for such year and also makes a good faith determination as to the amount of such income and actually distributed for such year the entire amount so determined. The term "income," as used in the preceding two sentences, is defined in §§ 1.643(b)-1 and 1.643(b)-2. Since, under such definitions, certain items may be included in distributable net income but are not, under applicable local law, "income" (as, for example, certain extraordinary dividends), a trust that has undistributed net income from such sources might still qualify as a trust that has not accumulated income. Also, for example, if a trust establishes a reserve for depreciation or depletion and applicable local law permits the deduction for such reserve in the computation of "income," amounts so added to the reserve do not constitute an accumulation of income. If a trust has separate shares, and any share accumulates income, all shares of the trust will be considered to have accumulated income for purposes of section 668(a)(3). Amounts retained by a trust or a portion of a trust that is subject to subpart E (sections 671-678) shall not be considered accumulated income.

(d) See section 1302(a)(2)(B) to the effect that amounts included in the income of a beneficiary of a trust under section 668(a) are not eligible for income averaging.

§ 1.668(a)-2A Allocation among beneficiaries; in general.—The portion of the total amount includable in income under § 1.668(a)-1A which is includable in the income of a particular beneficiary is based upon the ratio determined under the second

sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for taxable year 1975 is \$10,000. The trust had undistributed net income for taxable year 1973, the first year of the trust, of \$5,000, to which a tax of \$1,100 was allocable. On May 1, 1975, the trustee distributes \$10,000 to A, and on November 29, 1975, he distributes \$5,000 to B. Thus, of the total distribution of \$15,000, A received two-thirds and B receives one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1975, the trust is deemed to have made the following distributions:

Amount distributed out of 1975 income (distributable net income)	\$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1973 under section 666(a)	5,000
Taxes imposed on the trust attributable to the undistributed net income deemed distributed under section 666(b)	1,100

(c) A will include in his income for 1975 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income \$6,666.67 ($10,000/15,000 \times \$10,000$) of the 1975 distributable net income of the trust as provided in section 662(a)(2) (which is not an amount includible in his income under § 1.668(a)-1A(a)). He will include in his income \$3,333.33 ($10,000/15,000 \times \$5,000$) of the accumulation distribution and \$733.33 ($10,000/15,000 \times \$1,100$) of the taxes imposed on the trust, as provided in section 668(a).

(d) B will include in his income for 1975 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

(e) To the extent the total accumulation distribution consists of undistributed net income and undistributed capital gain, A and B shall be treated as receiving a pro rata share of each for the preceding taxable year 1973.

§ 1.668(a)-3A Determination of tax.—In a taxable year in which an amount is included in a beneficiary's income under § 1.668(a)-1A(a), the tax on the beneficiary for such taxable year is determined only as provided in section 668 and consists of the sum of:

(a) A partial tax computed on (1) the beneficiary's taxable income reduced by (2) an amount equal to the total amounts includible in his income under § 1.668(a)-1A(a), at the rate and in the manner as if section 668 had not been enacted,

(b) A partial tax determined as provided in § 1.668(b)-1A, and

(c) In the case of a beneficiary of a trust which is not required to distribute all of its income currently, a partial tax determined as provided in § 1.669(b)-1A.

§ 1.668(b)-1A Tax on distribution.—(a) In general.—The partial tax imposed on the beneficiary by section 668(a)(2) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the "exact" method), or

(2) The tax computed under paragraph (c) of this section (the "short-cut" method), except as provided in § 1.668(b)-4A (relating to failure to furnish proper in-

formation) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary’s choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(3).

(b) Computation of partial tax by the exact method.—The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. For purposes of this paragraph, the “section 666 amounts” for a preceding taxable year are the amounts deemed distributed under section 666(a) on the last day of the preceding taxable year, plus the amount of taxes deemed distributed on such day under section 666(b) or (c). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 666 amounts in the beneficiary’s gross income and the tax for such year computed without including them in such gross income. Tax computations for each such year shall reflect a taxpayer’s marital, dependency, exemption, and filing status for such year. To the extent the undistributed net income of a trust deemed distributed in an accumulation distribution includes amounts received as an accumulation distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 666(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income and taxes of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income and taxes, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)-1A and 1.666(c)-1A as does not exceed such sum. The resulting amount, if any, is the partial tax, computed under the exact method, for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to the beneficiary.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. (i) Assume that in 1979 a trust makes an accumulation distribution of \$15,000 to A. The accumulation distribution is allocated under section 666(a) in the amounts of \$5,000 to 1971, \$4,000 to 1972, and \$6,000 to 1973. Under section 666(b) and (c), taxes in the amounts of \$935, \$715, and \$1,155 (totaling \$2,805) are deemed distributed in 1971, 1972, and 1973, respectively.

(ii) A, the beneficiary, had taxable income and paid income tax in 1971-73 as follows:

Year	Taxable income	Tax
1971.....	\$10,000	\$2,190

Year	Taxable income	Tax
1972.....	12,000	2,830
1973.....	14,000	3,550

(iii) Taxes attributable to the section 666 amounts (paragraph (i) of this example) are \$6,979, computed as follows:

1971

Taxable income including section 666 amounts (\$10,000 + \$5,000 + \$935)	\$15,935
Tax on \$15,935.....	\$4,305
Less: Tax paid by A in 1971.....	<u>2,190</u>
Tax attributable to 1971 section 666 amounts	2,115

1972

Taxable income including section 666 amounts (\$12,000 + \$4,000 + \$715)	\$16,715
Tax on \$16,715.....	\$4,620
Less: Tax paid by A in 1972.....	<u>2,830</u>
Tax attributable to 1972 section 666 amounts	1,790

1973

Taxable income including section 666 amounts (\$14,000 + \$6,000 + \$1,155)	\$21,155
Tax on \$21,155.....	\$6,624
Less: Tax paid by A in 1973.....	<u>3,550</u>
Tax attributable to 1973 section 666 amounts	3,074

Total tax attributable to section 666 amounts:	
1971.....	\$2,115
1972.....	1,790
1973.....	<u>3,074</u>
Total	6,979

(iv) The partial tax computed under the exact method is \$4,174, computed by subtracting the taxes deemed distributed (\$2,805) from the tax attributable to the section 666 amounts (\$6,979).

(c) Computation of tax by the short-cut method.—(1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received an accumulation distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such accumulation distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income of trust Y for the taxable years 1972, 1973, and

1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed net income deemed distributed is less than 25 percent of (a) the total amounts deemed under section 666(a) to be undistributed net income from preceding taxable years divided by (b) the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed without application of this sentence. For example, assume that an accumulation distribution of \$90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of \$29,000 in each of the years 1972, 1973, and 1974, and \$3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is four. However, the distribution deemed made in 1975 (\$3,000) is less than \$5,625, which is 25 percent of (a) the total undistributed net income deemed distributed under section 666(a) (\$90,000) divided by (b) the number of such preceding taxable years (4), or \$22,500. Therefore, for purposes of this subparagraph the accumulation distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the accumulation distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subdivision (i) of this subparagraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of each class of income as the total of each class of income deemed distributed in the accumulation distribution bears to the total undistributed net income from such preceding taxable years deemed distributed in the accumulation distribution. For example, assume that an amount of \$50,000 is deemed distributed under section 666(a) from undistributed net income of 5 preceding taxable years of the trust, and consists of \$25,000 of interest, \$15,000 of dividends, and \$10,000 of net rental income. Taxes attributable to such amounts in the amount of \$10,000 are also deemed distributed. The amount determined under this subdivision, \$12,000 (\$50,000 income plus \$10,000 tax divided by 5 years), is deemed to consist of \$6,000 in interest, \$3,600 in dividends, and \$2,400 in net rental income.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.—The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph. For example, assume that a distribution of \$12,000, is includible in the income of each of the beneficiary's 3 preceding taxable years when his income (without the inclusion of the accumulation distribution) was \$20,000, \$30,000, and \$40,000. The inclusion of \$12,000 in income would produce taxable income of \$32,000, \$42,000, and \$52,000, and the tax attributable to such increases would be \$4,000, \$5,000, and \$6,000, respectively.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3. For example, if these additional taxes are \$4,000, \$5,000, and \$6,000 for the 3 preceding taxable years, this amount would be \$5,000 (\$4,000+\$5,000+\$6,000 divided by 3).

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subdivision (i) of this subparagraph). For example, if an amount is deemed distributed for 5 preceding taxable years, the resulting amount would be five times the \$5,000 amount.

(vi) Sixth, the resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)-1A and 1.666(c)-1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 668(b)(1)(B).

(2) The computation of the tax by the short-cut method may be illustrated by the following example:

Example: In 1971, X creates a trust which is to accumulate its income and pay the income to Y when Y reaches 30. Y is 19. Over the 11 years of the trust, the trust earns \$1,200 of interest income annually and has expenses each year of \$100 allocable to the production of income. The trust pays a total tax of \$1,450 on the accumulated income. In 1981, when Y reaches 30, the \$9,550 of accumulated undistributed net income and the \$1,100 of current net income are distributed to Y. Y is treated as having received a total distribution of \$11,000 (the \$9,550 accumulation distribution plus the taxes paid by the trust which are deemed to have been distributed to Y). The income of the current year (1981) is taxed directly to Y. The computation is as follows: \$11,000 (accumulation distribution plus taxes) divided by 10 (number of years out of which distribution was made) equals \$1,100. The \$1,100 added to the income of the beneficiary's preceding 3 years produces increases in tax as follows:

1980.....	\$350
1979.....	300
1978.....	<u>250</u>
Total	900

\$900 (total additional tax) divided by 3 equals \$300 (average annual increase in tax). \$300 (average annual increase in tax) times 10 equals \$3,000, from which is deducted the amount of taxes (\$1,450) paid by the trust attributable to the undistributed net income deemed distributed. The amount of tax to be paid currently under the short-cut method is therefore \$1,550.

(d) Disallowance of short-cut method.—If, in any prior taxable year of the beneficiary in which any part of the accumulation distribution of undistributed net income is deemed to have been distributed under section 666(a) to such beneficiary, any part of prior accumulation distributions of undistributed net income by each of two or more other trusts is deemed under section 666(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(2) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes an accumulation distribution of undistributed net income to A, who is on the calendar year basis, and part of the accumulation distribution is deemed under section 666(a) to have been distributed on March 31, 1974. In 1977, A had received an accumulation distribution of undistributed net income from both trust Y and trust Z. Part of the accumulation distribution from trust Y was deemed under section 666(a) to have been

distributed to A on June 30, 1974, and part of the accumulation distribution from trust Z was deemed under section 666(a) to have been distributed to A on December 31, 1974. Because there were portions of accumulation distributions of undistributed net income from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 accumulation distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 666(a)(2).

§ 1.668(b)-2A Special rules applicable to section 668.—(a) Rule when beneficiary not in existence on the last day of a taxable year.—If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.668(b)-1A, that the beneficiary:

- (1) Was in existence on such last day,
- (2) Was a calendar year taxpayer,
- (3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,
- (4) If an individual, was unmarried and had no dependents,
- (5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and
- (6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of an accumulation distribution made in 1980 is deemed under section 666(a) to have been distributed to the beneficiary, A, in 1973; \$10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.668(b)-1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the \$10,000 from the earlier accumulation distribution deemed distributed in 1973, and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. It should be noted that the standard deduction for 1973 will be available to A with respect to the distribution only to the extent it qualifies as “earned income” in the hands of the trust. See section 141(e) and the regulations thereunder and § 1.652(b)-1. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A’s first actual taxable year.

(b) Effect of other distributions.—The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.668(b)-1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a “prior accumulation distribution” is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term “prior accumulation distribution” also includes accumulation distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (c) of this section to treat as having been distributed before the accumulation distribution for which tax is being com-

puted under § 1.668(b)-1A. Any capital gain distribution from the same trust paid, credited, or required to be distributed in the same taxable year of the beneficiary shall not be considered under this paragraph to be a “prior capital gain distribution.”

(c) Multiple distributions in the same taxable year.—For purposes of paragraph (b) of this section, accumulation distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several accumulation distributions. The beneficiary shall indicate the order he has determined to deem the accumulation distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(d) Examples. The provisions of paragraphs (b) and (c) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made an accumulation distribution of undistributed net income to A, a calendar year taxpayer, of which \$3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another accumulation distribution of undistributed net income to A, \$10,000 of which is deemed under section 666 to have been distributed in 1974. Also in 1980, trust Y makes an accumulation distribution of undistributed net income to A, of which \$5,000 is deemed under section 666 to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A’s gross income for 1974 includes (i) the \$3,000 deemed distributed from the 1978 distribution, and (ii) the \$5,000 deemed distributed in 1974 from the 1980 trust Y accumulation distribution. To compute A’s tax under the exact method for 1974 on the \$10,000 from the 1980 trust X accumulation distribution deemed distributed in 1974, A’s gross income for 1974 includes (i) the \$10,000, (ii) the \$3,000 previously deemed distributed in 1974 from the 1978 trust X accumulation distribution, and (iii) the \$5,000 deemed distribution in 1974 from the 1980 trust Y accumulation distribution.

Example 2. In 1978, trust T makes an accumulation distribution of undistributed net income to B, a calendar year taxpayer. Determination of the tax on the accumulation distribution under the short-cut method requires the use of B’s gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution of undistributed net income from trust U, of which \$2,000 was deemed to have been distributed in 1975, and \$3,000 in 1976. B’s gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T accumulation distribution, will be deemed to include the \$2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the \$3,000 deemed distributed by trust U in 1976.

§ 1.668(b)-3A Computation of the beneficiary’s income and tax for a prior taxable year.—(a) Basis for computation.—(1) The beneficiary’s income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.668(b)-4A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for computation purposes. The term “as finally determined” has reference

to the final status of the gross income, deductions, credits, and taxes of the taxable year after the expiration of the period of limitations or after completion of any court action regarding the tax for the taxable year.

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 666 amount in the beneficiary's gross income and the tax for such year computed without including such amounts in such gross income shall be based upon the return after the correction of such mathematical errors, and the beneficiary shall be credited for the correct amount of tax that should have been properly paid.

(b) Effect of allocation of undistributed net income on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover. (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed net income allocated to such year. For example, if \$1,000 of undistributed net income is allocated to 1970, adjusted gross income for 1970 is increased from \$5,000 to \$6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed net income deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed net income on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1978, a trust makes an accumulation distribution of undistributed net income to X of \$50,000 that is deemed under section 666(a) to have been distributed in 1972. X had income in 1972, 1973, and 1974¹, and had a net operating loss in 1975 that offset his taxable income (computed as provided in § 1.172-5) for those years, as follows:

Year	Actual income or loss	Income after net operating loss carryback (n.o.l.c.b.)
1972	\$10,000	\$0
1973	50,000	0

1. The official version reads '1973'.

Year	Actual income or loss	Income after net operating loss carryback (n.o.l.c.b.)
1974	50,000	10,000
1975	(100,000)	0

As a result of the allocation of the 1973 accumulation distribution to 1972, X's income for 1972, 1973, 1974, and 1975, after taking into account the 1975 n.o.l.c.b., is deemed to be as follows:

Year Income deemed to have been earned after consideration of n.o.l.c.b. and accumulation distribution

Year	Income deemed to have been earned after consideration of N.O.L.C.B., and accumulation distribution
1972	0 (\$10,000 + \$50,000 – \$60,000 n.o.l.c.b.).
1973	\$10,000 (\$50,000 – \$40,000 balance of n.o.l.c.b.).
1974	\$50,000.
1975	0.

Therefore, the tax on the 1978 accumulation distribution to X is the tax X would have paid in 1973 and 1974 had he had the above income in such years.

(c) Averaging.—A beneficiary who uses the exact method may recompute his tax for a prior taxable year by using income averaging for all of his actual income for that year, plus the amount deemed distributed in that year under section 666, even though he may not have actually used section 1301 to determine his income tax for such taxable year. For purposes of such recomputation, the beneficiary's income for all other taxable years involved must include any amounts deemed distributed in such years from the current and all prior accumulation distributions. See § 1.668(b)-4A(c)(3) for additional information requirements. The beneficiary may not apply the provisions of this paragraph to a taxable year in which an amount is deemed to be income by reason of § 1.666(d)-1A(b). The accumulation distribution itself is not eligible for income averaging in the years in which it is paid, credited, or required to be distributed. See section 1302(a)(2)(B) and the regulations thereunder.

§ 1.668(b)-4A Information requirements with respect to beneficiary.—(a) Information to be supplied by beneficiary—(1) In general. The beneficiary must supply the information required by subparagraph (3) of this paragraph for any prior taxable year for which a recomputation is required under either the exact method or the shortcut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(2) is imposed.

(2) Failure to furnish.—If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.668(b)-1A (the shortcut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(2). See, however, paragraph (b) of this section for an exception to this rule

where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(3) Information required.—The beneficiary shall file the following items with his income tax return for the taxable year in which the accumulation distribution is included in income:

(i) A statement showing the gross income, adjustments, deductions, credits, taxes paid, and computations for each of his taxable years for which a computation is required under the method by which he computes his partial tax imposed by section 668(a)(2). Such statement shall include such amounts for the taxable year as adjusted by any events subsequent to such year, such as any adjustment resulting from the determination of a deficiency or an overpayment, or from a court action regarding the tax.

(ii) A copy of the statement required by this subparagraph to be furnished by the beneficiary for any prior taxable year in which an accumulation distribution was received by him which was also deemed distributed in whole or in part in the prior taxable year for which the statement under subdivision (i) of this subparagraph is required.

(iii) A copy of any statements furnished the beneficiary by the trustee (such as schedules E and J of Form 1041, etc.) with regard to the current taxable year or any prior taxable year for which a statement is furnished under subdivision (i) of this subparagraph.

(b) Exception.—If by reason of § 1.668(b)-1A(e) the beneficiary may not compute the partial tax on the accumulation distribution under § 1.668(b)-1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by subparagraph (3) of paragraph (a) of this section for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

(c) Records to be supplied by the beneficiary.—(1) Year when return was filed. If the beneficiary filed an income tax return for a taxable year for which a recomputation is necessary, and the period of limitations on assessment under section 6501 for such year has expired as of the filing of the return for the year in which the accumulation distribution was made, then a copy of such return, plus proof of any changes of liability for such year due to the determination of a deficiency or an overpayment, court action, etc., shall, to the extent they verify the statements required under paragraph (a) of this section, serve as proof of such statements. If the period of limitations on assessment under section 6501 for a prior taxable year has not expired as of the filing of the beneficiary's return for the year in which the accumulation distribution was received, then the records required by section 6001 to be retained by the beneficiary for such prior taxable year shall serve as the basis of proof of the statements required to be filed under paragraph (a) of this section.

(2) Year for which no return was filed. If the beneficiary did not file a return for a taxable year for which a recomputation is necessary, he shall be deemed to have had in such year, in the absence of proof to the contrary, gross income in the amount equal to the maximum amount of gross income that he could have received without having had to file a return under section 6012 for such year.

(3) Distributions deemed averaged.—In order for a beneficiary to use income averaging with respect to a prior taxable year (see § 1.668(b)-3A(c)), he must furnish

all the information that would support the computation under section 1301 as if the distribution were actually received and averaged in such prior taxable year, even if a portion of the information relates to years in which no amount was deemed distributed to the beneficiary.

§ 1.668(a)-1 Amounts treated as received in prior taxable years; inclusion in gross income.—(a) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the gross income of the beneficiary or beneficiaries receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amounts would have been included under section 662(a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder. See paragraphs (h)(1)(ii) and (j)(1)(ii) of § 1.668(b)-2.

(b) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in paragraph (a) of this section in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(c) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

§ 1.668(a)-2 Allocation among beneficiaries; in general.—The portion of the total amount includible in gross income under § 1.668(a)-1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is \$10,000. The trust had undistributed net income for the taxable year 1954 of \$5,000, to which a tax of \$1,100 was allocable. During the taxable year 1955, the trustee distributes \$10,000 to A and \$5,000 to B. Thus, of the total distribution of \$15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	\$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666(a)	5,000

Taxes imposed on the trust deemed distributed under section 666(b) 1,100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income \$6,666.67 (10,000/15,000 × \$10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and \$3,333.33 (10,000/\$15,000 × \$5,000) of the accumulation distribution and \$733.33 (10,000/15,000 × \$1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

§ 1.668(a)-3 Excluded amounts.—When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under section 665(b)(1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, in the gross income of the beneficiaries pursuant to § 1.668(a)-1 is first allocated to the beneficiaries as provided in § 1.668(a)-2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b)(1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example 1. (a) A trust in 1957 has income as defined in section 643(b) of \$35,000 and expenses allocable to corpus of \$5,000. Its distributable net income is, therefore, \$30,000 (\$35,000-\$5,000). The undistributed net income of the trust and the taxes imposed on the trust were \$12,840 and \$7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed \$50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662(a)(2) one-half (\$15,000) of the distributable net income (\$30,000) of the trust for 1957.

(c) The excess distribution of \$35,000 (\$50,000-\$15,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in B's gross income under section 668(a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668(a).

(d) The accumulation distribution of the trust is \$35,000, computed as follows:

Total distribution by the trust		\$100,000
Less: Distributable net income for 1957	\$30,000	
Excess distribution to B	<u>35,000</u>	<u>65,000</u>
Accumulation distribution to A		35,000

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(e) The accumulation distribution of \$35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	1955	1954	Total
Undistributed net income	\$12,840	\$12,840	\$9,320	\$35,000
Taxes Total imposed on the trust	7,260	7,260	5,270	19,790
Total	20,100	20,100	14,590	54,790

Thus, A will include \$54,790 in his gross income for 1957 under section 668(a). A will, however, receive credit against his tax under section 668(b).

Example 2. (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also make discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is \$30,000. It had undistributed net income of \$12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were \$7,260. The trustee distributed \$15,000 to A during 1955 and on December 31, 1955, he distributed \$60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount (\$75,000) distributed by the trust during 1955, he must include in his gross income under section 662(a)(2) four-fifths (\$24,000) of the distributable net income (\$30,000) of the trust for 1955. A will include in her gross income under section 662(a)(2) one-fifth (\$6,000) of the distributable net income (\$30,000) of the trust for 1955.

(c) The excess distribution of \$36,000 (\$60,000-\$24,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in his gross income under section 668(a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668(a) is \$9,000, computed as follows:

Total distribution by the trust	\$75,000
Less: Distributable net income for 1955	\$30,000
Excess distribution to B	<u>36,000</u>
Amount treated as an accumulation distribution	9,000
	<u>66,000</u>

(e) Inasmuch as the amount of \$9,000 is less than the total undistributed net income of the trust (\$12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include \$14,089 in her gross income for 1955 under section 668(a) computed as follows:

1954 Accumulation distribution	\$9,000
Taxes imposed on the trust $(9,000/12,840 \times \$7,260)$	<u>5,089</u>
Total	14,089

A will, however, receive credit against her tax under section 668(b).

§ 1.668(a)-4 Tax attributable to throwback.—(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662(c) and the regulations thereunder). In the case of a trust (other than a foreign trust created by a U.S. person), the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662(a)(2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. In the case of a foreign trust created by a U.S. person, the tax on the beneficiary shall be computed in accordance with the provisions of section 669 and the regulations thereunder. The tax liability of the beneficiary of a trust (other than a foreign trust created by a U.S. person), including the portion of an entire foreign trust which does not constitute a foreign trust created by a U.S. person (see § 1.643(d)-1), for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer’s marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, plus:

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), or (ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph), whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, \$10,000 is deemed distributed under section 666 to a beneficiary, of which \$6,000 is deemed distributed by the trust on the last day of 1955 and \$4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of \$5,000 for 1956, \$10,000 for 1955, and \$10,000 for 1954. The beneficiary’s tax liability for 1956 is \$4,730 determined as follows:

Year 1956

Tax on \$15,000 (taxable income including section 666 amounts).....	\$4,730
Tax on \$5,000 (taxable income excluding section 666 amounts).....	1,100
Tax attributable to section 666 amounts	3,630

Year 1955

Tax on \$16,000 (taxable income including section 666 amounts).....	\$5,200
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Tax on \$10,000 (taxable income excluding section 666 amounts).....	2,640
Tax attributable to section 666 amounts	2,560

Year 1954

Tax on \$14,000 (taxable income including section 666 amounts).....	\$4,260
Tax on \$10,000 (taxable income excluding section 666 amounts).....	2,640
Tax attributable to section 666 amounts	1,620

(2) Inasmuch as the tax of \$3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of \$4,180 (\$2,560 plus \$1,620) determined for the preceding taxable years the amount of \$3,630 is added to the tax (\$1,100) computed for 1956 without including the section 666 amounts.

§ 1.668(b)-1 Credit for taxes paid by the trust.—(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 666 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666(a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668(b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

§ 1.668(b)-2 Illustration of the provisions of subpart D.—The provisions of Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, other than provisions relating to a foreign trust created by a U.S. person, may be illustrated by the following example:

Example. (a) Facts.—(1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of \$20,000 for 1954, and \$10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643(a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954	\$15,000	\$20,000	\$10,000	\$5,000	\$50,000
1955	10,000	15,000	10,000	5,000	40,000
1956	10,000	20,000	15,000	5,000	50,000

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	10,000	15,000	15,000	5,000	45,000

(2) One-half (\$7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	\$25,000	None
1955	20,000	None
1956	25,000	\$45,000
1957	22,500	29,550

(b) Distributions to A.—A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662(a)-2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) Tax liability of the trust.—(1) 1954.—(i) The tax liability of the trust for the taxable year 1954 is \$13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)	\$50,000
Less amounts not includible in gross income:	
Tax-exempt interest.....	\$5,000
Dividend exclusion	<u>50</u>
	5,050
Distributable net income as adjusted	44,950
Add: Capital gains (long-term)	<u>20,000</u>
Total	64,950
Deductions:	
Distributions to A.....	\$22,475
Capital gain deduction	\$10,000
Personal exemption.....	<u>100</u>
	32,575
Taxable income	32,375
Alternative tax.....	13,601
Dividend received credit	<u>150</u>
Tax liability	13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust is deemed to be distributed to A, \$25 of such distribution is deemed to be made from the dividend exclusion of \$50, and the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, \$3,725 from dividends received on or before July 31, 1954, and \$3,750 from dividends received after July 31, 1954). The trust is entitled to a dividend received credit attributable to the dividends of \$3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) 1955. (i) The tax liability of the trust for the taxable year 1955 is \$8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)	\$40,000
Less amounts not includible in gross income:	
Tax-exempt interest	\$5,000
Dividend exclusion	<u>50</u>
	<u>5,050</u>
Distributable net income as adjusted	34,950
Add: Capital gains (long-term)	<u>10,000</u>
Total	44,950
Deductions:	
Distributions to A	\$17,475
Capital gain deduction	5,000
Personal exemption	<u>100</u>
	<u>22,575</u>
Taxable income	22,375
Alternative tax	8,388
Dividend received credit	<u>199</u>
Tax liability	8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half (\$4,975) of the dividends of \$9,950 (\$10,000 less dividend exclusion of \$50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of \$4,975 which were not distributed to any beneficiary during the taxable year.

(3) 1956 and 1957.—The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) Accumulation distributions.—(1) Accumulation distributions of \$20,000 and \$7,050, as defined in section 665(b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643(a)	\$50,000	\$45,000
Less: Income currently distributable to A	25,000	22,500
Balance of income	25,000	22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	20,000	7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1) of this example) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of subpart D to the 1956 accumulation distribution and to the undistributed net incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) Throwback of 1956 accumulation distribution to 1955.—The accumulation distribution of \$20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) 1955 Undistributed net income.—(i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is \$12,885, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)	\$40,000
Less:	
Distributions to A	\$20,000
Taxes imposed on the trust	<u>7,115</u>
	<u>27,115</u>
Undistributed net income as of the close of 1955.	12,885

(ii) The taxes imposed on the trust of \$7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the “balance” in the computation below) and is determined as follows:

Taxable income (paragraph (c)(2)(i) of this example).....	\$22,375
Capital gains allocable to corpus	\$10,000
Less:	
Capital gain deduction	\$5,000
Personal exemption.....	<u>100</u>
	<u>5,100</u>

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Portion of taxable income allocable to corpus.....	<u>4,900</u>
Balance.....	<u>17,475</u>
Total taxes paid by the trust	8,189
Taxes on income (\$4,900) allocable to corpus.....	<u>1,074</u>
Taxes imposed on the trust (section 665(c)).....	7,115

(iii) The amount of \$1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) Allocation of 1956 accumulation distribution to the preceding taxable year 1955. The portion of the 1956 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is \$12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust (\$7,115) is, under section 666(b), also deemed to be distributed to B on the last day of 1955. Thus, a total of \$20,000 (\$12,885 plus \$7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of \$20,000 in the hands of B.

(3) Character of amounts deemed distributed.—Inasmuch as one-half of the 1955 distributable net income of the trust as determined under section 643(a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of \$5,000, rents of \$7,500, taxable interest of \$5,000, and tax-exempt interest of \$2,500.

(4) Credit for taxes paid by the trust.—The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b) is \$7,115. See also paragraph (h)(3) of this example.

(5) Effect of application of provisions of subpart D to the year 1955. After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is \$7,115, determined as follows:

1956 accumulation distribution (paragraph (d)(1) of this example).....	\$20,000
Less: Amount allocable to 1955.....	<u>12,885</u>
Balance allocable to second preceding taxable year 1954.....	7,115

(f) Throwback of 1956 accumulation distribution to 1954.—The unabsorbed portion of the 1956 accumulation distribution of \$7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) 1954 undistributed net income.—(i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is \$14,155, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)	\$50,000
Less:	

Distributions to A.....	\$25,000	
Taxes imposed on the trust.....	10,845	<u>35,845</u>
Undistributed net income as of the close of 1954.....		14,155

(ii) The taxes imposed on the trust of \$10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below in this subdivision) and is determined as follows:

Taxable income (paragraph (c)(1)(i) of this example).....		\$32,375
Capital gains allocable to corpus	\$20,000	
Less: Capital gain deduction.....	\$10,000	
Personal exemption.....	<u>100</u>	<u>10,100</u>
Portion of taxable income allocable to corpus.....		<u>\$9,900</u>
Balance.....		<u>22,475</u>
Total taxes paid by the trust		13,451
Taxes on income (\$9,900) allocable to corpus.....		<u>2,606</u>
Taxes imposed on the trust (section 665(c))		10,845

(iii) The amount of \$2,606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.—Since the unabsorbed portion of the 1956 accumulation distribution of \$7,115 is less than the 1954 undistributed net income of \$14,155, the trust is deemed under section 666(c) to have also distributed an additional amount (\$5,451) equal to a pro rata portion ($7,115/14,155 \times \$10,845$) of the taxes imposed on the trust for 1954. Thus, a total of \$12,566 (\$7,115 plus \$5,451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of \$12,566 in the hands of B.

(3) Character of amounts deemed distributed to B.—The amount of \$12,566 which, under section 666, is deemed to be distributed to B on December 31, 1954, is deemed to be composed of the following items of income of the trust: Dividends, \$3,770 ($15,000/50,000 \times \$12,566$); rents, \$5,026 ($20,000/50,000 \times \$12,566$); taxable interest, \$2,513 ($10,000/50,000 \times \$12,566$); and tax-exempt interest, \$1,257 ($5,000/50,000 \times \$12,566$). One-half of the dividends of \$3,770 is considered as distributed from the dividends received by the trust on or before July 31, 1954, of which \$13 ($3,770/15,000 \times \50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of \$12,566 deemed distributed to B, \$11,296 is considered as made from income included in the gross income of the trust and \$1,270 from non-taxable income of the trust.

(4) Credit for taxes paid by the trust.—The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b), because of the allocation of the 1956 accumulation distribution to 1954, is \$5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c)(1) of this example)		\$32,375
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Less:

Amount deemed distributed to B under section 666 from the taxable income of the trust	11,296
Taxable income adjusted as of the close of 1956.....	<u>21,079</u>
Taxes on \$21,079 (alternative tax).....	\$8,050
Taxes on income allocable to corpus (subparagraph (1)(ii) of this paragraph).....	<u>\$2,606</u>
Taxes imposed on the trust determined as of the close of 1956.....	<u>5,444</u>
Taxes imposed on the trust determined as of the close of 1954.....	\$10,845
Taxes imposed on the trust determined as of the close of 1956.....	<u>5,444</u>
Amount of taxes allowed as a credit to B under section 668(b)	<u>5,401</u>

(5) Effect of application of provisions of subpart D to the year 1954.—

(i) The undistributed portion of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is \$12,434, computed as follows:

Distributable net income (section 643(a)).....	\$50,000
Less: Amount currently distributable to A	\$25,000
Amount deemed distributed to B under section 666	<u>12,566</u>
Undistributed portion of distributable net income as of the close of 1956	<u>37,566</u> 12,434

(ii) The amount of \$12,434 is deemed to consist of dividends of \$3,730, rents of \$4,974, taxable interest of \$2,487, and tax-exempt interest of \$1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	\$15,000	\$20,000	\$10,000	\$5,000	¹ \$50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	² 25,000
To B	3,770	5,026	2,513	1,257	³ 12,566
Total	11,270	15,026	7,513	3,757	37,566
Balance	3,730	4,974	2,487	1,243	12,434

1. See paragraph (a)(1) of this example.
2. See paragraph (b) of this example.
3. See paragraph (f)(3) of this example.

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is \$6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	\$12,434
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Less:

Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph).....	5,444
Undistributed net income as of the close of 1956.....	6,990

(g) Throwback of 1957 accumulation distribution.—Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of subpart D to the accumulation distribution made during 1956, the 1957 accumulation distribution of \$7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) of this example for computation of the accumulation distribution.

(1) Allocation of 1957 accumulation distribution to the preceding taxable year 1954.—The portion of the 1957 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1954 is \$6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust (\$5,444), determined as of the close of 1956, is under section 666(b) also deemed to be distributed to B on the last day of 1954. See paragraph (f)(4) and (5) of this example. Thus, a total of \$12,434 (\$6,990 plus \$5,444) is deemed to be distributed to B on December 31, 1954, by reason of the allocation of the 1957 accumulation distribution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of \$12,434 in the hands of B.

(2) Character of amounts deemed distributed.—Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of \$3,730, rents of \$4,974, taxable interest of \$2,487, and tax-exempt interest of \$1,243. See paragraph (f)(5)(ii) of this example.

(3) Credit for taxes paid by the trust.—The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668(b) is \$5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f)(4) of this example.

(4) Effect of application of provisions of subpart D to the year 1954.—After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of \$60 (\$7,050 less \$6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) Determination of B’s tax liability; taxable year 1956.—(1) Amount of trust income includible in gross income. (i) Of the amount of \$45,000 distributed by the trust to B during the taxable year 1956, \$25,000 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and \$20,000 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, \$12,885 plus taxes of \$7,115 is deemed distributed to B on December 31, 1955, and \$7,115 plus taxes of \$5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B’s gross income for 1956 to the extent that they would have been includible in his gross income under section 662(a)(2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	\$5,000	\$10,000	\$7,500	\$2,500	¹ \$25,000
1955	5,000	7,500	5,000	2,500	² 20,000
1954	3,770	5,026	2,513	1,257	³ 12,566
Total	13,770	22,526	15,013	6,257	57,566

1. See paragraph (d)(2) of this example.
2. See paragraph (e)(3) of this example.
3. See paragraph (f)(3) of this example.

Thus, B will include in gross income for 1956 dividends of \$13,770 (subject to the dividend exclusion), rents of \$22,526, and taxable interest of \$15,013, and will exclude the tax-exempt interest of \$6,257.

(2) Computation of tax.—(i) For the purpose of computing B's tax liability, it is assumed that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income (derived from salary) for each of the years 1954 and 1955 amounted to \$13,400 on which a tax of \$4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was \$15,000 derived from salary, and he had allowable deductions of \$10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a)(1) of § 1.668(a)-4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	\$15,000	\$15,000
Income from trust:		
Dividends (\$50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	37,450	66,259
Less: Allowable deductions	10,600	10,600
Taxable income	26,850	55,659
Total tax	11,267	31,064
Less: Dividend received credit	198	475
Tax liability	11,069	30,589
Tax on income from which section 666 amounts are excluded	.....	11,069
1956 tax attributable to section 666 amounts	.....	19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f)(3) of this example.

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a)(2) of § 1.668(a)-4, is as follows:

	Preceding taxable years	
	First 1955	Second 1954
Taxable income previously reported	13,400	13,400
Section 666 amounts:		
Dividends (\$50 excluded)	4,950	3,720
Rents	7,500	5,026

Taxable interest	Preceding taxable years	
	5,000	2,513
Taxable income as adjusted	30,850	24,659
Total tax	13,747	9,949
Less: Dividend received credit	198	75
Balance of tax	13,549	9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	9,547	5,872

Only that portion (\$1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of \$75 for the year 1954. See paragraph (f)(3) of this example.

(iv) Inasmuch as the aggregate of the taxes of \$15,419 (\$9,547 plus \$5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of \$19,520 determined for the taxable year 1956, the amount of \$15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is \$26,488 (\$11,069 plus \$15,419).

(3) Credits against the tax. B is allowed under section 668(b) a credit of \$12,516 (\$5,401 for 1954 and \$7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e)(4) and (f)(4) of this example.

(i) [Reserved]

(j) Taxable year 1957.—(1) Amount of trust income includible in gross income.—(i) Of the amount of \$29,550 distributed by the trust to B during the taxable year 1957, \$22,500 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and \$7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, \$6,990 plus taxes of \$5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662(a)(2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	\$5,000	7,500	\$7,500	\$2,500	\$22,500

1954	3,730	4,974	2,487	1,243	12,434
Total	8,730	12,474	9,987	3,743	34,934

Thus, B will include in gross income for the year 1957 dividends of \$8,730 (subject to the dividend exclusion), rents of \$12,474, and taxable interest of \$9,987 and will exclude the tax-exempt interest of \$3,743.

(2) Computation of tax.—(i) For the purpose of computing B’s tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of \$15,000 from salary. Also, he had allowable deductions of \$8,100, which included the deductions for personal exemption.

(ii) The computation of the tax for the taxable year 1957 attributable to the section 666 amounts which are included in B’s gross income for that year, as provided in paragraph (a)(1) of § 1.668(a)-4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	\$15,000	\$15,000
Trust income:		
Dividends (\$50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	34,950	46,141
Less: Allowable deductions	8,100	8,100
Taxable income	26,850	38,041
Total tax	11,267	18,388
Less: Dividend received credit	198	275
Tax liability	11,069	18,113
Tax on income from which section 666 amounts are excluded	.....	11,069
1957 tax attributable to section 666 amounts	.....	7,044

See explanation following computation in paragraph (h)(2)(ii) of this example with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is \$6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h)(2)(iii) of this example).....	\$24,659
Section 666 amounts:	

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Dividends	3,730
Rents	4,974
Taxable interest	<u>2,487</u>
Taxable income as adjusted.....	<u>35,850</u>
Total tax.....	16,963
Less: Dividends received credit.....	<u>150</u>
Balance of tax	16,813
Tax liability for 1954.....	\$4,002
Tax attributable to 1956 accumulation distribution (this example).....	<u>5,872</u>
.....	<u>9,874</u>
Tax attributable to the section 666 amounts distributed in 1957	<u>6,939</u>

Only that portion (\$3,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of \$150. See paragraphs (f)(3) and (g)(2) of this example.

(iv) Inasmuch as the tax of \$6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of \$7,044 attributable to these amounts for the year 1957, the amount of \$6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is \$18,008 (\$11,069 plus \$6,939).

(3) Credit against the tax. B is allowed under section 668(b) a credit of \$5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph (g)(3) of this example.

(Sec. 669(a) as amended by sec. 331(a), Tax Reform Act 1969 (83 Stat. 592))

§ 1.669(a)-1A Amount allocated.—(a) In general.—After a trust has distributed all of its undistributed net income, the rules concerning the treatment of capital gain distributions (prescribed under section 669) may become applicable to an accumulation distribution. This section prescribes rules to determine from which years capital gain distributions are considered to be made. For the definition of “capital gain distribution,” see § 1.665(g)-1A. Section 669 does not apply to a trust that has distributed all of its income currently since its inception. See § 1.668(a)-1A(c). Capital gain retains its character in the hands of the beneficiary. See § 1.669(f)-1A. A capital gain distribution to more than one beneficiary will be allocated among them. See § 16.668(a)-2A.

(b) First-in, first-out rule.—A capital gain distribution is allocated to the preceding taxable years of the trust (as defined in § 1.665(e)-1A(a)(1)(iii)), according to the undistributed capital gain of the trust for such years. For this purpose, a capital gain distribution is first allocated to the earliest such preceding taxable year in which there is undistributed capital gain and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the capital gain distribution allocated to the earliest preceding taxable year is the amount of undistributed capital gain for that preceding taxable year. The portion of the capital gain distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the capital gain distribution over the aggregate

of the undistributed capital gain for all earlier preceding taxable years. See paragraph (c) of this section for adjustments to undistributed capital gain for prior distributions.

(c) Reduction of undistributed capital gain for prior capital gain distributions.—For the purposes of allocating to any preceding taxable year a capital gain distribution of the taxable year, the undistributed capital gain of such preceding taxable year is reduced by the amount from such year deemed distributed in any capital gain distribution made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust subject to the capital gain throwback has no undistributed net income but has undistributed capital gain for 1974, and makes capital gain distributions during the taxable years 1978 and 1979, then in determining that part of the 1979 capital gain distribution that is thrown back to 1974, the undistributed capital gain for 1974 is reduced by the amount of such undistributed capital gain for 1974 deemed distributed in the 1978 capital gain distribution.

(d) Rule when no undistributed capital gain.—If, before the application of the provisions of subpart D to a capital gain distribution for the taxable year, there is no undistributed capital gain for a preceding taxable year, then no portion of the capital gain distribution is deemed distributed on the last day of such preceding taxable year. Thus, for example, if a capital gain distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed capital gain for 1970, then no portion of the 1975 capital gain distribution is deemed distributed on the last day of 1970.

(e) Example. The provisions of this section may be illustrated by the following example:

Example. In 1977, a trust reporting on the calendar year basis makes a capital gain distribution of \$33,000. In 1969, the trust had \$6,000 of undistributed capital gain; in 1970, \$4,000; in 1971, none; in 1972, \$7,000; in 1973, \$5,000; in 1974, \$8,000; in 1975, \$6,000; in 1976, \$4,000; and \$6,000 in 1977. The capital gain distribution is deemed distributed \$6,000 in 1969, \$4,000 in 1970, none in 1971, \$7,000 in 1972, \$5,000 in 1973, \$8,000 in 1974, and \$3,000 in 1975.

§ 1.669(b)-1A Tax on distribution.—(a) In general.—The partial tax imposed on the beneficiary by section 668(a)(3) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the “exact” method), or

(2) The tax computed under paragraph (c) of this section (the “short-cut” method), except as provided in § 1.669(c)-3A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary’s choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(2).

(b) Computation of partial tax by the exact method.—The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 669 amounts for each of the preceding taxable years. For purposes of this paragraph, the “section 669 amounts” for a preceding taxable year are the amounts deemed distributed under section 669(a) on the last day of such preceding taxable year, plus the amount of taxes deemed distributed on such day under section 669 (d) or (e). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary’s gross in-

come and the tax for such year computed with the inclusion of them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed capital gain of a trust deemed distributed in a capital gain distribution includes amounts received as a capital gain distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 669(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 669(a) amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)-1A and 1.669(e)-1A as does not exceed such sum. The resulting amount, if any, is the partial tax on the beneficiary, computed under the exact method, for the taxable year in which the capital gain distribution is paid, credited, or required to be distributed to the beneficiary.

(c) Computation of tax by the short-cut method.—(1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received a capital gain distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such capital gain distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed capital gain deemed distributed is less than 25 percent of (a) the total amounts deemed under section 669(a) to be undistributed capital gain from preceding taxable years, divided by (b) the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed without application of this sentence. For example, assume that a capital gain distribution of \$90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of \$29,000 in each of the years 1972, 1973, and 1974, and \$3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is 4. However, the distribution deemed made in 1975 (\$3,000) is less than \$5,625, which is 25 percent of (a) the total undistributed capital gain deemed distributed under section 669(a) (\$90,000) divided by (b) the number of such preceding taxable years (4), or \$22,500. Therefore, for purposes of this subparagraph, the capital gain distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the capital gain distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (determined as provided in subdivision (i) of this paragraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of long-term and short-term capital gain as the total of each type of capital gain deemed distributed in the capital gain distribution bears to the total undistributed capital gain from such preceding taxable years deemed distributed in the capital gain distribution. For example, assume that an amount of \$50,000 is deemed distributed under section 669(a) from undistributed capital gain of 5 preceding taxable years of the trust, and consists of \$30,000 of long-term capital gain and \$20,000 of short-term capital gain. Taxes attributable to such amounts in the amount of \$10,000 are also deemed distributed. The amount determined under this subdivision, \$12,000 (\$50,000 income plus \$10,000 tax, divided by 5 years), is deemed to consist of \$7,200 of long-term capital gain and \$4,800 in short-term capital gain.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the capital gain distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3.

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (previously determined under subdivision (i) of this subparagraph).

(vi) The resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)-1A and 1.669(e)-1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 669(b)(1)(B).

(2) See § 1.668(b)-1A(c) for examples of the short-cut method in the context of an accumulation distribution.

(d) Disallowance of short-cut method.—If, in any prior taxable year of the beneficiary in which any part of the capital gain distribution is deemed to have been distributed under section 669(a) to such beneficiary, any part of prior capital gain distributions by each of two or more other trusts is deemed under section 669(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(3) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes a capital gain distribution to A, who is on the calendar year basis, and part of the distribution is deemed under section 669(a) to have been distributed on March 31, 1974. In 1977, A had received a capital gain distribution from both trust Y and trust Z. Part of the capital gain distribution from trust Y was deemed under

section 669(a) to have been distributed to A on June 30, 1974, and part of the capital gain distribution from trust Z was deemed under section 669(a) to have been distributed to A on December 31, 1974. Because there were portions of capital gain distributions from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 capital gain distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 668(a)(3).

§ 1.669(c)-1A Special rules applicable to section 669.—(a) Effect of other distributions.—The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.669(b)-1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a prior accumulation distribution is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term prior accumulation distribution also includes accumulation distributions of the same or other trusts which were distributed to the beneficiary in the same taxable year. The term “prior capital gain distribution” also includes capital gain distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (b) of this section to treat as having been distributed before the capital gain distribution for which tax is being computed under § 1.669(b)-1A.

(b) Multiple distributions in the same taxable year.—For purposes of paragraph (a) of this section, capital gain distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several capital gain distributions. The beneficiary shall indicate the order he has determined to deem the capital gain distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(c) Rule when beneficiary not in existence on the last day of a taxable year.—If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 669(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.669(b)-1A, that the beneficiary:

- (1) Was in existence on such last day,
- (2) Was a calendar year taxpayer,
- (3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,
- (4) If an individual, was unmarried and had no dependents,
- (5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of a capital gain distribution made in 1980 is deemed under section 669(a) to have been distributed to the beneficiary, A, in 1973. \$10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.669(b)-1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the \$10,000 from the accumulation distribution deemed distributed in 1973 and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(d) Examples. The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made a capital gain distribution to A, a calendar year taxpayer, of which \$3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another capital gain distribution to A, \$10,000 of which is deemed under section 669(a) to have been distributed in 1974. Also in 1980, trust Y makes a capital gain distribution to A, of which \$5,000 is deemed under section 669(a) to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the \$3,000 deemed distributed from the 1978 distribution, and (ii) the \$5,000 deemed distributed in 1974 from the 1980 Trust Y capital gain distribution. To compute A's tax under the exact method for 1974 on the \$10,000 from the 1980 trust X capital gain distribution deemed distributed in 1974, A's gross income for 1974 includes (i) the \$10,000, (ii) the \$3,000 previously deemed distributed in 1974 from the 1978 trust X capital gain distribution, and (iii) the \$5,000 deemed distributed in 1974 from the 1980 trust Y capital gain distribution.

Example 2. In 1978, trust T makes a capital gain distribution to B, a calendar year taxpayer. Determination of the tax on the distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution from trust U, of which \$2,000 was deemed to have been distributed in 1975, and \$3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T capital gain distribution, will be deemed to include the \$2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the \$3,000 deemed distributed by trust U in 1976.

§ 1.669(c)-2A Computation of the beneficiary's income and tax for a prior taxable year.—(a) Basis for computation.—(1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.669(c)-3A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for recomputation purposes. The term as finally determined shall have the same meaning for purposes of this section as in § 1.668(b)-3A(a).

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's

gross income, and the tax for such year computed without including such amounts in such gross income, shall be based upon the return after the correction of such mathematical errors.

(b) Effect of allocation of undistributed capital gain on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover. (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed capital gain allocated to such year. For example, if \$2,000 of undistributed long-term capital gain is allocated to 1970, adjusted gross income for 1970 is increased from \$5,000 to \$6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed capital gain deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed capital gain on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated.

§ 1.669(c)-3A Information requirements with respect to beneficiary.—(a) Information to be supplied by beneficiary.—(1) Use of exact method.—The beneficiary must supply the information required by subparagraph (3) of § 1.668(b)-4A(a) for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(3) is imposed.

(2) Failure to furnish.—If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.669(b)-1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(3). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(b) Exception.—If, by reason of § 1.669(b)-1A(e), the beneficiary may not compute the partial tax on the capital gain distribution under § 1.669(b)-1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by § 1.668(b)-4A(a)(3) for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

§ 1.669(d)-1A Total taxes deemed distributed.—(a) If a capital gain distribution is deemed under § 1.669(a)-1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed capital gain for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust attrib-

utable to the undistributed capital gain” (as defined in § 1.665(d)-1A(c)) for such preceding taxable year is also deemed to have been properly distributed. For example, assume a trust has no distributable net income and has undistributed capital gain of \$18,010 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed capital gain are \$2,190. During the taxable year 1977, a capital gain distribution of \$18,010 is made to the beneficiary which is deemed under § 1.669(a)-1A to have been distributed on the last day of 1974. The 1977 capital gain distribution is not less than the 1974 undistributed capital gain. Accordingly, taxes of \$2,190 imposed on the trust attributable to the undistributed capital gain for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of \$20,200 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)-1A.

§ 1.669(e)-1A Pro rata portion of taxes deemed distributed.—(a) If a capital gain distribution is deemed under § 1.669(a)-1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed capital gain for such preceding taxable year, then an additional amount is also deemed to have been properly distributed. The additional amount is equal to the “taxes imposed on the trust attributable to the undistributed capital gain” (as defined in § 1.665(d)-1A(c)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the capital gain distribution allocated to such preceding taxable year and the denominator of which is the undistributed capital gain for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.669(e)-2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)-1A, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.669(e)-2A.

§ 1.669(e)-2A Illustration of the provisions of section 669.—The application of the provisions of §§ 1.669(a)-1A, 1.669(d)-1A, and 1.669(e)-1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes capital gain distributions as follows:

1979.....	\$14,000
1980.....	60,000

The trust had accumulated income in 1974.

For 1974 through 1978, the undistributed portion of capital gain, taxes imposed on the trust attributable to the undistributed capital gain, and undistributed capital gain are as follows:

Year	Undistributed portion of capital gain	Taxes imposed on the trust attributable to the undistributed capital gain	Undistributed capital gain
------	---------------------------------------	---	----------------------------

1974	\$24,200	\$2,830	\$21,370
1975	32,200	4,330	27,870
1976	12,200	1,130	11,070
1977	None	None	None
1978	10,200	910	9,290

(b) Since the entire amount of the capital gain distribution for 1979 (\$14,000), determined without regard to the capital gain distribution for 1980, is less than the undistributed capital gain for 1974 (\$21,370), an additional amount of \$1,854 ($14,000/21,370 \times 2,830$) is deemed distributed under section 669(e).

(c) In allocating the capital gain distribution for 1980, the amount of undistributed capital gain for 1974 will reflect the capital gain distribution for 1979. The undistributed capital gain for 1974 will then be \$7,370 and the taxes imposed on the trust for 1974 will be \$976, determined as follows:

Undistributed capital gain as of the close of 1974	\$21,370
Less: Capital gain distribution (1979).....	14,000
Balance (undistributed capital gain as of the close of 1979) ...	7,370
Taxes imposed on the trust attributable to the undistributed capital gain as of the close of 1979 ($7,370/21,370 \times 2,830$)	976

(d) The capital gain distribution of \$60,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of \$55,600, the total of the undistributed capital gain for such years, as shown in the tabulation below. In addition, \$7,346, the total taxes imposed on the trust attributable to the undistributed capital gain for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed capital gain	Taxes imposed on the Trust attributable to the undistributed capital gain
1974	370	\$976
1975	27,870	4,330
1976	11,070	1,130
1977	None	None
1978	9,290	910
1979	None	None
Total	55,600	7,346

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The trust is subject to capital gain throwback. Both X and the trust report on the calendar year basis. All of the income for 1974 was distributed and the capital gain was accumulated. The capital gain of the trust for the taxable year 1974 is \$40,200 and the income taxes paid by the trust for 1974 attributable to the undistributed capital gain are \$6,070. All of the income and capital gains for 1975 and 1976 were distributed and in addition

the trustee made capital gain distributions within the meaning of section 665(g) of \$8,000 for each year.

(b) The undistributed capital gain of the trust determined under section 665(f) as of the close of 1974 is \$34,130, computed as follows:

Capital gain	\$40,200
Less: Taxes imposed on the trust attributable to the undistributed capital gain	<u>6,070</u>
Undistributed capital gain as of the close of 1974	34,130

(c) The capital gain distribution of \$8,000 made during the taxable year 1975 is deemed under section 669(a) to have been made on December 31, 1974. Since this capital gain distribution is less than the 1974 undistributed capital gain of \$34,130, a portion of the taxes imposed on the trust for 1974 is also deemed under section 669(e) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974, is \$9,486, computed as follows:

Capital gain distribution.....	\$8,000
Taxes deemed distributed (8,000/34,130 × \$6,070).....	<u>1,423</u>
Total	9,423

(d) After the application of the provisions of subpart D to the capital gain distribution of 1975, the undistributed capital gain of the trust for 1974 is \$26,130, computed as follows:

Undistributed capital gain as of the close of 1974	\$34,130
Less: 1975 capital gain distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	<u>8,000</u>
Undistributed capital gain for 1974 as of the close of 1975	26,130

(e) The taxes imposed on the trust attributable to the undistributed capital gain for the taxable year 1974, as adjusted to give effective to the 1975 capital gain distribution, amount to \$4,647, computed as follows:

Taxes imposed on the trust attributable to undistributed capital gain as of the close of 1974.....	\$6,070
Less: Taxes deemed distributed in 1974	<u>1,423</u>
Taxes attributable to the undistributed capital gain determined as of the close of 1975	4,647

(f) The capital gain distribution of \$8,000 made during the taxable year 1976 is, under section 669(a), deemed an amount properly distributed to X on December 31, 1974. Since the capital gain distribution is less than the 1974 adjusted undistributed capital gain of \$26,130, the trust is deemed under section 669(e) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the capital gain distribution made in 1976, is \$9,423, computed as follows:

Capital gain distribution.....	\$8,000
Taxes deemed distributed (8,000/26,130 × \$4,647).....	<u>1,423</u>
Total	9,423

(g) After the application of the provisions of subpart D to the capital gain distribution of 1976, the undistributed capital gain of the trust for 1974 is \$18,130, computed as follows:

Undistributed capital gain for 1974 as of the close of 1975	\$26,130
Less: 1976 capital gain distribution deemed distributed on December 31, 1974 (paragraph (f) of this example).....	<u>8,000</u>
Undistributed capital gain for 1974 as of the close of 1976	18,130

(h) The taxes imposed on the trust attributable to the undistributed capital gain of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to \$3,224 (\$4,647 less \$1,423).

§ 1.669(f)-1A Character of capital gain.—Amounts distributed as a capital gain distribution and the taxes attributable thereto (determined under § 1.665(d)-1A(c)) retain the character that the gain had with respect to the trust. Thus, a capital gain that was taxed to the trust as a “long-term” capital gain and the pro rata amount of taxes attributable to such long-term gain shall be treated to the beneficiary as a “long-term” capital gain when they are deemed distributed as part of a capital gain distribution. If a trust has different types of capital gain for the same taxable year, and all of the capital gains are not deemed distributed for such year under section 669(a), the amount deemed distributed from such year (including taxes deemed distributed) shall be treated as consisting of the different types of gains in the ratio that the total of each such type of gains of the trust bears to the total of all such gains for the taxable year. For example, assume that in 1975 a trust had net long-term capital gains of \$4,000 and net short-term capital gains of \$2,000. Taxes attributable to such undistributed capital gain were \$700. Therefore, undistributed capital gain for 1975 is \$5,300. In 1980, the trust distributes \$2,650 that is deemed to be undistributed capital gain from 1975. Such distribution is deemed to consist of long-term gain of \$1,766.67 and short-term gain of \$883.33. The taxes deemed distributed of \$350 consist of long-term gain of \$233.33 and short-term gain of \$116.67.

§ 1.669(f)-2A Exception for capital gain distributions from certain trusts.—
(a) General rule.—If a capital gain distribution is paid, credited, or required to be distributed before January 1, 1973, from a trust that was in existence on December 31, 1969, section 669 shall not apply and no tax shall be imposed on such capital gain distribution under section 668(a)(3). If capital gain distributions from more than one such trust are paid, credited, or required to be distributed to a beneficiary before January 1, 1973, the exception under the preceding sentence shall apply only to the capital gain distributions from one of the trusts. The beneficiary shall indicate on his income tax return for the taxable year in which the distribution would otherwise be included in income under section 668(a) the trust to which the exception provided by this section shall apply.

(b) Special rule for section 2056(b)(5) trust.—A capital gain distribution paid, credited, or required to be distributed by a trust that qualifies under section 2056(b)(5) of the Code (commonly known as a “marital deduction trust”) to a surviving spouse shall, in general, not be taxed under section 668(a)(3) since such a trust is required to distribute all of its income annually or more often. See section 2056(b)(5) and the regulations thereunder.

(c) Effect of exception.—If this section applies to a capital gain distribution from a trust, such distribution shall reduce the undistributed capital gain of the trust. Since section 669 does not apply to such capital gain distribution, no amount of taxes paid by the trust attributable to such capital gain distribution are deemed distributed under section 669(d) and (e).

§ 1.669(a)-1 Limitation on tax.—(a) In general.—Section 669 provides that, at the election of a beneficiary who is a U.S. person (as defined in section 7701(a)(30)) and who satisfies the requirements of section 669(b) (that certain information with re-

spect to the operation and accounts of the trust be supplied), the tax attributable to the amounts treated under section 668(a) as having been received by him, from a foreign trust created by a U.S. person, on the last day of a preceding taxable year of the trust shall not be greater than the tax computed under section 669(a)(1)(A) (the computation under this provision will hereinafter be referred to as the “exact throwback” method) or under section 669(a)(1)(B) (the computation under this provision will hereinafter be referred to as the “short-cut throwback” method). This election of the beneficiary with respect to the taxable year of the beneficiary in which the distribution is made shall be made with the district director before the expiration of the period of limitations for assessment provided in section 6501 for such taxable year.

(b) Where no election is made.—If the beneficiary does not make the election provided in section 669(a) in the manner required in section 669(b) and § 1.669(b)-2, or furnish the information with respect to the operation and accounts of the foreign trust created by a U.S. person required by section 669(b) and § 1.669(b)-1, the tax on an accumulation distribution treated under section 668(a) as having been received by him from such foreign trust on the last day of a preceding taxable year of the trust shall be computed without reference to section 668 or 669. In such case, the entire accumulation distribution will be included in the gross income of the beneficiary in the year in which it is paid, credited, or required to be distributed, and tax for such year will be computed on the basis of the beneficiary’s total taxable income for the year after taking into account such inclusion in gross income.

(c) Year for which tax is payable.—The tax, regardless of the manner in which computed, of the beneficiary which is attributable to an accumulation distribution is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made to him unless the taxable year of the beneficiary is different from that of the trust. See section 662(c) and § 1.662(c)-1.

§ 1.669(a)-2 Rules applicable to section 669 computations.—(a) In general.—(1) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the foreign trust created by a U.S. person on the last day of a preceding taxable year of such trust shall be included in the gross income of the beneficiary or the beneficiaries who are U.S. persons receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amount would have been included in his gross income under section 662(a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and § 1.662(c)-1). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules contained in section 662(b) and §§ 1.662(b)-1 and 1.662(b)-2.

(2) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in subparagraph (1) of this paragraph in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(3) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of the amounts included in a beneficiary’s gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary’s income.

(b) Allocation among beneficiaries of a foreign trust.—Where there is more than one beneficiary the portion of the total amount includible in gross income under paragraph (a) of this section which is includible in the gross income of a beneficiary who is a U.S. person is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year in which distributed (and not for the preceding taxable year). This paragraph may be illustrated by the example in § 1.668(a)-2.

(c) Treatment of income taxes paid by the trust.—(1) Current distributions.—The income taxes imposed by the provisions of section 871 on the income of a foreign trust created by a U.S. person shall be included in the gross income of the beneficiary, who is a U.S. person, for the taxable year in which such income is paid, credited, or required to be distributed to the beneficiary.

(2) Accumulation distribution.—(i) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year is likewise deemed distributed under section 661(a)(2).

(ii) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount (representing taxes) is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year, multiplied by the fraction the numerator of which is the amount of the accumulation distribution attributable to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year.

(3) Credits under sections 32 and 668(b).—Credit under section 32 is allowable to the beneficiary for income taxes withheld at source under subchapters A and B of chapter 3 and which are deemed distributed to him. Credit under section 668(b) is allowable to the beneficiary for income taxes imposed upon the foreign trust by section 871(b). These credits shall be allowed against the tax of the beneficiary for the taxable year of the beneficiary in which the income is paid, credited, or required to be distributed to him, or in which the accumulation distribution to which such taxes relate is made to him.

(d) Credit for foreign income taxes paid by the trust.—To the extent provided in section 901, credit under section 33 is allowable to the beneficiary for the foreign taxes paid or accrued by the trust to a foreign country.

§ 1.669(a)-3 Tax computed by the exact throwback method.

(a) Tax attributable to amounts treated as received in preceding taxable years. If a taxpayer elects to compute the tax, on amounts deemed distributed under section 666, by the exact throwback method provided in section 669(a)(1)(A), the tax liability of the beneficiary for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed is computed as provided in paragraph (b) of this section. The beneficiary may not elect to use the exact throwback method of computing his tax on an accumulation distribution as provided in section 669(a)(1)(A) if he were not alive on the last day of each preceding taxable year of the foreign trust created by a U.S. person with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years before the beneficiary was born, the beneficiary is not permitted to elect the exact throwback method provided in section 669(a)(1)(A). See § 1.669(a)-4

for the computation of the tax on an accumulation distribution by the short-cut throwback method provided in section 669(a)(1)(B) under these circumstances.

(b) Computation of tax.—The tax referred to in paragraph (a) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. To determine the section 666 amounts attributable to each of the preceding taxable years, see § 1.666(a)-1. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding taxable year computed with the inclusion of the section 666 amounts in gross income, and the tax for such year computed without including them in gross income. Tax computations for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(2) Second, add

(i) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), and

(ii) The tax for the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him, computed without including the section 666 amounts in gross income. The total of these amounts is the beneficiary's tax, computed under section 669(a)(1)(A) for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him.

(c) Effect of prior election.—In computing the tax attributable to an accumulation distribution for the taxable year in which such accumulation distribution is paid, credited, or required to be distributed to him, the beneficiary in computing the tax attributable to section 666 amounts for each of the preceding taxable years, must include in his gross income for each such year the section 666 amounts deemed distributed to him in such year resulting from prior accumulation distributions made to him in taxable years prior to the current taxable year. These section 666 amounts resulting from such prior accumulation distributions must be included in the gross income for such preceding taxable year even though the tax on the accumulation distribution of such prior taxable year was computed by the short-cut throwback method provided in section 669(a)(1)(B) and § 1.669(a)-4.

§ 1.669(a)-4 Tax attributable to short-cut throwback method.—(a) Manner of computing tax.—If a beneficiary has elected under section 669(a) to compute the tax on the amounts deemed distributed under section 666 by the short-cut throwback method provided in section 669(a)(1)(B), the tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, determine the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed. In any case where there has been a prior accumulation distribution with respect to which the beneficiary has elected to compute his tax either by the exact throwback method or by the short-cut throwback method, or to which the next to the last sentence of section 668(a) has applied, for purposes of an election to use the short-cut throwback method with respect to a subsequent accumulation distribution, in determining the number of preceding taxable years of the trust with respect to which an amount of the subsequent accumulation distribution is deemed distributed to a beneficiary under section 666(a), there shall be excluded any preceding taxable year during which any part of the prior accumulation distribution was deemed distributed to the beneficiary. For example, assume that an accumulation distribution of \$90,000 made to a beneficiary in 1963 is

deemed distributed in the amounts of \$25,000 in each of the years 1962, 1961, and 1960, and in the amount of \$15,000 in 1959, and a subsequent accumulation distribution of \$85,000 made to the same beneficiary in 1964 is deemed distributed in the amount of \$10,000 during 1959, and \$25,000 during each of the years 1958, 1957, and 1956. The accumulation distribution made in 1963 is deemed distributed in 4 preceding taxable years of the trust (1962, 1961, 1960, and 1959). Inasmuch as the year 1959 was a year during which part of the 1963 accumulation distribution was deemed distributed, for purposes of determining the number of preceding taxable years in which the accumulation distribution of \$85,000 made in 1964 is deemed distributed, the year 1959 is excluded and the \$85,000 accumulation distribution is deemed distributed in three preceding taxable years (1958, 1957, and 1956),

(2) Second, divide the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subparagraph (1) of this paragraph) into the amount (representing an accumulation distribution made by a foreign trust created by a U.S. person) required to be included under section 669(a) in the gross income of the beneficiary for the taxable year,

(3) Third, compute the tax of the beneficiary for the current taxable year (the year in which the accumulation distribution is paid, credited, or required to be distributed to him) and for each of the 2 taxable years immediately preceding such year,

(i) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subparagraph (2) of this paragraph, and

(ii) Without such inclusion.—The difference between the amount of tax computed under subdivision (i) of this subparagraph for each year and the amount computed under subdivision (ii) of this subparagraph for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subparagraph (2) of this paragraph. If the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed, is less than three, the taxable years of the beneficiary for which this recomputation is made shall equal the number of years in which an amount is deemed under section 666(a) to have been distributed, commencing with the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him. If the beneficiary was not alive during one of the two taxable years immediately preceding the taxable year, the tax resulting from the inclusion of the amount determined in subparagraph (2) of this paragraph in the gross income of the beneficiary will be computed only for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him and the preceding year during which the beneficiary was alive. In the event the beneficiary was not alive during either of the 2 years immediately preceding the taxable year in which the accumulation distribution was paid, credited, or required to be distributed, the tax shall be computed on the basis of the beneficiary's taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B). For example, assume that a foreign trust created by a U.S. person accumulates \$3,000 of income in 1964 and \$7,000 in 1963 and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax is determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding \$5,000 to his gross income for each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding \$5,000 to his gross income for such year. In the case of the infant, the resulting increase in tax would be multiplied by two to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

(4) Fourth, add the additional taxes resulting from the application of subparagraph (3) of this paragraph for the taxable year and the 2 taxable years (or the 1 taxable year, where applicable) immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed and then divide this amount by three (or two, where applicable). The resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subparagraph (1) of this paragraph). The resulting amount is the tax, under the short-cut throwback method provided in section 669(a)(1)(B), which is attributable to the amounts treated under section 668(a) as having been received by the beneficiary from a foreign trust created by a U.S. person on the last day of the preceding taxable year.

(5) Fifth, add the amount determined under subparagraph (4) of this paragraph to the beneficiary's tax for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him, computed without inclusion of the accumulation distribution in gross income for that year. The total is the beneficiary's income tax for such year.

(b) Credit for tax paid by trust.—The income taxes deemed distributed to a beneficiary in the manner described in paragraphs (c) and (d) of § 1.669(a)-2 are included in the beneficiary's gross income for purposes of the computations required by this section. To the extent provided in § 1.669(a)-2, credits for such taxes are allowable to the beneficiary. In the computations under the short-cut throwback method provided in section 669(a)(1)(B), the rules set forth in section 662(b) and § 1.662(b)-1 shall be applied in determining the character, in the hands of the beneficiary, of the amounts, including taxes includible in the distribution or deemed distributed, treated as received by a beneficiary in prior taxable years. For example, if one-fifth of such amounts represents tax-free income, then one-fifth of the amount determined under paragraph (a)(2) of this section shall be treated as tax-free income.

§ 1.669(b)-1 Information requirements.—The election of a beneficiary who is a U.S. person to apply the limitations on tax provided in section 669(a) shall not be effective unless the beneficiary, at or before the time the election is made, supplies, in a letter addressed to the district director for the internal revenue district in which the taxpayer files his return (or the Director of International Operations where appropriate), or in a statement attached to his return, the following information with respect to the operation and accounts of the foreign trust created by a U.S. person for each of the preceding taxable years, on the last day of which an amount is deemed distributed under section 666(a):

(a) The gross income of the trust.—The gross income should be separated to show the amount of each type of income received by the trust and to identify its source. For example, the beneficiary should list separately, by type (dividends, rents, capital gains, taxable interest, exempt interest, etc.) and source (name and country of payor), each item of income included in the gross income of the trust. For this purpose, the gross income of the trust includes gross income from U.S. sources which is exempt from taxation under section 894.

(b) The amount of tax withheld under section 1441 by the United States on income from sources within the United States.

(c) The amount of the tax paid to each foreign country by the trust.

(d) The expenses of the trust attributable to each type of income disclosed in paragraph (b) of this section, and the general expenses of the trust.

(e) The distributions, if any, made by the trust to the beneficiaries (including those who are not U.S. persons). These distributions should be separated into amounts of in-

come required to be distributed currently within the meaning of section 661(a)(1), and any other amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2).

(f) Any other information which is necessary for the computation of tax on the accumulation distribution as provided in section 669(a).

(g) If the foreign trust created by a U.S. person is less than the entire foreign trust, the information listed in paragraphs (a) through (f) of this section shall also be furnished with respect to that portion of the entire foreign trust which is not a foreign trust created by a U.S. person.

§ 1.669(b)-2 Manner of exercising election.—(a) By whom election is to be made.—Except as otherwise provided in this paragraph, a taxpayer whose tax liability is affected by the election shall make the election provided in section 669(a). In the case of a partnership, or a corporation electing under the provisions of Subchapter S, Chapter 1 of the Code, the election shall be exercised by the partnership or such corporation.

(b) Time and manner of making election.—The election under section 669(a) may be made, or revoked, at any time before the expiration of the period provided in section 6501 for assessment of the tax. If an election is revoked, a new election may be made at any time before the expiration of such period. The election (or a revocation of an election) may be made in a letter addressed to the district director of internal revenue for the district in which the taxpayer files his tax return (or the Director of International Operations where appropriate) or may be made in a statement attached to the return. In any case where all the information described in § 1.669(b)-1 is not furnished at or before the time the beneficiary signifies his intention of making an election and by reason thereof an election has not been made, and subsequent thereto, but before the expiration of the period provided in section 6501 for the assessment of the tax, there is furnished the required information not previously furnished, the election will be considered as made at the time such additional information is furnished.

§ 1.671-1 Grantors and others treated as substantial owners; scope.—(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675).

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677). Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See Sec. 1.662 (a)-4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder.

(e) For the effective date of subpart E see section 683 and the regulations thereunder.

(f) For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see Sec. 1.1001-2.

§ 1.671-2 Applicable principles.—(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in Sec. 1.671-3.

(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in Sec. 1.643(b)-1 is meant, the phrase "ordinary income" is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e)(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also Sec. 1.672(f)-5(a).

(2)(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in Sec. 301.7701-4(c) of this chapter, liquidating trusts described in Sec. 301.7701-4(d) of this chapter, or environmental remediation trusts described in Sec. 301.7701-4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts, and all other persons are United States persons. The examples are as follows:

Example 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under Sec. 301.7701-4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers \$100 to FT out of A's funds. A is reimbursed by B for the \$100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the \$100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6. A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7. A, B's brother, creates a trust, T, for B's benefit and transfers \$50,000 to T. The trustee invests the \$50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of \$1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of \$100,000. Under paragraph (e)(2)(ii) of this section, the \$900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at \$100,000, and C is a grantor of T with respect to the portion of the trust valued at \$900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999.

§ 1.671-3 Attribution or inclusion of income, deductions, and credits against tax.—(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be ap-

portioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a peri-

od such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of Sec. 1.677(a)-1.

§ 1.671-4 Method of reporting.—(a) Portion of trust treated as owned by the grantor or another person. Except as otherwise provided in paragraph (b) of this section, items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form. Section 301.7701-4(e)(2) of this chapter provides guidance on how these reporting rules apply to an environmental remediation trust.

(b) A trust all of which is treated as owned by one or more grantors or other persons.—(1) In general. In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending upon the type of reportable payments made.

(2) A trust all of which is treated as owned by one grantor or by one other person.—

(i) In general. In the case of a trust all of which is treated as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either—

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors. (A) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must furnish the grantor or other person treated as the owner of the trust with a statement that—

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.

(iii) Additional obligations of the trustee when name, TIN, and address of the trust are furnished to payors—

(A) Obligation to file Forms 1099. The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) Obligation to furnish statement. (1) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or other person treated as the owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year;

(ii) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(iv) Examples. The following examples illustrate the provisions of this paragraph (b)(2): Example 1. G, a United States citizen, creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 679. Under the applicable local law, capital gains must be added to corpus. Since G has a right to receive income, he is treated as an owner of a portion of the trust under section 677. The tax consequences of any items of capital gain of the trust are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. Because not all of the trust is treated as owned by the grantor or another person, the trustee may not report by the methods described in paragraph (b)(2) of this section.

Example 2. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. During the 1996 taxable year the trust has the following items of income and gross proceeds:

Interest.....	\$2,500
Dividends	3,205
Proceeds from sale of B stock.....	2,000

(B) The trust has no items of deduction or credit.

(ii)(A) The payors of the interest paid to the trust are X (\$2,000), Y (\$300), and Z (\$200). The payors of the dividends paid to the trust are A (\$3,200), and D (\$5). The payor of the gross proceeds paid to the trust is D, a brokerage firm, which held the B stock as the nominee for the trust. The B stock was purchased by T for \$1,500 on January 3, 1996, and sold by T on November 29, 1996. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to X, Y, Z, A, and D. X, Y, and Z each furnish T with a Form 1099-INT showing the trust as the payee. A furnishes T with a Form 1099-DIV showing the trust as the payee. D does not furnish T with a Form 1099-DIV because D paid a dividend of less than \$10 to T. D furnishes T with a Form 1099-B showing the trust as the payee.

(B) On or before February 28, 1997, T files a Form 1099-INT with the Internal Revenue Service on which T reports interest attributable to G, as the owner of the trust, of \$2,500; a Form 1099-DIV on which T reports dividends attributable to G, as the owner of the trust, of \$3,205; and a Form 1099-B on which T reports gross proceeds from the sale of B stock attributable to G, as the owner of the trust, of \$2,000. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest.....	\$2,500
Dividends	3,205
Gain from sale of B stock	500

Information regarding sale of B stock:

Proceeds	\$2,000
Basis.....	1,500
Date acquired	1/03/96
Date sold	11/29/96

(C) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(D) T has complied with T’s obligations under this section.

(iii)(A) Same facts as paragraphs (i) and (ii) of this Example 2, except that G contributed the B stock to the trust on January 2, 1996. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G’s taxable income:

Interest.....	\$2,500
Dividends	3,205

Information regarding sale of B stock:

Proceeds	\$2,000
Date sold	11/29/96

(B) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(C) T has complied with T’s obligations under this section.

Example 3. On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The only asset of the trust is an interest in C, a common trust fund under section 584(a). T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to C. C files a Form 1065 and a Schedule K-1 (Partner’s Share of Income, Credits, Deductions, etc.) showing the name, TIN, and address of the trust with the Internal Revenue Service and furnishes a copy to T. Because the trust did not receive any amounts described in paragraph (b)(5) of this section, T does not file any type of return with the Internal Revenue Service. On or before April 15, 1997, T furnishes G with a statement that shows all items of income, deduction, and credit of the trust for the 1996 taxable year. In addition, T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person. T has complied with T’s obligations under this section.

(3) A trust all of which is treated as owned by two or more grantors or other persons.—(i) In general. In the case of a trust all of which is treated as owned by two or more grantors or other persons, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year, and comply with the additional requirements described in paragraph (b)(3)(ii) of this section.

(ii) Additional obligations of trustee.—(A) Obligation to file Forms 1099. The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross pro-

ceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) Obligation to furnish statement.—(1) The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person;

(ii) Provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) Except for the requirements pursuant to section 3406 and the regulations thereunder, by furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(4) Persons treated as payors—

(i) In general.—For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K-

(1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

(ii) Application to brokers and customers. For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

(5) Amounts required to be included on Forms 1099 filed by the trustee—

(i) In general.—The amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to this section do not include any amounts that are reportable by the payor on an information return other than Form 1099. For example, in the case of a trust which owns an interest in a partnership, the trust's distributive share of the income and gain of the partnership is not includible on any Forms 1099 filed by the trustee pursuant to this section because the distributive share is reportable by the partnership on Schedule K-1.

(ii) Example. The following example illustrates the provisions of this paragraph (b)(5): Example. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The assets of the trust during the 1996 taxable year are shares of stock in X, an S corporation, a limited partnership interest in P, shares of stock in M, and shares of stock in N. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to X, P, M, and N. M furnishes T with a Form 1099-DIV showing the trust as the payee. N does not furnish T with a Form 1099-DIV because N paid a dividend of less than \$10 to T. X and P furnish T with Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.) and Schedule

K-1 (Partner's Share of Income, Credits, Deductions, etc.), respectively, showing the trust's name, TIN, and address.

(B) For the 1996 taxable year the trust has the following items of income and deduction:

Dividends paid by M.....	\$12
Dividends paid by N .....	.6
Administrative expense	\$20

Items reported by X on Schedule K-1 attributable to trust's shares of stock in X:

Interest.....	\$20
Dividends	35

Items reported by P on Schedule K-1 attributable to trust's limited partnership interest in P:

Ordinary income	\$300
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(ii)(A) On or before February 28, 1997, T files with the Internal Revenue Service a Form 1099-DIV on which T reports dividends attributable to G as the owner of the trust in the amount of \$18. T does not file any other returns.

(B) T has complied with T's obligation under paragraph (b)(2)(iii)(A) of this section to file the appropriate Forms 1099.

(6) Trusts that cannot report under this paragraph (b). The following trusts cannot use the methods of reporting described in this paragraph (b)—

- (i) A common trust fund as defined in section 584(a);
- (ii) A trust that has its situs or any of its assets located outside the United States;
- (iii) A trust that is a qualified subchapter S trust as defined in section 1361(d)(3);
- (iv) A trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year;
- (v) A trust all of which is treated as owned by one grantor or one other person who is not a United States person; or
- (vi) A trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

(7) Grantors or other persons who are treated as owners of the trust and are exempt recipients for information reporting purposes—

- (i) Trust treated as owned by one grantor or one other person.—The trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to this paragraph (b) if the grantor or other person is an exempt recipient for information reporting purposes.
- (ii) Trust treated as owned by two or more grantors or other persons.—The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to this paragraph (b) if one or more grantors or other persons treated as owners are exempt recipients for information reporting purposes unless—

(A) At least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and

(B) The trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

(8) Husband and wife who make a single return jointly.—A trust all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under section 6013 is considered to be owned by one grantor for purposes of this paragraph (b).

(c) Due date for Forms 1099 required to be filed by trustee.—The due date for any Forms 1099 required to be filed with the Internal Revenue Service by a trustee pursuant to this section is the due date otherwise in effect for filing Forms 1099.

(d) Due date and other requirements with respect to statement required to be furnished by trustee—(1) In general. The due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust pursuant to this section is the date specified by section 6034A(a). The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing such statement specified in this paragraph (d).

(2) Statement for the taxable year ending with the death of the grantor or other person treated as the owner of the trust. If a trust ceases to be treated as owned by the grantor, or other person, by reason of the death of that grantor or other person (decedent), the due date for the statement required to be furnished for the taxable year ending with the death of the decedent shall be the date specified by section 6034A(a) as though the decedent had lived throughout the decedent's last taxable year. See paragraph (h) of this section for special reporting rules for a trust or portion of the trust that ceases to be treated as owned by the grantor or other person by reason of the death of the grantor or other person.

(e) Backup withholding requirements.—(1) Trustee reporting under paragraph (b)(2)(i)(A) of this section. In order for the trustee to be able to report pursuant to paragraph (b)(2)(i)(A) of this section and to furnish to all payors the name and TIN of the grantor or other person treated as the owner of the trust, the grantor or other person must provide a complete Form W-9 to the trustee in the manner provided in paragraph (b)(1) of this section, and the trustee must give the name and TIN shown on that Form W-9 to all payors. In addition, if the Form W-9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold. If the Form W-9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W-9, or a copy thereof, to a payor because the Form W-9 contains the address of the grantor or other person and paragraph (b)(2)(i)(A) of this section requires the trustee to furnish the address of the trust to all payors and not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required by this paragraph (e)(1). Thus, a payor may rely on the name and TIN provided to the payor by the trustee, and, if given, on the trustee's statement that the grantor is subject to backup withholding.

(2) Other backup withholding requirements.—Whether a trustee is treated as a payor for purposes of backup withholding is determined pursuant to section 3406 and the regulations thereunder.

(f) Penalties for failure to file a correct Form 1099 or furnish a correct statement. A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust as required by paragraph (b) of this section is subject to the penalties provided by sections 6721 and 6722 and the regulations thereunder.

(g) Changing reporting methods.—(1) Changing from reporting by filing Form 1041 to a method described in paragraph (b) of this section. If the trustee has filed a Form 1041 for any taxable year ending before January 1, 1996 (and has not filed a final Form 1041 pursuant to Sec. 1.671-4(b)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)), or files a Form 1041 for any taxable year thereafter, the trustee must file a final Form 1041 for the taxable year which ends after January 1, 1995, and which immediately precedes the first taxable year for which the trustee reports pursuant to paragraph (b) of this section, on the front of which form the trustee must write: “Pursuant to Sec. 1.671-4(g), this is the final Form 1041 for this grantor trust.”.

(2) Changing from reporting by a method described in paragraph (b) of this section to the filing of a Form 1041. The trustee of a trust who reported pursuant to paragraph (b) of this section for a taxable year may report pursuant to paragraph (a) of this section for subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(A) of this section, and therefore furnished the name and TIN of the grantor to all payors, the trustee must furnish the name, TIN, and address of the trust to all payors for such subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(B) or (b)(3)(i) of this section, and therefore furnished the name and TIN of the trust to all payors, the trustee must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee so reports that it is the final return of the trust.

(3) Changing between methods described in paragraph (b) of this section.—(i) Changing from furnishing the TIN of the grantor to furnishing the TIN of the trust. The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(A) of this section for a taxable year, and therefore furnished the name and TIN of the grantor to all payors, may report pursuant to paragraph (b)(2)(i)(B) of this section, and furnish the name and TIN of the trust to all payors, for subsequent taxable years.

(ii) Changing from furnishing the TIN of the trust to furnishing the TIN of the grantor. The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(B) of this section for a taxable year, and therefore furnished the name and TIN of the trust to all payors, may report pursuant to paragraph (b)(2)(i)(A) of this section, and furnish the name and TIN of the grantor to all payors, for subsequent taxable years. The trustee, however, must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee reports pursuant to paragraph (b)(2)(i)(B) of this section that it is the final return of the trust.

(4) Example. The following example illustrates the provisions of paragraph (g) of this section:

Example. (i) On January 3, 1994, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. On or before April 17, 1995, T files with the Internal Revenue Service a Form 1041 with an attached statement

for the 1994 taxable year showing the items of income, deduction, and credit of the trust. On or before April 15, 1996, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1995 taxable year showing the items of income, deduction, and credit of the trust. On the Form 1041, T states that “pursuant to Sec. 1.671-4(g), this is the final Form 1041 for this grantor trust.” T may report pursuant to paragraph (b) of this section for the 1996 taxable year.

(ii) T reports pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to all payors, for the 1996 and 1997 taxable years. T chooses to report pursuant to paragraph (a) of this section for the 1998 taxable year. On each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) which T files for the 1997 taxable year (or appropriately on magnetic media), T indicates that it is the trust’s final return. On or before April 15, 1999, T files with the Internal Revenue Service a Form 1041 with an attached statement showing the items of income, deduction, and credit of the trust. On the Form 1041, T uses the same TIN which T used on the Forms 1041 and Forms 1099 it filed for previous taxable years. T has complied with T’s obligations under paragraph (g)(2) of this section.

(h) Reporting rules for a trust, or portion of a trust, that ceases to be treated as owned by a grantor or other person by reason of the death of the grantor or other person—(1) Definition of decedent. For purposes of this paragraph (h), the decedent is the grantor or other person treated as the owner of the trust, or portion of the trust, under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code on the date of death of that person.

(2) In general.—The provisions of this section apply to a trust, or portion of a trust, treated as owned by a decedent for the taxable year that ends with the decedent’s death. Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section. A trust, all of which was treated as owned by the decedent, must obtain a new TIN upon the death of the decedent, if the trust will continue after the death of the decedent. See Sec. 301.6109-1(a)(3)(i) of this chapter for rules regarding obtaining a TIN upon the death of the decedent.

(3) Special rules.—(i) Trusts reporting pursuant to paragraph (a) of this section for the taxable year ending with the decedent’s death. The due date for the filing of a return pursuant to paragraph (a) of this section for the taxable year ending with the decedent’s death shall be the due date provided for under Sec. 1.6072-1(a)(2). The return filed under this paragraph for a trust all of which was treated as owned by the decedent must indicate that it is a final return.

(ii) Trust reporting pursuant to paragraph (b)(2)(B) of this section for the taxable year of the decedent’s death. A trust that reports pursuant to paragraph (b)(2)(B) of this section for the taxable year ending with the decedent’s death must indicate on each Form 1096 “Annual Summary and Transmittal of the U.S. Information Returns” that it files (or appropriately on magnetic media) for the taxable year ending with the death of the decedent that it is the final return of the trust.

(iii) Trust reporting under paragraph (b)(3) of this section.—If a trust has been reporting under paragraph (b)(3) of this section, the trustee may not report under that paragraph if any portion of the trust has a short taxable year by reason of the death of the decedent and the portion treated as owned by the decedent does not terminate on the death of the decedent.

(i) Effective date and transition rule—(1) Effective date.—The trustee of a trust any portion of which is treated as owned by one or more grantors or other persons must

report pursuant to paragraphs (a), (b), (c), (d)(1), (e), (f), and (g) of this section for taxable years beginning on or after January 1, 1996.

(2) Transition rule.—For taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the manner of reporting of—

(i) A trustee of a trust all of which is treated as owned by one or more grantors or other persons who did not report in accordance with Sec. 1.671-4(a) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) as in effect for taxable years beginning prior to January 1, 1996, but did report in a manner substantially similar to one of the reporting methods described in paragraph (b) of this section; or

(ii) A trustee of two or more trusts all of which are treated as owned by one or more grantors or other persons who filed a single Form 1041 for all of the trusts, rather than a separate Form 1041 for each trust, provided that the items of income, deduction, and credit of each trust were shown on a statement attached to the single Form 1041.

(3) Effective date for paragraphs (d)(2) and (h) of this section. Paragraphs (d)(2) and (h) of this section apply for taxable years ending on or after December 24, 2002.

(j) Cross-reference.—For rules relating to employer identification numbers, and to the obligation of a payor of income or proceeds to the trust to furnish to the payee a statement to recipient, see Sec. 301.6109-1(a)(2) of this chapter.

§ 1.671-5 Reporting for widely held fixed investment trusts.

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 - (1) An *asset* includes any real or personal, tangible or intangible property held by the trust, including an interest in a contract.
 - (2) An *affected expense* is an expense described in §1.67-2T(i)(1).
 - (3) A *beneficial owner* is a trust interest holder (TIH) (as defined in paragraph (b)(20) of this section) that holds a beneficial interest in a widely held fixed investment trust (WHFIT) (as defined in paragraph (b)(22) of this section.)
 - (4) The *calculation period* is the period the trustee chooses under paragraph (c)(1)(ii) of this section for calculating the trust information required to be provided under paragraph (c) of this section.
 - (5) The *cash held for distribution* is the amount of cash held by the WHFIT (other than trust sales proceeds and proceeds from sales described in paragraphs (c)(2)(iv)(D)(4), (G), and (H) of this section) less reasonably required reserve funds as of the date that the amount of a distribution is required to be determined under the WHFIT's governing document.
 - (6) A *clean-up call* is the redemption of all trust interests in termination of the WHFIT when the administrative costs of the WHFIT outweigh the benefits of maintaining the WHFIT.
 - (7) An *exempt recipient* is—

- (i) Any person described in §1.6049-4(c)(1)(ii);
- (ii) A middleman (as defined in paragraph (b)(10) of this section);
- (iii) A real estate mortgage investment conduit (as defined in section 860(D)(a) (REMIC);
- (iv) A WHFIT; or
- (v) A trust or an estate for which the trustee or middleman of the WHFIT is also required to file a Form 1041, "U.S. Income Tax Return for Estates and Trusts," in its capacity as a fiduciary of that trust or estate.

(8) An *in-kind redemption* is a redemption in which a beneficial owner receives a pro-rata share of each of the assets of the WHFIT that the beneficial owner is deemed to own under section 671. For example, for purposes of this paragraph (b)(8), if beneficial owner A owns a one percent interest in a WHFIT that holds 100 shares of X corporation stock, so that A is considered to own a one percent interest in each of the 100 shares, A's pro-rata share of the X corporation stock for this purpose is one share of X corporation stock.

(9) An *item* refers to an item of income, expense, or credit as well as any trust event (for example, the sale of an asset) or any characteristic or attribute of the trust that affects the income, deductions, and credits reported by a beneficial owner in any taxable year that the beneficial owner holds an interest in the trust. An item may refer to an individual item or a group of items depending on whether the item must be reported separately under paragraphs (c)(1)(i) and (e)(1) of this section.

(10) A *middleman* is any TIH, other than a qualified intermediary as defined in §1.1031(k)-1(g), who, at any time during the calendar year, holds an interest in a WHFIT on behalf of, or for the account of, another TIH, or who otherwise acts in a capacity as an intermediary for the account of another person. A middleman includes, but is not limited to—

- (i) A custodian of a person's account, such as a bank, financial institution, or brokerage firm acting as custodian of an account;
- (ii) A nominee;
- (iii) A joint owner of an account or instrument other than—
 - (A) A joint owner who is the spouse of the other owner; and
 - (B) A joint owner who is the beneficial owner and whose name appears on the Form 1099 filed with respect to the trust interest under paragraph (d) of this section; and
- (iv) A broker (as defined in section 6045(c)(1) and §1.6045-1(a)(1)), holding an interest for a customer in street name.

(11) A *mortgage* is an obligation that is principally secured by an interest in real property within the meaning of §1.860G-2(a)(5), except that a mortgage does not include an interest in another WHFIT or mortgages held by another WHFIT.

(12) A *non-mortgage widely held fixed investment trust* (NMWHFIT) is a WHFIT other than a widely held mortgage trust (as defined in paragraph (b)(23) of this section).

(13) A *non pro-rata partial principal payment* is any partial payment of principal received on a debt instrument which does not retire the debt instrument and which is not a pro-rata prepayment described in §1.1275-2(f)(2).

(14) The *redemption asset proceeds* equal the redemption proceeds (as defined in paragraph (b)(15) of this section) less the cash held for distribution with respect to the redeemed trust interest.

(15) The *redemption proceeds* equal the total amount paid to a redeeming TIH as the result of a redemption of a trust interest.

(16) A *requesting person* is—

- (i) A middleman;
- (ii) A beneficial owner who is a broker;
- (iii) A beneficial owner who is an exempt recipient who holds a trust interest directly and not through a middleman;
- (iv) A noncalendar-year beneficial owner who holds a trust interest directly and not through a middleman; or
- (v) A representative or agent of a person specified in this paragraph (b)(16).

(17) The *sales asset proceeds* equal the sales proceeds (as defined in paragraph (b)(18) of this section) less the cash held for distribution with respect to the sold trust interest at the time of the sale.

(18) The *sales proceeds* equal the total amount paid to a selling TIH in consideration for the sale of a trust interest.

(19) The *start-up date* is the date on which substantially all of the assets have been deposited with the trustee of the WHFIT.

(20) A *trust interest holder* (TIH) is any person who holds a direct or indirect interest, including a beneficial interest, in a WHFIT at any time during the calendar year.

(21) *Trust sales proceeds* equal the amount paid to a WHFIT for the sale or disposition of an asset held by the WHFIT, including principal payments received by the WHFIT that completely retire a debt instrument (other than a final scheduled principal payment) and pro-rata partial principal prepayments described under §1.1275-2(f)(2). Trust sales proceeds do not include amounts paid for any interest income that would be required to be reported under §1.6045-1(d)(3). Trust sales proceeds also do not include amounts paid to a NMWHFIT as the result of pro-rata sales of trust assets to effect a redemption described in paragraph (c)(2)(iv)(G) of this section or the value of assets received as a result of a tax-free corporate reorganization as described in paragraph (c)(2)(iv)(H) of this section.

(22) A *widely held fixed investment trust* (WHFIT) is an arrangement classified as a trust under §301.7701-4(c) of this chapter, provided that—

- (i) The trust is a United States person under section 7701(a)(30)(E);
- (ii) The beneficial owners of the trust are treated as owners under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code; and
- (iii) At least one interest in the trust is held by a middleman.

(23) A *widely held mortgage trust* (WHMT) is a WHFIT, the assets of which consist only of one or more of the following—

- (i) Mortgages;
- (ii) Regular interests in a REMIC;
- (iii) Interests in another WHMT;

- (iv) Reasonably required reserve funds;
- (v) Amounts received on the assets described in paragraphs (b)(23)(i), (ii), (iii), and (iv) of this section pending distribution to TIHs; and
- (vi) During a brief initial funding period, cash and short-term contracts for the purchase of the assets described in paragraphs (b)(23)(i), (ii), and (iii).

(c) *Trustee's obligation to report information*—(1) *In general.* Upon the request of a requesting person (as defined in paragraph (b)(16) of this section), a trustee of a WHFIT must report the information described in paragraph (c)(2) of this section to the requesting person. The trustee must determine such information in accordance with the following rules—

(i) *Calculation.* WHFIT information may be calculated in any manner that enables a requesting person to determine with reasonable accuracy the WHFIT items described in paragraph (c)(2) of this section that are attributable (or, if permitted under paragraphs (c)(2)(iv)(B) or (f)(2)(iii) of this section, distributed) to a beneficial owner for the taxable year of that owner. The manner of calculation must generally conform with industry practice for calculating the WHFIT items described in paragraph (c)(2) of this section for the type of asset or assets held by the WHFIT, and must enable a requesting person to separately state any WHFIT item that, if taken into account separately by a beneficial owner, would result in an income tax liability different from that which would result if the owner did not take the item into account separately.

(ii) *Calculation period*—WHFIT information may be calculated on the basis of a calendar month, calendar quarter, or half or full calendar year, provided that a trustee uses the same calculation period for the life of the WHFIT and the information provided by the trustee meets the requirements of paragraph (c)(1)(i) of this section. Regardless of the calculation period chosen by the trustee, the trustee must provide information requested by a requesting person under paragraph (c)(5) on a calendar year basis. The trustee may provide additional information to requesting persons throughout the calendar year at the trustee's discretion.

(iii) *Accounting method*—(A) *General rule.* WHFIT information must be calculated and reported using the cash receipts and disbursements method of accounting unless another method is required by the Internal Revenue Code or regulations with respect to a specific trust item. Accordingly, a trustee must provide information necessary for TIHs to comply with the rules of subtitle A, chapter 1, subchapter P, part V, subpart A of the Internal Revenue Code, which require the inclusion of accrued amounts with respect to OID, and section 860B(b), which requires the inclusion of accrued amounts with respect to a REMIC regular interest.

(B) *Exception for WHFITs marketed predominantly to taxpayers on the accrual method.* If the trustee or the trust's sponsor knows or reasonably should know that a WHFIT is marketed primarily to accrual method TIHs and the WHFIT holds assets for which the timing of the recognition of income is materially affected by the use of the accrual method of accounting, the trustee must calculate and report trust information using the accrual method of accounting.

(iv) *Gross income requirement.* The amount of income required to be reported by the trustee is the gross income (as defined in section 61) generated by the WHFIT's assets. Thus, in the case of a WHFIT that receives a payment of income from which an expense (or expenses) has been deducted, the trustee, in calculating the income to be reported under paragraph (c)(2)(ii) of this section, must report the income earned on the trusts assets unreduced by the deducted expense or expenses and separately report the deducted expense or expenses. See paragraph (c)(2)(iv) of this section regarding reporting with respect to sales and dispositions.

(2) *Information to be reported by all WHFITs.* With respect to all WHFITs—

(i) *Trust identification and calculation period chosen.* The trustee must report information identifying the WHFIT, including—

(A) The name of the WHFIT;

(B) The employer identification number of the WHFIT;

(C) The name and address of the trustee;

(D) The Committee on Uniform Security Identification Procedure (CUSIP) number, account number, serial number, or other identifying number of the WHFIT;

(E) The classification of the WHFIT as either a WHMT or NMWHFIT; and

(F) The calculation period used by the trustee.

(ii) *Items of income, expense, and credit.* The trustee must report information detailing—

(A) All items of gross income (including OID, except that OID is not required to be included for a WHMT that has a start-up date (as defined in paragraph (b)(19) of this section) prior to August 13, 1998).

(B) All items of expense (including affected expenses); and

(C) All items of credit.

(iii) *Non pro-rata partial principal payments.* The trustee must report information detailing non pro-rata partial principal payments (as defined in paragraph (b)(13) of this section) received by the WHFIT.

(iv) *Asset sales and dispositions.* The trustee must report information regarding sales and dispositions of WHFIT assets as required in this paragraph (c)(2)(iv). For purposes of this paragraph (c)(2)(iv), a payment (other than a final scheduled payment) that completely retires a debt instrument (including a mortgage held by a WHMT) or a pro-rata prepayment on a debt instrument (see §1.1275-2(f)(2)) held by a WHFIT must be reported as a full or partial sale or disposition of the debt instrument. Pro-rata sales of trust assets to effect redemptions, as defined in paragraph (c)(2)(iv)(G) of this section, or exchanges of trust assets as the result of a corporate reorganization under paragraph (c)(2)(iv)(H) of this section, are not reported as sales or dispositions under this paragraph (c)(2)(iv).

(A) *General rule.* Except as provided in paragraph (c)(2)(iv)(B) (regarding the exception for certain NMWHFITs) or paragraph (c)(2)(iv)(C) (regarding the exception for certain WHMTs) of this section, the trustee must report with respect to each sale or disposition of a WHFIT asset—

(1) The date of each sale or disposition;

(2) Information that enables a requesting person to determine the amount of trust sales proceeds (as defined in paragraph (b)(21) of this section) attributable to a beneficial owner as a result of each sale or disposition; and

(3) Information that enables a beneficial owner to allocate, with reasonable accuracy, a portion of the owner's basis in its trust interest to each sale or disposition.

(B) *Exception for certain NMWHFITs.* If a NMWHFIT meets paragraph (c)(2)(iv)(D)(1) (regarding the general de minimis test), paragraph (c)(2)(iv)(E) (regarding the qualified NMWHFIT exception), or paragraph (c)(2)(iv)(F) (regarding

the NMWHFIT final calendar year exception) of this section, the trustee is not required to report under paragraph (c)(2)(iv)(A) of this section. Instead, the trustee must report sufficient information to enable a requesting person to determine the amount of trust sales proceeds distributed to a beneficial owner during the calendar year with respect to each sale or disposition of a trust asset. The trustee also must provide requesting persons with a statement that the NMWHFIT is permitted to report under this paragraph (c)(2)(iv)(B).

(C) *Exception for certain WHMTs.* If a WHMT meets either the general or the special de minimis test of paragraph (c)(2)(iv)(D) of this section for the calendar year, the trustee is not required to report under paragraph (c)(2)(iv)(A) of this section. Instead, the trustee must report information to enable a requesting person to determine the amount of trust sales proceeds attributable to a beneficial owner as a result of the sale or disposition. The trustee also must provide requesting persons with a statement that the WHMT is permitted to report under this paragraph (c)(2)(iv)(C).

(D) *De minimis tests—(1) General WHFIT de minimis test.* The general WHFIT de minimis test is satisfied if trust sales proceeds for the calendar year are not more than five percent of the net asset value of the trust (aggregate fair market value of the trust's assets less the trust's liabilities) as of the later of January 1 and the start-up date (as defined in paragraph (b)(19) of this section); or, if the trustee chooses, the later of January 1 and the measuring date. The measuring date is the date of the last deposit of assets into the WHFIT (not including any deposit of assets into the WHFIT pursuant to a distribution reinvestment program), not to exceed 90 days after the date the registration statement of the WHFIT becomes effective under the Securities Act of 1933.

(2) *Special WHMT de minimis test.* A WHMT that meets the asset requirement of paragraph (g)(1)(ii)(E) of this section satisfies the special WHMT de minimis test in this paragraph (c)(2)(iv)(D)(2) if trust sales proceeds for the calendar year are not more than five percent of the aggregate outstanding principal balance of the WHMT (as defined in paragraph (g)(1)(iii)(D) of this section) as of the later of January 1 of that year or the trust's start-up date. For purposes of applying the special WHMT de minimis test in this paragraph (c)(2)(iv)(D)(2), amounts that result from the complete or partial payment of the outstanding principal balance of the mortgages held by the trust are not included in the amount of trust sales proceeds. The IRS and the Treasury Department may provide by revenue ruling, or by other published guidance, that the special de minimis test of this paragraph (c)(2)(iv)(D)(2) may be applied to WHFITs holding debt instruments other than those described in paragraph (g)(1)(ii)(E) of this section.

(3) *Effect of clean-up call.* If a WHFIT fails to meet either de minimis test described in this paragraph (c)(2)(iv)(D) solely as the result of a clean-up call, as defined in paragraph (b)(6) of this section, the WHFIT will be treated as having met the de minimis test.

(4) *Exception for certain fully reported sales—(i) Rule.* If a trustee of a NMWHFIT reports the sales described in paragraph (c)(2)(iv)(D)(4)(ii) of this section as provided under paragraph (c)(2)(iv)(A) of this section (regardless of whether the general minimis test in paragraph (c)(2)(iv)(D)(1) of this section is satisfied for a particular calendar year) consistently throughout the life of the WHFIT, a trustee may exclude the trust sales proceeds received by the WHFIT as a result of those sales from the trust sales proceeds used to determine whether a WHFIT has satisfied the general de minimis test in paragraph (c)(2)(iv)(D)(1) of this section.

(ii) *Applicable sales and dispositions.* This paragraph (c)(2)(iv)(D)(4) applies to sales and dispositions resulting from corporate reorganiza-

tions and restructurings for which the trust receives cash, the sale of assets received by the trust in corporate reorganizations and restructurings (including conversions of closed-end investment companies to open-end investment companies), principal prepayments, bond calls, bond maturities, and the sale of securities by the trustee as required by the governing document or applicable law governing fiduciaries in order to maintain the sound investment character of the trust, and any other nonvolitional dispositions of trust assets.

(iii) *Certain small sales and dispositions.* If the amount of trust sales proceeds from a sale or disposition described in paragraph (c)(2)(iv)(D)(4)(ii) of this section is less than .01 percent of the net fair market value of the WHFIT as determined for applying the de minimis test for the calendar year, the trustee is not required to report the sale or disposition under paragraph (c)(2)(iv)(A) of this section provided the trustee includes the trust sales proceeds, received for purposes of determining whether the trust has met the general de minimis test of paragraph (c)(2)(iv)(D)(1) of this section.

(E) *Qualified NMWHFIT exception.* The qualified NMWHFIT exception is satisfied if—

(1) The NMWHFIT has a start-up date (as defined in paragraph (b)(19) of this section) before February 23, 2006;

(2) The registration statement of the NMWHFIT becomes effective under the Securities Act of 1933, as amended (15 U.S.C. 77a, *et seq.*) and trust interests are offered for sale to the public before February 23, 2006; or

(3) The registration statement of the NMWHFIT becomes effective under the Securities Act of 1933 and trust interests are offered for sale to the public on or after February 23, 2006, and before July 31, 2006, and the NMWHFIT is fully funded before October 1, 2006. For purposes of determining whether a NMWHFIT is fully funded under this paragraph (c)(2)(iv)(E), deposits to the NMWHFIT after October 1, 2006, that are made pursuant to a distribution reinvestment program that is consistent with the requirements of §301.7701-4(c) of this chapter are disregarded.

(F) *NMWHFIT final calendar year exception.* The NMWHFIT final calendar year exception is satisfied if—

(1) The NMWHFIT terminates on or before December 31 of the year for which the trustee is reporting;

(2) Beneficial owners exchange their interests for cash or are treated as having exchanged their interests for cash upon termination of the trust; and

(3) The trustee makes reasonable efforts to engage in pro-rata sales of trust assets to effect redemptions.

(G) *Pro-rata sales of trust assets to effect a redemption—(1) Rule.* Pro-rata sales of trust assets to effect redemptions are not required to be reported under this paragraph (c)(2)(iv).

(2) *Definition.* Pro-rata sales of trust assets to effect redemptions occur when—

(i) One or more trust interests are tendered for redemption;

(ii) The trustee identifies the pro-rata shares of the trust assets that are deemed to be owned by the trust interest or interests tendered for redemption (See paragraph (b)(8) of this section for a description of how pro-rata is to be

applied for purposes of this paragraph (c)(2)(iv)(G)) and sells those assets as soon as practicable;

(iii) Proceeds from the sales of the assets identified in paragraph (c)(2)(iv)(G)(2)(ii) of this section are used solely to effect redemptions; and

(iv) The redemptions are reported as required under paragraph (c)(2)(v) of this section by the trustee.

(3) *Additional rules—(i) Calendar month aggregation.* The trustee may compare the aggregate pro-rata share of the assets deemed to be owned by the trust interests tendered for redemption during the calendar month with the aggregate sales of assets to effect redemptions for the calendar month to determine the pro-rata sales of trust assets to effect redemptions for the calendar month. If the aggregate pro-rata share of an asset deemed to be owned by the trust interests tendered for redemption for the month is a fractional amount, the trustee may round that number up to the next whole number for the purpose of determining the pro-rata sales to effect redemptions for the calendar month;

(ii) *Sales of assets to effect redemptions may be combined with sales of assets for other purposes.* Sales of assets to effect redemptions may be combined with the sales of assets to obtain cash for other purposes but the proceeds from the sales of assets to effect redemptions must be used solely to provide cash for redemptions and the sales of assets to obtain cash for other purposes must be reported as otherwise provided in this paragraph (c)(2)(iv). For example, if a trustee sells assets and the proceeds are used by the trustee to pay trust expenses, these amounts are to be included in the amounts reported under paragraph (c)(2)(iv)(A) or (B), as appropriate.

(4) *Example—(i) January 1, 2008.* Trust has one million trust interests and all interests have equal value and equal rights. The number of shares of stock in corporations A through J and the pro-rata share of each stock that a trust interest is deemed to own as of January 1, 2008, is as follows:

Stock	Total shares	Per trust interest
A	24,845	.024845
B	28,273	.028273
C	35,575	.035575
D	13,866	.013866
E	25,082	.025082
F	39,154	.039154
G	16,137	.016137
H	14,704	.014704
I	17,436	.017436
J	31,133	.031133

(ii) *Transactions of January 2, 2008.* On January 2, 2008, 50,000 trust interests are tendered for redemption. The deemed pro-rata ownership of

stocks A through J represented by the 50,000 redeemed trust interests and the stocks sold to provide cash for the redemptions are set out in the following table:

Stock	Deemed pro-rata ownership	Shares sold
A	1,242.25	1,242
B	1,413.65	1,413
C	1,778.75	1,779
D	693.30	694
E	1,254.10	1,254
F	1,957.70	1,957
G	806.85	807
H	735.20	735
I	871.80	872
J	1,556.65	1,557

(iii) *Transactions on January 15 through 17, 2008.* On January 15, 2008, 10,000 trust interests are tendered for redemption. Trustee lends money to Trust for redemptions. On January 16, B merges into C at a rate of .55 per share. On January 17, Trustee sells stock to obtain cash to be reimbursed the cash loaned to Trust to effect the redemptions. The pro-rata share of the stock deemed to be owned by the 10,000 redeemed trust interests and the stock sold by the trustee to effect the redemptions are set out in the following table:

Stock	Deemed pro-rata ownership	Shares sold
A	248.45	249
B	00	00
C	511.25	512
D	138.66	138
E	250.82	251
F	391.54	392
G	161.37	162
H	147.04	148
I	174.36	174
J	311.33	311

(iv) *Transactions on January 28 and 29, 2008.* On January 28, 2008, the value of the H stock is \$30.00 per share and Trustee, pursuant to Trust's governing document, sells the H stock to preserve the financial integrity of Trust and receives \$414,630. Trustee intends to report this sale under paragraph (c)(2)(iv)(A) of this section and to distribute the proceeds of the sale pro-rata to trust interest holders

on Trust's next scheduled distribution date. On January 29, 2008, while trustee still holds the proceeds from the January 28 sale, 10,000 trust interests are tendered for redemption. The pro-rata share of the stock deemed to be owned by the 10,000 redeemed trust interests and the stock sold by the trustee to effect the redemptions are set out in the following table:

Stock	Deemed pro-rata ownership	Shares sold
A	248.45	248
B	0	0
C	511.25	511
D	138.66	139
E	250.82	251
F	391.54	391
G	161.37	161
H	0 ¹	0
I	174.36	175
J	311.33	312

¹Share of cash proceeds: \$4,458.39.

(v) *Monthly amounts.* To determine the pro-rata sales to effect redemptions for January, trustee compares the aggregate pro-rata share of stocks A through J (rounded to the next whole number) deemed to be owned by the trust interests tendered for redemption during the month of January with the sales of stocks A through J to effect redemptions:

Stock	Deemed pro-rata ownership	Shares sold
A	1740	1739
B	0	0
C	3579	3579
D	971	971
E	1756	1756
F	2741	2741
G	1130	1130
H	883	883
I	1221	1221
J	2180	2180

(vi) *Pro-rata sales to effect redemptions for the month of January.* For the month of January, the deemed pro-rata ownership of shares of stocks A through J equal or exceed the sales of stock to effect redemptions for the month. Ac-

cordingly, all of the sales to effect redemptions during the month of January are considered to be pro-rata and are not required to be reported under this paragraph (c)(2)(iv).

(H) *Corporate Reorganizations.* The exchange of trust assets for other assets of equivalent value pursuant to a tax free corporate reorganization is not required to be reported as a sale or disposition under this paragraph (c)(2)(iv).

(v) *Redemptions and sales of WHFIT interests—(A) Redemptions—(1) In general.* Unless paragraph (c)(2)(v)(C) of this section applies, for each date on which the amount of a redemption proceeds for the redemption of a trust interest is determined, the trustee must provide information to enable a requesting person to determine—

(i) The redemption proceeds (as defined in paragraph (b)(15) of this section) per trust interest on that date;

(ii) The redemption asset proceeds (as defined in paragraph (b)(14) of this section) per trust interest on that date; and

(iii) The gross income that is attributable to the redeeming beneficial owner for the portion of the calendar year that the redeeming beneficial owner held its interest (including income earned by the WHFIT after the date of the last income distribution.

(2) *In kind redemptions.* The value of the assets received with respect to an in-kind redemption (as defined in paragraph (b)(8) of this section) is not required to be reported under this paragraph (c)(2)(v)(A). Information regarding the income attributable to a redeeming beneficial owner must, however, be reported under paragraph (c)(2)(v)(A)(1) (iii) of this section.

(B) *Sale of a trust interest.* Under paragraph (c)(2)(v)(C) of this section applies, if a secondary market for interests in the WHFIT is established, the trustee must provide, for each day of the calendar year, information to enable requesting persons to determine—

(1) The sale assets proceeds (as defined in paragraph (b)(17) of this section) per trust interest on that date; and

(2) The gross income that is attributable to a selling beneficial owner and to a purchasing beneficial owner for the portion of the calendar year that each held the trust interest.

(C) *Simplified Reporting for Certain NMWHFITs—(1) In general.* The trustee of an NMWHFIT described in paragraph (c)(2)(v)(C)(2) of this section is not required to report the information described in paragraph (c)(2)(v)(A) of this section (regarding redemptions) or (c)(2)(v)(B) of this section (regarding sales). However, the trustee must report to requesting persons, for each date on which the amount of redemption proceeds to be paid for the redemption of a trust interest is determined, information that will enable requesting persons to determine the redemption proceeds per trust interest on that date. The trustee also must provide requesting persons with a statement that this paragraph applies to the NMWHFIT.

(2) *NMWHFITs that qualify for the exception.* This paragraph (c)(2)(v)(C) applies to a NMWHFIT if—

(i) Substantially all the assets of the NMWHFIT produce income that is treated as interest income (but only if these assets trade on a recognized exchange or securities market without a price component attributable to accrued interest) or produce dividend income (as defined in section 6042(b) and the regulations under that section). (Trust sales proceeds and gross proceeds from sales described in

paragraphs (c)(2)(iv)(G) and (H) of this section are ignored for the purpose of determining if substantially all of a NMWHFIT's assets produce dividend or the interest income described in this paragraph); and

(ii) The qualified NMWHFIT exception of paragraph (c)(2)(iv)(E) of this section is satisfied, or the trustee is required by the governing document of the NMWHFIT to determine and distribute all cash held for distribution (as defined in paragraph (b)(5) of this section) no less frequently than monthly. A NMWHFIT will be considered to have satisfied this paragraph (c)(2)(v)(C)(2)(i) notwithstanding that the governing document of the NMWHFIT permits the trustee to forego making a required monthly or more frequent distribution, if the cash held for distribution is less than 0.1 percent of the aggregate net asset value of the trust as of the date specified in the governing document for calculating the amount of the monthly distribution.

(vi) *Information regarding bond premium.* The trustee generally must report information that enables a beneficial owner to determine, in any manner that is reasonably consistent with section 171, the amount of the beneficial owner's amortizable bond premium, if any, for each calendar year. However, if a NMWHFIT meets the general *de minimis* test in paragraph (c)(2)(iv)(D)(1) of this section, the qualified NMWHFIT exception of paragraph (c)(2)(iv)(E) of this section, or the NMWHFIT final calendar year exception of paragraph (c)(2)(iv)(F) of this section, the trustee of the NMWHFIT is not required to report information regarding bond premium.

(vii) *Information regarding market discount.* The trustee generally must report information that enables a beneficial owner to determine, in any manner reasonably consistent with section 1276 (including section 1276(a)(3)), the amount of market discount that has accrued during the calendar year. However, if a NMWHFIT meets the general *de minimis* test in paragraph (c)(2)(iv)(D) of this section, the qualified NMWHFIT exception of paragraph (c)(2)(iv)(E) of this section, or the NMWHFIT final calendar year exception of paragraph (c)(2)(iv)(F) of this section, the trustee of such NMWHFIT is not required to provide information regarding market discount.

(viii) *Other information.* The trustee must provide any other information necessary for a beneficial owner of a trust interest to report, with reasonable accuracy, the items (as defined in paragraph (b)(9) of this section) attributable to the portion of the trust treated as owned by the beneficial owner under section 671.

(3) *Identifying the representative who will provide trust information.* The trustee must identify a representative of the WHFIT who will provide the information specified in this paragraph (c). The trustee also may identify an Internet website at which the trustee will provide the information specified in this paragraph (c). This information must be—

- (i) Printed in a publication generally read by, and available to, requesting persons;
- (ii) Stated in the trust's prospectus; or
- (iii) Posted at the trustee's Internet website.

(4) *Time and manner of providing information—(i) Time—(A) In general.* Except as provided in paragraph (c)(4)(i)(B) of this section, a trustee must provide the information specified in this paragraph (c) to requesting persons on or before the later of—

- (1) The 30th day after the close of the calendar year to which the request relates; or
- (2) The day that is 14 days after the receipt of the request.

(B) *Trusts holding interests in other WHFITs or in REMICs.* If the WHFIT holds an interest in one or more other WHFITs or holds one or more REMIC regular interests, or holds both, a trustee must provide the information specified in this paragraph (c) to requesting persons on or before the later of—

(1) The 44th day after the close of the calendar year to which the request relates; or

(2) The day that is 28 days after the receipt of the request.

(ii) *Manner.* The information specified in this paragraph (c) must be provided—

(A) By written statement sent by first class mail to the address provided by the requesting person;

(B) By causing it to be printed in a publication generally read by and available to requesting persons and by notifying requesting persons in writing of the publication in which it will appear, the date on which it will appear, and, if possible, the page on which it will appear;

(C) By causing it to be posted at an Internet website, provided the trustee identifies the website under paragraph (c)(3) of this section;

(D) By electronic mail provided that the requesting person requests that the trustee furnish the information by electronic mail and the person furnishes an electronic address; or

(E) By any other method agreed to by the trustee and the requesting person.

(iii) *Inclusion of information with respect to all calculation periods.* If a trustee calculates WHFIT information using a calculation period other than a calendar year, the trustee must provide information for each calculation period that falls within the calendar year requested.

(5) *Requesting information from a WHFIT—(i) In general.* Requesting persons may request the information specified in this paragraph (c) from a WHFIT.

(ii) *Manner of requesting information.* In requesting WHFIT information, a requesting person must specify the WHFIT and the calendar year for which information is requested.

(iii) *Period of time during which a requesting person may request WHFIT information.* For the life of the WHFIT and for five years following the date of the WHFIT's termination, a requesting person may request the information specified in this paragraph (c) for any calendar year of the WHFIT's existence beginning with the 2007 calendar year.

(6) *Trustee's requirement to retain records.* For the life of the WHFIT and for five years following the date of termination of the WHFIT, the trustee must maintain in its records a copy of the information required to be provided to requesting persons this paragraph (c) for each calendar year beginning with the 2007 calendar year. For a period of five years following the close of the calendar year to which the data pertains, the trustee also must maintain in its records such supplemental data as may be necessary to establish that the information provided to requesting persons is correct and meets the requirements of this paragraph (c).

(d) *Form 1099 requirement for trustees and middlemen—(1) Obligation to file Form 1099 with the IRS—(i) In general.* Except as provided in paragraphs (d)(1)(ii) and (iii) of this section—

(A) The trustee must file with the IRS the appropriate Forms 1099, reporting the information specified in paragraph (d)(2) of this section with respect to any TIH who holds an interest in the WHFIT directly and not through a middleman; and

(B) Every middleman must file with the IRS the appropriate Forms 1099, reporting the information specified in paragraph (d)(2) of this section with respect to any TIH on whose behalf or account the middleman holds an interest in the WHFIT or acts as an intermediary.

(ii) *Forms 1099 not required for exempt recipients*—(A) *In general.* A Form 1099 is not required with respect to a TIH who is an exempt recipient (as defined in paragraph (b)(7) of this section), unless the trustee or middleman backup withholds under section 3406 on payments made to an exempt recipient (because, for example, the exempt recipient has failed to furnish a Form W-9 on request). If the trustee or middleman backup withholds, then the trustee or middleman is required to file a Form 1099 under this paragraph (d) unless the trustee or middleman refunds the amount withheld in accordance with §31.6413(a)-3 of this chapter.

(B) *Exempt recipients must include WHFIT information in computing taxable income.* A beneficial owner who is an exempt recipient must obtain WHFIT information and must include the items (as defined in paragraph (b)(9) of this section) of the WHFIT in computing its taxable income on its federal income tax return. Paragraphs (c)(3) and (h) of this section provide rules for exempt recipients to obtain information from a WHFIT.

(iii) *Reporting and withholding with respect to foreign persons.* The items of the WHFIT attributable to a TIH who is not a United States person must be reported, and amounts must be withheld, as provided under subtitle A, chapter 3 of the Internal Revenue Code (sections 1441 through 1464) and the regulations thereunder and not reported under this paragraph (d).

(2) *Information to be reported*—(i) *Determining amounts to be provided on Forms 1099.* The amounts reported to the IRS for a calendar year by a trustee or middleman on the appropriate Form 1099 must be consistent with the information provided by the trustee under paragraph (c) of this section and must reflect with reasonable accuracy the amount of each item required to be reported on a Form 1099 that is attributable (or if permitted under paragraphs (d)(2)(ii)(D) and (E) of this section, distributed) to the TIH. If the trustee, in providing WHFIT information, uses the safe harbors in paragraph (f)(1) or (g)(1) of this section, then the trustee or middleman must calculate the information to be provided to the IRS on the Forms 1099 in accordance with paragraph (f)(2) or (g)(2) of this section, as appropriate.

(ii) *Information to be provided on Forms 1099.* The trustee or middleman must include on the appropriate Forms 1099:

(A) *Taxpayer information.* The name, address, and taxpayer identification number of the TIH;

(B) *Information regarding the person filing the Form 1099.* The name, address, taxpayer identification number, and telephone number of the person required to file the Form 1099;

(C) *Gross income.* All items of gross income of the WHFIT attributable to the TIH for the calendar year (including OID (unless the exception for certain WHMTs applies (see paragraph (c)(2)(ii)(A) of this section)) and all amounts of income attributable to a selling, purchasing, or redeeming TIH for the portion of the cal-

endar year that the TIH held its interest (unless paragraph (c)(2)(v)(C) of this section (regarding an exception for certain NMWHFITs) applies));

(D) *Non pro-rata partial principal payments.* All non pro-rata partial principal payments (as defined in paragraph (b)(13) of this section) received by the WHFIT that are attributable (or distributed, in the case of a trustee or middleman reporting under paragraph (f)(2)(iii) of this section) to the TIH;

(E) *Trust sales proceeds.* All trust sales proceeds (as defined in paragraph (b)(21) of this section) that are attributable to the TIH for the calendar year, if any, or, if paragraph (c)(2)(iv)(B) of this section (regarding certain NMWHFITs) applies, the amount of trust sales proceeds distributed to the TIH for the calendar year;

(F) *Reporting Redemptions.* All redemption asset proceeds (as defined in paragraph (b)(14) of this section) paid to the TIH for the calendar year, if any, or, if paragraph (c)(2)(v)(C) of this section (regarding an exception for certain NMWHFITs) applies, all redemption proceeds (as defined in paragraph (b)(15) of this section) paid to the TIH for the calendar year;

(G) *Reporting sales of a trust interest on a secondary market.* All sales asset proceeds (as defined in paragraph (b)(17) of this section) paid to the TIH for the sale of a trust interest or interests on a secondary market established for the NMWHFIT for the calendar year, if any, or, if paragraph (c)(2)(v)(C) of this section (regarding an exception for certain NMWHFITs) applies, all sales proceeds (as defined in paragraph (b)(18) of this section) paid to the TIH for the calendar year; and

(H) *Other information.* Any other information required by the Form 1099.

(3) *Time and manner of filing Forms 1099—(i) Time and place.* The Forms 1099 required to be filed under this paragraph (d) must be filed on or before February 28 (March 31, if filed electronically) of the year following the year for which the Forms 1099 are being filed. The returns must be filed with the appropriate Internal Revenue Service Center, at the address listed in the instructions for the Forms 1099. For extensions of time for filing returns under this section, see §1.6081-1, the instructions for the Forms 1099, and applicable revenue procedures (see §601.601(d)(2) of this chapter). For magnetic media filing requirements, see §301.6011-2 of this chapter.

(ii) *Reporting trust sales proceeds, redemption asset proceeds, redemption proceeds, sale asset proceeds, sales proceeds and non pro-rata partial principal payments—(A) Form to be used.* Trust sales proceeds, redemption asset proceeds, redemption proceeds, sale asset proceeds, sales proceeds, and non pro-rata partial principal payments are to be reported on the same type of Form 1099 as that required for reporting gross proceeds under section 6045.

(B) *Appropriate reporting for in-kind redemptions.* The value of the assets distributed with respect to an in-kind redemption is not required to be reported to the IRS. Unless paragraph (c)(2)(v)(C) of this section applies, the trustee or middleman must report the gross income attributable to the redeemed trust interest for the calendar year up to the date of the redemption under paragraph (d)(2)(ii)(C) of this section.

(e) *Requirement to furnish a written tax information statement to the TIH—(1) In general.* Every trustee or middleman required to file appropriate Forms 1099 under paragraph (d) of this section with respect to a TIH must furnish to that TIH (the person whose identifying number is required to be shown on the form) a written tax information statement showing the information described in paragraph (e)(2) of this section. The amount of a trust item reported to a TIH under this paragraph (e) must be consistent with the information reported to the IRS with respect to the TIH under paragraph

(d) of this section. Information provided in this written statement must be determined in accordance with the rules provided in paragraph (d)(2)(i) of this section (regardless of whether the information was required to be provided on a Form 1099). Further, the trustee or middleman must separately state on the written tax information statement any items that, if taken into account separately by that TIH, would result in an income tax liability that is different from the income tax liability that would result if the items were not taken into account separately.

(2) *Information required.* For the calendar year, the written tax information statement must meet the following requirements:

(i) *WHFIT information.* The written tax information statement must include the name of the WHFIT and the identifying number of the WHFIT ;

(ii) *Identification of the person furnishing the statement.* The written tax information statement must include the name, address, and taxpayer identification number of the person required to furnish the statement;

(iii) *Items of income, expense, and credit.* The written tax information statement must include information regarding the items of income (that is, the information required to be reported to the IRS on Forms 1099), expense (including affected expenses), and credit that are attributable to the TIH for the calendar year;

(iv) *Non pro-rata partial principal payments.* The written tax information statement must include the information required to be reported to the IRS on Forms 1099 under paragraph (d)(2)(ii)(D) of this section (regarding the non pro-rata partial principal payments that are attributable (or distributed, in the case of a trustee or middleman reporting under paragraph (f)(2)(iii) of this section) to the TIH for the calendar year).

(v) *Asset sales and dispositions—(A) General rule.* Unless paragraph (c)(2)(iv)(B) (regarding the exception for certain NMWHFITs) or (c)(2)(iv)(C) (regarding the exception for certain WHMTs) of this section applies, the written tax information statement must include, with respect to each sale or disposition of a WHFIT asset for the calendar year—

(1) The date of sale or disposition;

(2) Information regarding the trust sales proceeds that are attributable to the TIH as a result of the sale or disposition; and

(3) Information that will enable the TIH to allocate with reasonable accuracy a portion of the TIH's basis in the TIH's trust interest to the sale or disposition.

(B) *Special rule for certain NMWHFITs and WHMTs.* In the case of a NMWHFIT to which paragraph (c)(2)(iv)(B) of this section applies or in the case of a WHMT to which paragraph (c)(2)(iv)(C) of this section applies, the written tax information statement must include, with respect to asset sales and dispositions, only the information required to be reported to the IRS on Form 1099 under paragraph (d)(2)(ii)(E) of this section.

(vi) *Redemption or sale of a trust interest.* The written tax information statement must include the information required to be reported to the IRS on Forms 1099 under paragraphs (d)(2)(ii)(F) and (G) of this section (regarding the sales and redemptions of trust interests made by the TIH for the calendar year);

(vii) *Information regarding market discount and bond premium.* The written tax information statement must include the information required to be reported

by the trustee under paragraphs (c)(2)(vi) and (vii) of this section (regarding bond premium and market discount);

(viii) *Other information.* The written tax information statement must include any other information necessary for the TIH to report, with reasonable accuracy for the calendar year, the items (as defined in paragraph (b)(9) of this section) attributable to the portion of the trust treated as owned by the TIH under section 671. The written tax information statement may include information with respect to a trust item on a per trust interest basis if the trustee has reported (or calculated) the information with respect to that item on a per trust interest basis and information with respect to that item is not required to be reported on a Form 1099; and

(ix) *Required statement.* The written tax information statement must inform the TIH that the items of income, deduction, and credit, and any other information shown on the statement must be taken into account in computing the taxable income and credits of the TIH on the Federal income tax return of the TIH. If the written tax information statement reports that an amount of qualified dividend income is attributable to the TIH, the written tax information statement also must inform the TIH that the TIH must meet the requirements of section 1(h)(11)(B)(iii) to treat the dividends as qualified dividends.

(3) *Due date and other requirements.* The written tax information statement must be furnished to the TIH on or before March 15 of the year following the calendar year for which the statement is being furnished.

(4) *Requirement to retain records.* For a period of no less than five years from the due date for furnishing the written tax information statement, a trustee or middleman must maintain in its records a copy of any written tax information statement furnished to a TIH, and such supplemental data as may be required to establish the correctness of the statement.

(f) *Safe harbor for providing information for certain NMWHFITs—(1) Safe harbor for trustee reporting of NMWHFIT information.* The trustee of a NMWHFIT that meets the requirements of paragraph (f)(1)(i) of this section is deemed to satisfy paragraph (c)(1)(i) of this section, if the trustee calculates and provides WHFIT information in the manner described in this paragraph (f) and provides a statement to a requesting person giving notice that information has been calculated in accordance with this paragraph (f)(1).

(i) *In general—(A) Eligibility to report under this safe harbor.* Only NMWHFITs that meet the requirements set forth in paragraphs (f)(1)(i)(A)(1) and (2) of this section may report under this safe harbor. For purposes of determining whether the requirements of paragraph (f)(1)(i)(A)(1) of this section are met, trust sales proceeds and gross proceeds from sales described in paragraphs (c)(2)(iv)(G) and (H) of this section are ignored.

(1) Substantially all of the NMWHFIT's income is from dividends or interest; and

(2) All trust interests have identical value and rights.

(B) *Consistency requirements.* The trustee must—

(1) Calculate all trust items subject to the safe harbor consistent with the safe harbor; and, (2) Report under this paragraph (f)(1) for the life of the NMWHFIT; or, if the NMWHFIT has a start-up date before January 1, 2007, the NMWHFIT must begin reporting under this paragraph (f)(1) as of January 1, 2007 and must continue to report under this paragraph for the life of the NMWHFIT.

(ii) *Reporting NMWHFIT income and expenses.* A trustee must first determine the total amount of NMWHFIT distributions (both actual and deemed) for the calendar year and then express each income or expense item as a fraction of the total amount of NMWHFIT distributions. These fractions (hereinafter referred to as factors) must be accurate to at least four decimal places.

(A) *Step One: Determine the total amount of NMWHFIT distributions for the calendar year.* The trustee must determine the total amount of NMWHFIT distributions (actual and deemed) for the calendar year. If the calculation of the total amount of NMWHFIT distributions under this paragraph (f)(1)(ii)(A) results in a zero or a negative number, the trustee may not determine income and expense information under this paragraph (f)(1)(ii)(A) (but may report all other applicable items under this paragraph (f)(1)). The total amount of NMWHFIT distributions equals the amount of NMWHFIT funds paid out to all TIHs (including all trust sales proceeds, all principal receipts, and all redemption proceeds) for the calendar year—

(1) Increased by—

(i) All amounts that would have been distributed during the calendar year, but were instead reinvested pursuant to a reinvestment plan; and

(ii) All cash held for distribution to TIHs as of December 31 of the year for which the trustee is reporting; and

(2) Decreased by—

(i) All cash distributed during the current year that was included in a year-end cash allocation factor (see paragraph (f)(1)(ii)(C)(1) of this section) for a prior year;

(ii) All redemption asset proceeds paid for the calendar year, or if paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, all redemption proceeds paid for the calendar year;

(iii) trust sales proceeds distributed during the calendar year; and

(iv) All non pro-rata partial principal payments distributed during the calendar year.

(3) For the purpose of determining the amount of all redemption asset proceeds or redemption proceeds paid for the calendar year with respect to paragraph (f)(1)(ii)(A)(2)(ii) of this section, the value of the assets (not including cash) distributed with respect to an in-kind redemption is disregarded. Any cash distributed as part of the redemption must be included in the total amount of NMWHFIT distributions.

(B) *Step Two: Determine factors that express the ratios of NMWHFIT income and expenses to the total amount of NMWHFIT distributions.* The trustee must determine factors that express the ratios of NMWHFIT income and expenses to the total amount of NMWHFIT distributions as follows:

(1) *Income factors.* For each item of income generated by the NMWHFIT's assets for the calendar year, the trustee must determine the ratio of the gross amount of that item of income to the total amount of NMWHFIT distributions for the calendar year; and

(2) *Expense factors.* For each item of expense paid by a NMWHFIT during the calendar year, the trustee must determine the ratio of the gross amount of that item of expense to the total amount of NMWHFIT distributions for the calendar year.

(C) *Step Three: Determine adjustments for reconciling the total amount of NMWHFIT distributions (determined under Step One) with amounts actually paid to TIHs.* Paragraph (f)(1)(ii)(B) of this section (Step Two) requires an item of income or expense to be expressed as a ratio of that item to the total amount of NMWHFIT distributions as determined in paragraph (f)(1)(ii)(A) of this section (Step One). A TIH's share of the total amount of NMWHFIT distributions may differ from the amount actually paid to that TIH. A trustee, therefore, must provide information that can be used to compute a TIH's share of the total amount of NMWHFIT distributions based on the amount actually paid to the TIH. A trustee satisfies this requirement by providing a current year-end cash allocation factor, a prior year cash allocation factor, and the date on which the prior year cash was distributed to TIHs (prior year cash distribution date).

(1) *The current year-end cash allocation factor.* The current year-end cash allocation factor is the amount of cash held for distribution to TIHs by the NMWHFIT as of December 31 of the calendar year for which the trustee is reporting, divided by the number of trust interests outstanding as of that date.

(2) *The prior year cash allocation factor.* The prior year cash allocation factor is the amount of the distribution during the calendar year for which the trustee is reporting that was included in determining a year-end cash allocation factor for a prior year, divided by the number of trust interests outstanding on the date of the distribution.

(iii) *Reporting non pro-rata partial principal payments under the safe harbor.* The trustee must provide a list of dates on which non pro-rata partial principal payments were distributed by the trust, and the amount distributed, per trust interest.

(iv) *Reporting sales and dispositions of NMWHFIT assets under the safe harbor—(A) NMWHFITs that must report under the general rule—(1) In general.* If a NMWHFIT must report under the general rule of paragraph (c)(2)(iv)(A) of this section, the trustee must provide a list of dates (from earliest to latest) on which sales or dispositions of NMWHFIT assets occurred during the calendar year for which the trustee is reporting and, for each date identified, provide—

(i) The trust sales proceeds received by the trust, per trust interest, with respect to the sales and dispositions, on that date;

(ii) The trust sales proceeds distributed to TIHs, per trust interest, with respect to the sales and dispositions on that date, and the date that the trust sales proceeds were distributed to the TIHs; and

(iii) The ratio (expressed as a percentage) of the assets sold or disposed of on that date to all assets held by the NMWHFIT.

(2) *Determination of the portion of all assets held by the NMWHFIT that the assets sold or disposed of represented—*

(i) If a NMWHFIT terminates within twenty-four months of its start-up date, the ratio of the assets sold or disposed of on that date to all assets held by the NMWHFIT is based on the fair market value of the NMWHFIT's assets as of the start-up date; or

(ii) If a NMWHFIT terminates more than twenty-four months after its start-up date, the ratio of the assets sold or disposed of on that date to all assets held by the NMWHFIT is based on the fair market value of the NMWHFIT's assets as of the date of the sale or disposition.

(B) *NMWHFITs excepted from the general rule.* If paragraph (c)(2)(iv)(B) of this section applies to the NMWHFIT, the trustee must provide a list of

dates on which trust sales proceeds were distributed, and the amount of trust sales proceeds, per trust interest, that were distributed on that date. The trustee also must also provide requesting persons with the statement required by paragraph (c)(2)(iv)(B) of this section.

(v) *Reporting redemptions under the safe harbor—(A) In general.* The trustee must:

(1) Provide a list of dates on which the amount of redemption proceeds paid for the redemption of a trust interest was determined and the amount of the redemption asset proceeds determined per trust interest on that date, or if paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, the amount of redemption proceeds determined on that date; or

(2) Provide to each requesting person that held (either for its own behalf or for the behalf of a TIH) a trust interest that was redeemed during the calendar year, the date of the redemption and the amount of the redemption asset proceeds per trust interest determined on that date, or if paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, the amount of the redemption proceeds determined for that date; and

(B) *Paragraph (c)(2)(v)(C) statement.* If paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, the trustee must provide a statement to requesting persons to the effect that the trustee is providing information consistent with paragraph (c)(2)(v)(C) of this section.

(vi) *Reporting the sale of a trust interest under the safe harbor.* If paragraph (c)(2)(v)(C) of this section does not apply to the NMWHFIT, the trustee must provide, for each day of the calendar year, the amount of cash held for distribution, per trust interest, by the NMWHFIT on that date. If the trustee is able to identify the date on which trust interests were sold on the secondary market, the trustee alternatively may provide information for each day on which sales of trust interests occurred rather than for each day during the calendar year. If paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, the trustee is not required to provide any information under this paragraph (f)(1)(vi), other than a statement that the NMWHFIT meets the requirements to report under paragraph (c)(2)(v)(C) of this section.

(vii) *Reporting OID information under the safe harbor.* The trustee must provide, for each calculation period, the average aggregate daily accrual of OID per \$1,000 of original principal amount.

(viii) *Reporting market discount information under the safe harbor—(A) In general—(1) Trustee required to provide market discount information.* If the trustee is required to provide information regarding market discount under paragraph (c)(2)(vii) of this section, the trustee must provide—

(i) The information required to be provided under paragraph (f)(1)(iv)(A)(i) (iii) of this section; and

(ii) If the NMWHFIT holds debt instruments with OID, a list of the aggregate adjusted issue prices of the debt instruments per trust interest calculated as of the start-up date or measuring date (see paragraph (c)(2)(iv)(D)(4) of this section) (whichever provides more accurate information) and as of January 1 for each subsequent year of the NMWHFIT.

(2) *Trustee not required to provide market discount information.* If the trustee is not required to provide market discount information under paragraph (c)(2)(vii) of this section (because the NMWHFIT meets the general de minimis test of paragraph (c)(2)(iv)(D)(1) of this section, the qualified NMWHFIT exception

of paragraph (c)(2)(iv)(E) of this section, or the NMWHFIT final year exception of paragraph (c)(2)(iv)(F) of this section), the trustee is not required under this paragraph (f) to provide any information regarding market discount.

(B) *Reporting market discount information under the safe harbor when the yield of the debt obligations held by the WHFIT is expected to be affected by prepayments.* [Reserved]

(ix) *Reporting bond premium information under the safe harbor.* [Reserved]

(x) *Reporting additional information.* If a requesting person cannot use the information provided by the trustee under paragraphs (f)(1)(ii) through (ix) of this section to determine with reasonable accuracy the trust items that are attributable to a TIH, the requesting person must request, and the trustee must provide, additional information to enable the requesting person to determine the trust items that are attributable to the TIH. See, for example, paragraph (f)(2)(ii)(A)(4) of this section which requires a middleman to request additional information from the trustee when the total amount of WHFIT distributions attributable to a TIH equals zero or less.

(2) *Use of information provided by trustees under the safe harbor for NMWHFITs—(i) In general.* If a trustee reports NMWHFIT items in accordance with paragraph (f)(1) of this section, the information provided with respect to those items on the Forms 1099 required under paragraph (d) of this section to be filed with the IRS and on the statement required under paragraph (e) of this section to be furnished to the TIH must be determined as provided in this paragraph (f)(2).

(ii) *Determining NMWHFIT income and expense under the safe harbor.* The trustee or middleman must determine the amount of each item of income and expense attributable to a TIH as follows—

(A) *Step One: Determine the total amount of NMWHFIT distributions attributable to the TIH.* To determine the total amount of NMWHFIT distributions attributable to a TIH for the calendar year, the total amount paid to, or credited to the account of, the TIH during the calendar year (including amounts paid as trust sales proceeds or partial non-pro rata principal payments, redemption proceeds, and sales proceeds) is—

(1) Increased by—

(i) All amounts that would have been distributed during the calendar year to the TIH, but that were reinvested pursuant to a reinvestment plan (unless another person (for example, the custodian of the reinvestment plan) is responsible for reporting these amounts under paragraph (d) of this section); and

(ii) An amount equal to the current year-end cash allocation factor (provided by the trustee in accordance with paragraph (f)(1)(ii)(C)(1) of this section) multiplied by the number of trust interests held by the TIH as of December 31 of the calendar year for which the trustee is reporting; and

(2) Decreased by—

(i) An amount equal to the prior year cash allocation factor (provided by the trustee in accordance with paragraph (f)(1)(ii)(C)(2) of this section) multiplied by the number of trust interests held by the TIH on the date of the distribution;

(ii) An amount equal to all redemption asset proceeds paid to the TIH for the calendar year, or if paragraph (c)(2)(v)(C) of this section applies

to the NMWHFIT, an amount equal to all redemption proceeds paid to the TIH for the calendar year;

(iii) An amount equal to all sale asset proceeds paid to the TIH for the calendar year, or if paragraph (c)(2)(v)(C) of this section applies to the NMWHFIT, the amount of sales proceeds paid to the TIH for the calendar year;

(iv) In the case of a TIH that purchased a trust interest in a NMWHFIT to which paragraph (c)(2)(v)(C) of this section does not apply, an amount equal to the cash held for distribution per trust interest on the date that the TIH acquired its interest, multiplied by the trust interests acquired on that date;

(v) The amount of the trust sales proceeds distributed to the TIH, calculated as provided in paragraph (f)(2)(iv)(A)(3) of this section; and

(vi) The amount of non pro-rata partial principal prepayments distributed to the TIH during the calendar year, calculated as provided in paragraph (f)(2)(iii) of this section.

(3) *Treatment of in-kind distributions under this paragraph (f)(2)(i).* The value of the assets (not including cash) received with respect to an in-kind redemption is not included in the amount used in paragraph (f)(2)(ii)(A)(2)(ii) of this section. The cash distributed as part of the redemption, however, must be included in the total amount of NMWHFIT distributions paid to the TIH.

(4) *The total amount of distributions attributable to a TIH calculated under this paragraph (f)(2)(i)(A) equals zero or less.* If the total amount of distributions attributable to a TIH, calculated under this paragraph (f)(2)(i)(A), equals zero or less, the trustee or middleman may not report the income and expense attributable to the TIH under this paragraph (f)(2)(i). The trustee or middleman must request additional information from the trustee of the NMWHFIT to enable the trustee or middleman to determine with reasonable accuracy the items of income and expense that are attributable to the TIH. The trustee or middleman must report the other items subject to paragraph (f)(1) of this section in accordance with this paragraph (f)(2).

(B) *Step Two: Apply the factors provided by the trustee to determine the items of income and expense that are attributable to the TIH.* The amount of each item of income (other than OID) and each item of expense attributable to a TIH is determined as follows—

(1) *Application of income factors.* For each income factor, the trustee or middleman must multiply the income factor by the total amount of NMWHFIT distributions attributable to the TIH for the calendar year (as determined in paragraph (f)(2)(i)(A) of this section).

(2) *Application of expense factors.* For each expense factor, the trustee or middleman must multiply the expense factor by the total amount of NMWHFIT distributions attributable to the TIH for the calendar year (as determined in paragraph (f)(2)(i)(A) of this section).

(iii) *Reporting non pro-rata partial principal payments under the safe harbor:* To determine the amount of non pro-rata partial principal payments that are distributed to a TIH for the calendar year, the trustee or middleman must aggregate the amount of non pro-rata partial principal payments distributed to a TIH for each day that non pro-rata principal payments were distributed. To determine the amount of non pro-rata principal payments that are distributed to a TIH on each distribution date, the trustee or middleman must multiply the amount of non-pro rata principal payments per trust interest distributed on that date by the number of trust interests held by the TIH.

(iv) *Reporting sales and dispositions of NMWHFIT assets under the safe harbor*—(A) *Reporting under the safe harbor if the general rules apply to the NMWHFIT.* Unless paragraph (c)(2)(iv)(B) of this section applies, the trustee or middleman must comply with paragraphs (f)(2)(iv)(A)(1), (2), and (3) of this section.

(1) *Form 1099.* The trustee or middleman must report the amount of trust sales proceeds attributable to the TIH for the calendar year on Form 1099. To determine the amount of trust sales proceeds attributable to a TIH for the calendar year, the trustee or middleman must aggregate the total amount of trust sales proceeds attributable to the TIH for each date on which the NMWHFIT sold or disposed of an asset or assets. To determine the total amount of trust sales proceeds attributable to a TIH for each date that the NMWHFIT sold or disposed of an asset or assets, the trustee or middleman multiplies the amount of trust sales proceeds received by the NMWHFIT per trust interest on that date by the number of trust interests held by the TIH on that date.

(2) *The written tax information statement furnished to the TIH.* The written tax information statement required to be furnished to the TIH under paragraph (e) of this section must include a list of dates (in order, from earliest to latest) on which sales or dispositions of trust assets occurred during the calendar year and provide, for each date identified—

(i) The trust sales proceeds received by the trust, per trust interest, with respect to the sales or dispositions of trust assets on that date; and

(ii) The information provided by the trustee under paragraph (f)(1)(iv)(B)(2) of this section regarding the ratio of the assets sold or disposed of on that date to all the assets of the NMWHFIT held on that date, prior to such sale or disposition.

(3) *Calculating the total amount of trust sales proceeds distributed to the TIH.* To determine the total amount of NMWHFIT distributions attributable to a TIH, the trustee or middleman must calculate the amount of trust sales proceeds distributed to the TIH for the calendar year. (See paragraph (f)(2)(ii)(A)(2)(v) of this section.) To determine the amount of trust sales proceeds distributed to a TIH for the calendar year, the trustee or middleman must aggregate the total amount of trust sales proceeds distributed to the TIH for each date on which the NMWHFIT distributed trust sales proceeds. To determine the total amount of trust sales proceeds distributed to a TIH for each date that the NMWHFIT distributed trust sales proceeds, the trustee or middleman must multiply the amount of trust sales proceeds distributed by the NMWHFIT per trust interest on that date by the number of trust interests held by the TIH on that date.

(B) *Reporting under the safe harbor if paragraph (c)(2)(iv)(B) of this section applies to the NMWHFIT.* If paragraph (c)(2)(iv)(B) of this section applies, the trustee or middleman must calculate, in the manner provided in paragraph (f)(2)(iv)(A)(3) of this section, the amount of trust sales proceeds distributed to the TIH for the calendar year. The trustee or middleman must report this amount on the Form 1099 filed for the TIH and on the written tax information statement furnished to the TIH.

(v) *Reporting redemptions under the safe harbor*—(A) Except as provided in paragraph (f)(2)(v)(B) or (C) of this section, if the trustee has provided a list of dates for which the amount of the redemption proceeds to be paid for the redemption of a trust interest was determined and the redemption asset proceeds paid for that date, the trustee or middleman must multiply the redemption asset proceeds determined per trust interest for that date by the number of trust interests redeemed by the TIH on that date.

(B) If paragraph (c)(2)(v)(C) of this section applies, and the trustee has provided a list of dates for which the amount of the redemption proceeds to be paid for the redemption of a trust interest was determined and the redemption proceeds determined per trust interest on each date, the trustee or middleman must multiply the redemption proceeds per trust interest for each date by the number of trust interests redeemed by the TIH on that date.

(C) If the trustee has provided the requesting person with information regarding the redemption asset proceeds paid for each redemption of a trust interest held by the middleman for the calendar year, or if paragraph (c)(2)(v)(C) of this section applies and the trustee has provided the amount of redemption proceeds paid for each redemption of a trust interest held by the middleman during the calendar year, the requesting person may use this information to determine the amount of the redemption asset proceeds or redemption proceeds paid to the TIH for the calendar year.

(vi) *Reporting sales of trust interests under the safe harbor*—(A) Except as provided in paragraph (f)(2)(vi)(B) of this section, the trustee or middleman must subtract the amount of cash held for distribution per trust interest on the date of the sale from the sales proceeds paid to the TIH to determine the sale asset proceeds that are to be reported to the TIH for each sale of a trust interest.

(B) If paragraph (c)(2)(v)(C) of this section applies, the trustee or middleman must report the sales proceeds paid to the TIH as a result of each sale of a trust interest.

(vii) *Reporting OID information under the safe harbor*—The trustee or middleman must aggregate the amounts of OID that are allocable to each trust interest held by a TIH for each calculation period. The amount of OID that is allocable to a trust interest, with respect to each calculation period, is determined by multiplying—

(A) The product of the OID factor and the original principal balance of the trust interest, divided by 1,000; by

(B) The number of days during the OID calculation period in that calendar year that the TIH held the trust interest.

(viii) *Reporting market discount information under the safe harbor*—(A) Except as provided in paragraph (f)(2)(viii)(B) of this section, the trustee or middleman must provide the TIH with the information provided under paragraph (f)(1)(viii) of this section.

(B) If paragraph (c)(2)(iv)(B) of this section applies, the trustee and middleman are not required under this paragraph (f)(2) to provide any information regarding market discount.

(ix) *Reporting bond premium information under the safe harbor*. [Reserved]

(3) *Example of the use of the safe harbor for NMWHFITs*. The following example illustrates the use of the factors in this paragraph (f) to calculate and provide NMWHFIT information:

Example: (i) *Facts*—(A) *In general*—(1) Trust is a NMWHFIT that holds common stock in ten different corporations and has 100 trust interests outstanding. The start-up date for Trust is December 15, 2006, and Trust's registration statement under the Securities Act of 1933 became effective after July 31, 2006. Trust terminates on March 15, 2008. The agreement governing Trust requires Trust to distribute cash held by Trust reduced by accrued but unpaid expenses on April 15, July 15, and October 15 of the 2007 calendar year. The agreement also provides that the trust interests will be redeemed by the Trust for an amount equal to the value of the trust interest, as

of the close of business, on the day the trust interest is tendered for redemption. There is no reinvestment plan. A secondary market for interests in Trust will be created by Trust's sponsor and Trust's sponsor will provide Trustee with a list of dates on which sales occurred on this secondary market.

(2) As of December 31, 2006, Trust holds \$12x for distribution to TIHs on the next distribution date and has no accrued but unpaid expenses. Trustee includes the \$12x in determining the year-end cash allocation factor for December 31, 2006.

(B) *Events occurring during the 2007 calendar year—*(1) As of January 1, 2007, Broker1 holds ten trust interests in Trust in street name for each of *J* and *A* and Broker2 holds ten trust interests in Trust in street name for *S*, *J*, *A*, and *S*; are individual, cash method taxpayers.

(2) As of January 1, 2007, the fair market value of the Trust's assets equals \$10,000x.

(3) During 2007, Trust receives \$588x in dividend income. Trustee determines that \$400x of the dividend income received during 2007 meets the definition of a qualified dividend in section 1(h)(11)(B)(i) and the holding period requirement in section 1(h)(11)(B)(iii) with respect to the Trust. During 2007, Trust also receives \$12x in interest income from investment of Trust's funds pending distribution to TIHs, and pays \$45x in expenses, all of which are affected expenses.

(4) On April 15, 2007, Trustee distributes \$135x, which includes the \$12x included in determining the year-end cash allocation factor for December 31, 2006. As a result of the distribution, Broker1 credits *J*'s account and *A*'s account for \$13.50x each. Broker2 credits *S*'s account for \$13.50x.

(5) On June 1, 2007, Trustee sells shares of stock for \$1000x to preserve the soundness of the trust. The stock sold on June 1, 2007, equaled 20% of the aggregate fair market value of the assets held by Trust on the start-up date of Trust. Trustee has chosen not to report sales described in paragraph (c)(2)(iv)(4)(ii) of Trust's assets under paragraph (c)(2)(iv)(D)(4) of this section.

(6) On July 15, 2007, Trustee distributes \$1,135x, which includes the \$1,000x of trust sales proceeds received by Trust for the sale of assets on June 1, 2007. As a result of the distribution, Broker1 credits *J*'s account and *A*'s account for \$113.50x each. Broker 2 credits *S*'s account for \$113.50x.

(7) On September 30 2007, *J*, through Trust's sponsor, sells a trust interest to *S* for \$115.35x. Trustee determines that the cash held for distribution per trust interest on September 30 is \$1.35x. As a result of the sale, Broker1 credits *J*'s account for \$115.35x.

(8) On October 15, 2007, Trustee distributes \$123x. As a result of the distribution, Broker1 credits *J*'s account for \$11.07x and *A*'s account for \$12.30x. Broker2 credits *S*'s account for \$13.53x.

(9) On December 10, 2007, *J* tenders a trust interest to Trustee for redemption through Broker1. Trustee determines that the amount of the redemption proceeds to be paid for a trust interest that is tendered for redemption on December 10, 2007 is \$116x, of which \$115x represents the redemption asset proceeds. Trustee pays this amount to Broker1 on *J*'s behalf. On December 12, 2007, trustee engages in a non pro-rata sale of shares of common stock for \$115x to effect *J*'s redemption of a trust interest. The stock sold on December 12, 2007, equals 2% of the aggregate fair market value of all the assets of Trust as of the start-up date.

(10) On December 10, 2007, *J*, through Trust's sponsor, also sells a trust interest to *S* for \$116x. Trustee determines that the cash held for distribution per trust interest on that date is \$1x. As a result of the sale, Broker1 credits *J*'s account for \$116x.

(11) As of December 31, 2007, Trust holds cash of \$173x and has incurred \$15x in expenses that Trust has not paid. *J* is the only TIH to redeem a trust interest during the calendar year. The sale of two trust interests in Trust by *J* to *S* are the only sales that occurred on the secondary market established by Trust's sponsor during 2007.

(ii) *Trustee reporting—(A) Summary of information provided by Trustee.* Trustee meets the requirements of paragraph (f)(1) of this section if Trustee provides the following information to requesting persons:

(1) Income and expense information:

Factor for ordinary dividend income	0.3481
Factor for qualified dividend income	0.7407
Factor for interest income	0.0222
Factor for affected expenses	0.0833
Current year-end cash allocation factor	1.5960
Prior year cash allocation factor	0.1200
Prior year cash distribution date	April 15

(2) Information regarding asset sales and distributions:

Date of sale	Trust sales proceeds received	Trust sales proceeds distributed and date distributed	Percent of trust sold
June 1	\$10.0000x	\$10.0000x (July 15)	20
December 12	1.1616x	0.0000x	2

(3) Information regarding redemptions:

Date	Redemption asset proceeds
December 10	\$115x

(4) Information regarding sales of trust interests

Date	Cash held for distribution per trust interest
September 30	\$1.35x
December 10	1.00x

(B) *Trustee determines this information as follows:*

(1) *Step One: Trustee determines the total amount of NMWHFIT distributions for the calendar year.* The total amount of NMWHFIT distributions (actual and deemed) for the calendar year for purposes of determining the safe harbor factors is \$540x. This amount consists of the

amounts paid on each scheduled distribution date during the calendar year (\$1135x, \$135x, and \$123x), plus the total amount paid to *J* as a result of *J*'s redemption of a trust interest (\$116x) ($\$1,135x + \$135x + \$123x + \$116x = \$1,509x$)—

(i) Increased by all cash held for distribution to TIHs as of December 31, 2007 (\$158x), which is the cash held as of December 31, 2007 (\$173x) reduced by the accrued but unpaid expenses as of December 31, 2007 (\$15x), and

(ii) Decreased by all amounts distributed during the calendar year but included in the year-end cash allocation factor from a prior year (\$12x); all redemption asset proceeds paid for the calendar year (\$115x); and all trust sales proceeds distributed during the calendar year (\$1,000x).

(2) *Step Two: Trustee determines factors that express the ratio of NMWHFIT income (other than OID) and expenses to the total amount of NMWHFIT distributions.* Trustee determines the factors for each item of income earned by Trust and each item of expense as follows:

(i) *Ordinary dividend income factor.* The ordinary dividend income factor is 0.3481, which represents the ratio of the gross amount of ordinary dividends (\$188x) to the total amount of NMWHFIT distributions for the calendar year (\$540x).

(ii) *Qualified dividend income factor.* The qualified dividend income factor is 0.7407 which represents the ratio of the gross amount of qualified dividend income (\$400x) to the total amount of NMWHFIT distributions for the calendar year (\$540x).

(iii) *Interest income factor.* The interest income factor is 0.0222, which represents the ratio of the gross amount of interest income (\$12x) to the total amount of NMWHFIT distributions for the calendar year (\$540x).

(iv) *Expense factor.* The affected expenses factor is 0.0833, which represents the ratio of the gross amount of affected expenses paid by Trust for the calendar year (\$45x) to the total amount of NMWHFIT distributions for the calendar year (\$540x).

(3) *Step Three: Trustee determines adjustments for reconciling the total amount of NMWHFIT distributions with amounts paid to TIHs.* To enable requesting persons to determine the total amount of NMWHFIT distributions that are attributable to a TIH based on amounts actually paid to the TIH, the trustee must provide both a current year-end cash allocation factor and a prior year cash allocation factor.

(i) *Current year-end cash allocation factor.* The adjustment factor for cash held by Trust at year end is 1.5960, which represents the cash held for distribution as of December 31, 2007 (\$158x) (the amount of cash held by Trust on December 31, 2007 (\$173x) reduced by accrued, but unpaid, expenses (\$15x)), divided by the number of trust interests outstanding at year-end (99).

(ii) *Prior Year Cash Allocation Factor.* The adjustment factor for distributions of year-end cash from the prior year is 0.1200, which represents the amount of the distribution during the current calendar year that was included in a year-end cash allocation factor for a prior year (\$12x), divided by the number of trust interests outstanding at the time of the distribution (100). The prior year cash distribution date is April 15, 2007.

(4) *Reporting sales and dispositions of trust assets—(i) Application of the de minimis test.* The aggregate fair market value of the assets of Trust as

of January 1, 2007, was \$10,000x. During the 2007 calendar year, Trust received trust sales proceeds of \$1115x. The trust sales proceeds received by Trust for the 2007 calendar year equal 11.15% of Trust's fair market value as of January 1, 2007. Accordingly, the *de minimis* test is not satisfied for the 2007 calendar year. The qualified NMWHFIT exception in paragraph (c)(2)(iv)(E) of this section and the NMWHFIT final calendar year exception in (c)(2)(iv)(F) of this section also do not apply to Trust for the 2007 calendar year.

(ii) *Information to be provided.* To satisfy the requirements of paragraph (f)(1) of this section with respect to sales and dispositions of Trust's assets, Trustee provides a list of dates on which trust assets were sold during the calendar year, and provides, for each date: the trust sales proceeds (per trust interest) received on that date; the trust sales proceeds distributed to TIHs (per trust interest) with respect to sales or dispositions on that date; the date those trust sales proceeds were distributed, and the ratio of the assets sold or disposed of on that day to all the assets held by Trust. Because Trust will terminate within 15 months of its start-up date, Trustee must use the fair market value of the assets as of the start-up date to determine the portion of Trust sold or disposed of on any particular date.

(5) *Reporting redemptions.* Because Trust is not required to make distributions at least as frequently as monthly, and Trust does not satisfy the qualified NMWHFIT exception in paragraph (c)(2)(iv)(E) of this section, the exception in paragraph (c)(2)(v)(C) does not apply to Trust. To satisfy the requirements of paragraph (f)(1) of this section, Trustee provides a list of dates for which the redemption proceeds to be paid for the redemption of a trust interest was determined for the 2007 calendar year and the redemptions asset proceeds paid for each date. During 2007, Trustee only determined the amount of redemption proceeds paid for the redemption of a trust interest once, for December 10, 2007 and the redemption asset proceeds determined for that date was \$115x.

(6) *Reporting sales of trust interests.* Because trust is not required to make distributions at least as frequently as monthly, and Trust does not satisfy the qualified NMWHFIT exception in paragraph (c)(2)(iv)(E) of this section, the exception in paragraph (c)(2)(v)(C) of this section does not apply to Trust. Sponsor, in accordance with the trust agreement, provides Trustee with a list of dates on which sales on the secondary market occurred. To satisfy the requirements of paragraph (f)(1) of this section, Trustee provides requesting persons with a list of dates on which sales on the secondary market occurred and the amount of cash held for distribution, per trust interest, on each date. The first sale during the 2007 calendar year occurred on September 30, 2007, and the amount of cash held for distribution, per trust interest, on that date is \$1.35x. The second sale occurred on December 10, 2007, and the amount of cash held for distribution, per trust interest, on that date is \$1.00x.

(iii) *Brokers' use of information provided by Trustee.* (A) Broker1 and Broker2 use the information furnished by Trustee under the safe harbor to determine that the following items are attributable to J, A, and S—

With respect to *J*

Ordinary Dividend Income	\$17.89x
Qualified Dividend Income	38.07x
Interest Income	1.14x
Affected Expenses	4.28x
Trust sales proceeds reported on Form 1099	108.13x

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Redemption asset proceeds	
For redemption on December 10	115.00x
Sale asset proceeds	
For sale on September 30	114.00x
For sale on December 10	115.00x
With respect to <i>A</i>	
Ordinary Dividend Income	18.82x
Qualified Dividend Income	40.04x
Interest Income	1.20x
Affected Expenses	4.50x
Trust sales proceeds reported on Form 1099	11.62x
With respect to <i>S</i>	
Ordinary Dividend Income	19.54x
Qualified Dividend Income	41.58x
Interest Income	1.25x
Affected Expenses	4.68x
Trust sales proceeds reported on Form 1099	113.94x

With respect to *J*, *A*, and *S* (regarding the sales and dispositions executed by Trust during the calendar year)

Date	Trust sales proceeds received per trust interest	Percent of trust sold
June 15	\$10.0000x	20
December 12	1.1616x	2

(*B*) The brokers determine the information provided to *J*, *A*, and *S* as follows—

(*1*) *Step One: Brokers determine the total amount of NMWHFIT distributions attributable to J, A, and S.* Broker1 determines that the total amount of NMWHFIT distributions attributable to *J* is \$51.39x and the total amount of NMWHFIT distributions attributable to *A* is \$54.06x. Broker2 determines that the total amount of NMWHFIT distributions attributable to *S* is \$56.13x.

(*i*) To calculate these amounts the brokers begin by determining the total amount paid to *J*, *A*, and *S* for the calendar year—

(*A*) The total amount paid to *J* for the calendar year equals \$485.42x and includes the April 15, 2007, distribution of \$13.50x, the July 15, 2007, distribution of \$113.50x, the sales proceeds for the September 30, 2007, sale of \$115.35x, the October 15, 2007, distribution of \$11.07x, and the redemption proceeds of \$116x and sales proceeds of \$116x for the redemption and sale on December 10, 2007.

(B) The total amount paid to *A* for the calendar year equals \$139.30x and includes the April 15, 2007, distribution of \$13.50x, the July 15, 2007, distribution of \$113.50x and the October 15, 2007, distribution of \$12.30x.

(C) The total amount paid to *S* for the calendar year equals \$140.53x and includes the April 15, 2007, distribution of \$13.50x, the July 15, 2007, distribution of \$113.50x and the October 15, 2007, distribution of \$13.53x.

(ii) The brokers increase the total amount paid to *J*, *A*, and *S* by an amount equal to the current year-end cash allocation factor (1.5960) multiplied by the number of trust interests held by *J* (7), *A* (10), and *S* (12) as of December 31, 2007; that is for *J*, \$11.17x; for *A*, \$15.96x; and for *S*, \$19.15x.

(iii) The brokers reduce the amount paid to *J*, *A*, and *S* as follows—

(A) An amount equal to the prior year cash allocation factor (0.1200), multiplied by the number of trust interests held by *J* (10), *A* (10), and *S* (10) on the date of the prior year cash distribution; that is for *J*, *A*, and *S*, \$1.20x, each;

(B) An amount equal to all redemption asset proceeds paid to a TIH for the calendar year; that is, for *J*, \$115x;

(C) An amount equal to all sales asset proceeds attributable to the TIH for the calendar year; that is for *J*, \$229x (for the September 30, 2007, sale: $\$115.35x \times 1.35x$ (cash held for distribution per trust interest on that date) \$114x; and for the December 10, 2007, sale: $\$116x \times 1.00$ (cash held for distribution per trust interest on that date) = \$115x);

(D) In the case of a purchasing TIH, an amount equal to the amount of cash held for distribution per trust interest at the time the TIH purchased its trust interest, multiplied by the number of trust interests purchased; that is for *S*, \$2.35x (\$1.35x with respect to the September 30, 2007, sale and \$1x with respect to the December 10, 2007, sale);

(E) All amounts of trust sales proceeds distributed to the TIH for the calendar year; that is for *J*, *A*, and *S*, \$100. (\$100 each, with respect to the June 15, 2007, sale of assets by Trust, and \$0 each, with respect to the December 12, 2007, sale of assets by Trust).

(2) *Step two: The brokers apply the factors provided by Trustee to determine the Trust's income and expenses that are attributable to J, A, and S.* The amounts of each item of income (other than OID) and expense that are attributable to *J*, *A*, and *S* are determined by multiplying the factor for that type of income or expense by the total amount of NMWHFIT distributions attributable to *J*, *A*, and *S* as follows:

(i) *Application of factor for ordinary dividends.* The amount of ordinary dividend income attributable to *J* is \$17.89x, to *A* is \$18.82x, and to *S* is \$19.54x. The brokers determine these amounts by multiplying the total amount of NMWHFIT distributions attributable to *J*, *A*, and *S* (\$51.39x, \$54.06x, and \$56.13x, respectively) by the factor for ordinary dividends (0.3481).

(ii) *Application of factor for qualified dividend income.* The amount of qualified dividend income attributable to *J* is \$38.07x, to *A* is \$40.04x, and to *S* is \$41.58x. The brokers determine these amounts by multiplying the total amount of NMWHFIT distributions attributable to *J*, *A*, and *S* (\$51.39x, \$54.06x, and \$56.13x, respectively) by the factor for qualified dividends (0.7407).

(iii) *Application of factor for interest income.* The amount of interest income attributable to *J* is \$1.14x, to *A* is \$1.20x, and to *S* is \$1.25x. The brokers determine these amounts by multiplying the total amount of NMWHFIT distributions attributable to *J*, *A*, and *S* (\$51.39x, \$54.06x, and \$56.13x, respectively) by the factor for interest (0.0222).

(iv) *Application of factor for affected expenses.* The amount of affected expenses attributable to *J* is \$4.28x, to *A* is \$4.50x, and to *S* is \$4.68x. The brokers determine these amounts by multiplying the total amount of NMWHFIT distributions attributable to *J*, *A*, and *S* (\$51.39x, \$54.06x, and \$56.13x, respectively) by the factor for affected expenses (0.0833).

(3) *Brokers reporting of sales and dispositions of trust assets—(i) Determining the amount of trust sales proceeds to be reported on Form 1099 for J, A, and S.* The amount of trust sales proceeds to be reported on Form 1099 with respect to *J* is \$108.13x, to *A* is \$111.62x, and to *S* is \$113.94x. To determine these amounts, the brokers aggregate the amount of trust sales proceeds attributable to *J*, *A*, and *S* for each date on which Trust sold or disposed of assets. The brokers determine the amount of trust sales proceeds to be reported with respect to the June 15, 2007, asset sale by multiplying the number of trust interests held by *J* (10), *A* (10) and *S* (10) on that date by the trust sales proceeds received per trust interest on that date (\$10x). The brokers determine the amount of trust sales proceeds to be reported with respect to the December 12, 2007, asset sale by multiplying the number of trust interests held by *J* (7), *A* (10) and *S* (12) on that date by the trust sales proceeds received per trust interest on that date (\$1.1616x).

(ii) *Information provided on the tax information statements furnished to J, A, and S.* The tax information statements furnished to *J*, *A*, and *S* must include the dates of each sale or disposition (June 15, 2007, and December 12, 2007); the amount of trust sales proceeds per trust interest received on those dates (\$10.00x and \$1.1616x, respectively); and, the percentage of Trust sold or disposed of on that date (20% and 2%, respectively).

(4) *Reporting redemptions.* Broker1 reports on Form 1099 and on the written tax information statement furnished to *J* that *J* received \$115x in redemption asset proceeds for the calendar year.

(5) *Reporting sales of trust interests on the secondary market.* Broker1 reports on *J*'s two sales of trust interests. With respect to the sale on September 30, 2007, the sale asset proceeds equals \$114x (\$115.35x sale proceeds—\$1.35x cash held for distribution on that date) and with respect to the sale on December 10, 2007, the sale asset proceeds equal \$115x (\$116x sale proceeds—\$1x cash held for distribution on that date). Broker1 reports these amounts on Form 1099 and on the tax information statement furnished to *J*.

(g) *Safe Harbor for certain WHMTs—(1) Safe harbor for trustee of certain WHMTs for reporting information—(i) In general.* The trustee of a WHMT that meets the requirements of paragraph (g)(1)(ii) of this section is deemed to satisfy paragraph (c)(1)(i) of this section, if the trustee calculates and provides WHFIT information in the manner described in this paragraph (g) and provides a statement to the requesting person giving notice that information has been calculated in accordance with this paragraph (g)(1).

(ii) *Requirements.* A WHMT must meet the following requirements—

(A) The WHMT must make monthly distributions of the income and principal payments received by the WHMT to its TIHs;

(B) All trust interests in the WHMT must represent the right to receive an equal pro-rata share of both the income and the principal payments received by the WHMT on the mortgages it holds (for example, a WHMT that holds or issues trust interests that qualify as stripped interests under section 1286 may not report under this safe harbor);

(C) The WHMT must—

(1) Report under this paragraph (g)(1)(ii) for the life of the WHMT; or

(2) If the WHMT has a start-up date before January 1, 2007, the WHMT must begin reporting under this paragraph (g)(1)(ii) as of January 1, 2007, and must continue to report under this paragraph for the life of the WHMT;

(D) The WHMT must calculate all items subject to the safe harbor consistent with the safe harbor;

(E) The assets of the WHMT must be limited to—

(1) Mortgages with uniform characteristics;

(2) Reasonably required reserve funds; and

(3) Amounts received on mortgages or reserve funds and held for distribution to TIHs; and

(F) The aggregate outstanding principal balance (as defined in paragraph (g)(1)(iii)(D) of this section) as of the WHMT's start-up date must equal the aggregate of the original face amounts of all issued trust interests.

(iii) *Reporting WHMT income, expenses, non pro-rata partial principal payments, and sales and dispositions under the safe harbor.* A trustee must comply with each step provided in this paragraph (g)(1)(iii).

(A) *Step One: Determine monthly pool factors.* The trustee must, for each month of the calendar year and for January of the following calendar year, calculate and provide the ratio (expressed as a decimal carried to at least eight places and called a *pool factor*) of—

(1) The amount of the aggregate outstanding principal balance of the WHMT as of the first business day of the month; to

(2) The amount of the aggregate outstanding principal balance of the WHMT as of the start-up date.

(B) *Step Two: Determine monthly expense factors.* For each month of the calendar year and for each item of expense paid by the WHMT during that month, the trustee must calculate and provide the ratio (expressed as a decimal carried to at least eight places and called an *expense factor*) of—

(1) The gross amount, for the month, of each item of expense; to

(2) The amount that represents the aggregate outstanding principal balance of the WHMT as of the start-up date, divided by 1,000.

(C) *Step Three: Determine monthly income factors.* For each month of the calendar year and for each item of gross income earned by the WHMT during that month, the trustee must calculate and provide the ratio (expressed as a decimal carried to at least eight places and called an *income factor*) of—

(1) The gross amount, for the month, of each item of income, to

(2) The amount that represents the aggregate outstanding principal balance of the WHMT as of the start-up date, divided by 1,000.

(D) *Definition of aggregate outstanding principal balance.* For purposes of this paragraph (g)(1)(iii), the amount of the aggregate outstanding principal balance of a WHMT is the aggregate of—

(1) The outstanding principal balance of all mortgages held by the WHMT;

(2) The amounts received on mortgages as principal payments and held for distribution by the WHMT; and

(3) The amount of the reserve fund (exclusive of undistributed income).

(iv) *Reporting OID information under the safe harbor—(A) Reporting OID prior to the issuance of final regulations under section 1272(a)(6)(C)(iii)—(1)* For calendar years prior to the effective date of final regulations under section 1272(a)(6)(C)(iii), the trustee must provide, for each month during the calendar year, the aggregate daily accrual of OID per \$1,000 of aggregate outstanding principal balance as of the start-up date (daily portion). For purposes of this paragraph (g)(1)(iv), the daily portion of OID is determined by allocating to each day of the month its ratable portion of the excess (if any) of—

(i) The sum of the present value (determined under section 1272(a)(6)(B)) of all remaining payments under the mortgages held by the WHMT at the close of the month, and the payments during the month of amounts included in the stated redemption price of the mortgages, over

(ii) The aggregate of each mortgage's adjusted issue price as of the beginning of the month.

(2) In calculating the daily portion of OID, the trustee must use the prepayment assumption used in pricing the original issue of trust interests. If the WHMT has a start-up date prior to January 24, 2006, and the trustee, after a good faith effort to ascertain that information, does not know the prepayment assumption used in pricing the original issue of trust interests, the trustee may use any reasonable prepayment assumption to calculate OID provided it continues to use the same prepayment assumption consistently thereafter.

(B) *Reporting OID after the issuance of final regulations under section 1272(a)(6)(C)(iii).* [Reserved]

(v) *Reporting market discount information under the safe harbor—(A) Reporting market discount information prior to the issuance of final regulations under sections 1272(a)(6)(C)(iii) and 1276(b)(3).* For calendar years prior to the effective date of final regulations under sections 1272(a)(6)(C)(iii) and 1276(b)(3), the trustee must provide—

(1) In the case of a WHMT holding mortgages issued with OID, the ratio (expressed as a decimal carried to at least eight places) of—

(i) The OID accrued during the month (calculated in accordance with paragraph (g)(1)(iv) of this section); to

(ii) The total remaining OID as of the beginning of the month (as determined under paragraph (g)(1)(v)(A)(3) of this section); or

(2) In the case of a WHMT holding mortgages issued without OID, the ratio (expressed as a decimal carried to at least eight places) of—

(i) The amount of stated interest paid to the WHMT during the month; to

(ii) The total amount of stated interest remaining to be paid to the WHMT as of the beginning of the month (as determined under paragraph (g)(1)(v)(A)(3) of this section).

(3) *Computing the total amount of stated interest remaining to be paid and the total remaining OID at the beginning of the month.* To compute the total amount of stated interest remaining to be paid to the WHMT as of the beginning of the month and the total remaining OID as of the beginning of the month, the trustee must use the prepayment assumption used in pricing the original issue of trust interests. If the WHMT has a start-up date prior to January 24, 2006, and the trustee, after a good faith effort to ascertain that information, does not know the prepayment assumption used in pricing the original issue of trust interests, the trustee may use any reasonable prepayment assumption to calculate these amounts provided it continues to use the same prepayment assumption consistently thereafter.

(vi) *Reporting bond premium information under the safe harbor.* [Reserved]

(2) *Use of information provided by a trustee under the safe harbor—(i) In general.* If a trustee reports WHMT items in accordance with paragraph (g)(1) of this section, the information provided with respect to those items on the Forms 1099 required to be filed with the IRS under paragraph (d) of this section and on the statement required to be furnished to the TIH under paragraph (e) of this section must be determined as provided in this paragraph (g)(2).

(ii) *Reporting WHMT income, expenses, non pro-rata partial principal payments, and sales and dispositions under the safe harbor.* The amount of each item of income, the amount of each item of expense, and the combined amount of non pro-rata partial principal payments and trust sales proceeds that are attributable to a TIH for each month of the calendar year must be computed as follows:

(A) *Step One: Determine the aggregate of the non pro-rata partial principal payments and trust sales proceeds that are attributable to the TIH for the calendar year.* For each month of the calendar year that a trust interest was held on the record date—

(1) *Determine the monthly amounts per trust interest.* The trustee or middleman must determine the aggregate amount of non pro-rata partial principal payments and the trust sales proceeds that are attributable to each trust interest for each month by multiplying—

(i) The original face amount of the trust interest; by

(ii) The difference between the pool factor for the current month and the pool factor for the following month.

(2) *Determine the amount for the calendar year.* The trustee or middleman must multiply the monthly amount per trust interest by the number of trust interests held by the TIH on the record date of each month. The trustee or middleman then must aggregate these monthly amounts, and report the aggregate amount on the Form 1099 filed with the IRS and on the tax information statement furnished to the TIH as trust sales proceeds. No other information is required to be reported to the IRS or the TIH to satisfy the requirements of paragraphs (d) and (e) of this section under this paragraph (g) with respect to sales and dispositions and non pro-rata partial principal payments.

(B) *Step Two: Determine the amount of each item of expense that is attributable to a TIH—(1) Determine the monthly amounts per trust interest.* For each month of the calendar year that a trust interest was held on the record date, the trustee

or middleman must determine the amount of each item of expense that is attributable to each trust interest by multiplying—

- (i) The original face amount of the trust interest, divided by 1000; by
- (ii) The expense factor for that month and that item of expense.

(2) *Determine the amount for the calendar year.* The trustee or middleman must multiply the monthly amount of each item of expense per trust interest by the number of trust interests held by the TIH on the record date of each month. The trustee or middleman then must aggregate the monthly amounts for each item of expense to determine the total amount of each item of expense that is attributable to the TIH for the calendar year.

(C) *Step Three: Determine the amount of each item of income that is attributable to the TIH for the calendar year—*(1) *Determine the monthly amounts per trust interest.* For each month of the calendar year that a trust interest was held on the record date, the trustee or middleman must determine the amount of each item of income that is attributable to each trust interest by multiplying—

- (i) The original face amount of the trust interest, divided by 1,000; by
- (ii) The income factor for that month and that item of income.

(2) *Determine the amount for the calendar year.* The trustee or middleman must multiply the monthly amount of each item of income per trust interest by the number of trust interests held by the TIH on the record date of each month. The trustee or middleman then must aggregate the monthly amounts for each item of income to determine the total amount of each item of income that is attributable to the TIH for the calendar year.

(D) *Definitions for this paragraph (g)(2).* For purposes of this paragraph (g)(2)(ii)—

(1) The *record date* is the date used by the WHMT to determine the owner of the trust interest for the purpose of distributing the payment for the month.

(2) The *original face amount of the trust interest* is the original principal amount of a trust interest on its issue date.

(iii) *Reporting OID information under the safe harbor.* With respect to each month, trustee or middleman must determine the amount of OID that is attributable to each trust interest held by a TIH by multiplying—

(A) The product of the OID factor multiplied by the original face amount of the trust interest, divided by 1,000; by

(B) The number of days during the month that the TIH held the trust interest.

(iv) *Requirement to provide market discount information under the safe harbor.* The trustee or middleman must provide the market discount information in accordance with paragraph (g)(1)(v) of this section to the TIH in, or with, the written statement required to be furnished to the TIH under paragraph (e) of this section.

(v) *Requirement to provide bond premium information under the safe harbor:* [Reserved]

(3) *Example of safe harbor in paragraph (g)(1) of this section.* The following example illustrates the use of the factors in this paragraph (g) to calculate and provide WHMT information:

Example. (i) *Facts—(A) In general.* *X* is a WHMT. *X*'s start-up date is January 1, 2007. As of that date, *X*'s assets consist of 100 15-year mortgages, each having an unpaid principal balance of \$125,000 and a fixed, annual interest rate of 7.25 percent. None of the mortgages were issued with OID. *X*'s TIHs are entitled to monthly, pro-rata distributions of the principal payments received by *X*. *X*'s TIHs are also entitled to monthly, pro-rata distributions of the interest earned on the mortgages held by *X*, reduced by expenses. Trust interests are issued in increments of \$5,000 with a \$25,000 minimum. The prepayment assumption used in pricing the original issue of trust interests is six percent. Broker holds a trust interest in *X*, with an original face amount of \$25,000, in street name, for *C* during the entire 2007 calendar year.

(B) *Trust events during the 2007 calendar year.* During the 2007 calendar year, *X* collects all interest and principal payments when due and makes all monthly distributions when due. One mortgage is repurchased from *X* in July 2007 for \$122,249, the mortgage's unpaid principal balance plus accrued, but unpaid, interest at the time. During November 2007, another mortgage is prepaid in full. *X* earns \$80 interest income each month from the temporary investment of *X*'s funds pending distribution to the TIHs. All of *X*'s expenses are affected expenses. The aggregate outstanding principal balance of *X*'s mortgages, *X*'s interest income, and *X*'s expenses, for each month of the 2007 calendar year, along with the aggregate outstanding principal balance of *X* as of January 2008, are as follows:

Month	Principal balance	Income	Expenses
January	\$12,500,000	\$75,601	\$5,288
February	12,461,413	75,368	5,273
March	12,422,593	75,133	5,256
April	12,383,538	74,897	5,240
May	12,344,247	74,660	5,244
June	12,304,719	74,421	5,207
July	12,264,952	74,181	5,191
August	12,102,696	73,200	5,122
September	12,062,849	72,960	5,106
October	12,022,762	72,718	5,089
November	11,982,432	72,474	5,073
December	11,821,234	71,500	5,006
January	11,780,829		

(ii) *Trustee reporting.* (A) Trustee, *X*'s fiduciary, comes within the safe harbor of paragraph (g)(1)(ii) of this section by providing the following information to requesting persons:

Month	Pool factor	Income factor	Expense factor
January	1.0000000	6.04806667	0.42304000
February	0.99691304	6.02941628	0.42184000
March	0.99380744	6.01065328	0.42048000
April	0.99068304	5.99177670	0.41920000
May	0.98753976	5.97278605	0.41952000
June	0.98437752	5.95368085	0.41656000
July	0.98119616	5.93446013	0.41528000
August	0.96821564	5.85603618	0.40976000
September	0.96502792	5.83677704	0.40848000
October	0.96182096	5.81740161	0.40712000
November	0.95859459	5.79790896	0.40584000
December	0.94569875	5.71999659	0.40048000
January	0.94246631		

(B) Trustee determines this information as follows:

(1) Step One: Trustee determines monthly pool factors.

Trustee calculates and provides *X*'s pool factor for each month of the 2007 calendar year. For example, for the month of January 2007 the pool factor is 1.0, which represents the ratio of—

(i) The amount that represents the aggregate outstanding principal balance of *X* (\$12,500,000) as of the first business day of January; divided by

(ii) The amount that represents the aggregate outstanding principal balance of *X* (\$12,500,000) as of the start-up day.

(2) Step Two: Trustee determines monthly expense factors.

Trustee calculates and provides the expense factors for each month of the 2007 calendar year. During 2007, *X* has only affected expenses, and therefore, will have only one expense factor for each month. For example, the expense factor for the month of January 2007 is 0.42304000, which represents the ratio of—

(i) The gross amount of expenses paid during January by *X* (\$5,288); divided by

(ii) The amount that represents the aggregate outstanding principal balance of *X* as of the start-up date (\$12,500,000) divided by 1,000 (\$12,500).

(3) Step Three: Trustee determines monthly income factors.

Trustee calculates and provides the income factors for each month of the 2007 calendar year. During 2007, *X* has only interest income, and therefore, will have only one income factor for each month. For example, the income factor for the month of January 2007 is 6.04806667, which represents the ratio of—

(i) The gross amount of interest income earned by *X* during January (\$75,601); divided by

(ii) The amount that represents that aggregate outstanding principal balance of X as of the start-up date (\$12,500,000), divided by 1,000 (\$12,500).

(4) *Step Four: Trustee calculates and provides monthly market discount fractions.* Trustee calculates and provides a market discount fraction for each month of the 2007 calendar year using a prepayment assumption of 6% and a stated interest rate of 7.25%.

(iii) *Broker's use of the information provided by Trustee.*

(A) Broker uses the information provided by Trustee under paragraph (g) of this section to determine that the following trust items are attributable to C :

Month	Aggregate trust sales proceeds and non pro-rata partial principal payments	Affected expenses	Gross interest income
January	\$77.17	\$10.58	\$151.20
February	77.64	10.55	150.74
March	78.11	10.51	150.27
April	78.58	10.48	149.79
May	79.06	10.49	149.32
June	79.53	10.41	148.84
July	324.51	10.38	148.36
August	79.69	10.24	146.40
September	80.17	10.21	145.92
October	80.66	10.18	145.43
November	322.40	10.15	144.95
December	80.81	10.01	143.00
Total	1438.33	124.19	1774.22

(B) Broker determines this information as follows:

(1) *Step One: Broker determines the amount of the non pro-rata partial principal payments and trust sales proceeds received by X that are attributable to C for the 2007 calendar year.* Broker determines the amount of the non pro-rata partial principal payments and trust sales proceeds received by X that are attributable to C for each month of the 2007 calendar year. For example, for the month of January, Broker determines that the amount of principal receipts and the amount of trust sales proceeds that are attributable to C is \$77.17. Broker determines this by multiplying the original face amount of C 's trust interest (\$25,000) by 0.00308696, the difference between the pool factor for January 2007 (1.00000000) and the pool factor for the following month of February 2007 (0.99691304). Broker reports the aggregate of the monthly amounts of non pro-rata partial principal payments and trust sales proceeds that are attributable to C for the 2007 calendar year as trust sales proceeds on the Form 1099 filed with the IRS.

(2) *Step Two: Broker applies the expense factors provided by Trustee to determine the amount of expenses that are attributable to C for the 2007 calendar year.* Broker determines the amount of X's expenses that are attributable to C for each month of the calendar year. For example, for the month of January 2007, Broker determines that the amount of expenses attributable to C is \$10.58. Broker determines this by multiplying the original face amount of C's trust interest (\$25,000), divided by 1,000 (\$25) by the expense factor for January 2007 (0.42304000). Broker determines the expenses that are attributable to C for the 2007 calendar year by aggregating the monthly amounts.

(3) *Step Three: Broker applies the income factors provided by Trustee to determine the amount of gross interest income attributable to C for the 2007 calendar year.* Broker determines the amount of gross interest income that is attributable to C for each month of the calendar year. For example, for the month of January 2007, Broker determines that the amount of gross interest income attributable to C is \$151.20. Broker determines this by multiplying the original face amount of C's trust interest (\$25,000), divided by 1,000 (\$25), by the income factor for January 2007 (6.04806667). Broker determines the amount of the gross interest income that is attributable to C for the 2007 calendar year by aggregating the monthly amounts.

(4) *Step Four: Broker provides market discount information to C.* Broker provides C with the market discount fractions calculated and provided by the trustee of X under paragraph (g)(3)(ii)(D) of this section.

(h) *Additional safe harbors—(1) Temporary safe harbor for WHMTs—(i) Application.* Pending the issuance of additional guidance, the safe harbor in this paragraph applies to trustees and middlemen of WHMTs that are not eligible to report under the WHMT safe harbor in paragraph (g) of this section because they hold interests in another WHFIT, in a REMIC, or hold or issue stripped interests.

(ii) *Safe harbor.* A trustee is deemed to satisfy the requirements of paragraph (c) of this section, if the trustee calculates and provides trust information in a manner that enables a requesting person to provide trust information to a beneficial owner of a trust interest that enables the owner to reasonably accurately report the tax consequences of its ownership of a trust interest on its federal income tax return. Additionally, to be deemed to satisfy the requirements of paragraph (c) of this section, the trustee must calculate and provide trust information regarding market discount and OID by any reasonable manner consistent with section 1272(a)(6). A middleman or a trustee may satisfy its obligation to furnish information to the IRS under paragraph (d) of this section and to the trust interest holder under paragraph (e) of this section by providing information consistent with the information provided under this paragraph by the trustee.

(2) *Additional safe harbors provided by other published guidance.* The IRS and the Treasury Department may provide additional safe harbor reporting procedures for complying with this section or a specific paragraph of this section by other published guidance (see §601.601(d)(2) of this chapter).

(i) [Reserved]

(j) *Requirement that middlemen furnish information to beneficial owners that are exempt recipients and noncalendar-year beneficial owners—(1) In general.* A middleman that holds a trust interest on behalf of, or for the account of, either a beneficial owner that is an exempt recipient defined in paragraph (b)(7) of this section or a non-calendar-year beneficial owner, must provide to such beneficial owner, upon request, the information provided by the trustee to the middleman under paragraph (c) of this section.

(2) *Time for providing information.* The middleman must provide the requested information to any beneficial owner making a request under paragraph (h)(1) of this section on or before the later of the 44th day after the close of the calendar year for which the information was requested, or the day that is 28 days after the receipt of the request. A middleman must provide information with respect to a WHFIT holding an interest in another WHFIT, or a WHFIT holding an interest in a REMIC, on or before the later of the 58th day after the close of the calendar year for which the information was requested, or the 42nd day after the receipt of the request.

(3) *Manner of providing information.* The requested information must be provided—

(i) By written statement sent by first class mail to the address provided by the person requesting the information;

(ii) By electronic mail provided that the person requesting the information requests that the middleman furnish the information by electronic mail and the person furnishes an electronic address;

(iii) At an Internet website of the middleman or the trustee, provided that the beneficial owner requesting the information is notified that the requested information is available at the Internet website and is furnished the address of the site; or

(iv) Any other manner agreed to by the middleman and the beneficial owner requesting the information.

(4) *Clearing organization.* A clearing organization described in §1.163–5(c)(2)(i)(D)(8) is not required to furnish information to exempt recipients or non-calendar-year TIHs under this paragraph (h).

(k) *Coordination with other information reporting rules.* In general, in cases in which reporting is required for a WHFIT under both this section and subpart B, part III, subchapter A, chapter 61 of the Internal Revenue Code (Sections 6041 through 6050S) (Information Reporting Sections), the reporting rules for WHFITs under this section must be applied. The provisions of the Information Reporting Sections and the regulations thereunder are incorporated into this section as applicable, but only to the extent that such provisions are not inconsistent with the provisions of this section.

(l) *Backup withholding requirements.* Every trustee and middleman required to file a Form 1099 under this section is a payor within the meaning of §31.3406(a)–2, and must backup withhold as required under section 3406 and any regulations thereunder.

(m) *Penalties for failure to comply—(1) In general.* Every trustee or middleman who fails to comply with the reporting obligations imposed by this section is subject to penalties under sections 6721, 6722, and any other applicable penalty provisions.

(2) *Penalties not imposed on trustees and middlemen of certain WHMTs for failure to report OID.* Penalties will not be imposed as a result of a failure to provide OID information for a WHMT that has a start-up date on or after August 13, 1998 and on or before January 24, 2006, if the trustee of the WHMT does not have the historic information necessary to provide this information and the trustee demonstrates that it has attempted in good faith, but without success, to obtain this information. For purposes of calculating a market discount fraction under paragraph (g)(1)(v) of this section, for a WHMT described in this paragraph, it may be assumed that the WHMT is holding mortgages that were issued without OID. A trustee availing itself of this paragraph must include a statement to that effect when providing information to requesting persons under paragraph (c) of these regulations.

(n) *Effective date.* These regulations are applicable January 1, 2007. Trustees must calculate and provide trust information with respect to the 2007 calendar year and all

subsequent years consistent with these regulations. Information returns required to be filed with the IRS and the tax information statements required to be furnished to trust interest holders after December 31, 2007 must be consistent with these regulations.

§ 1.672(a)-1 Definition of adverse party.—(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

§ 1.672(b)-1 Nonadverse party.—A nonadverse party is any person who is not an adverse party.

§ 1.672(c)-1 Related or subordinate party.—Section 672(c) defines the term "related or subordinate party". The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674(c) and 675(3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

§ 1.672(d)-1 Power subject to condition precedent.—Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

§ 1.672(f)-1 Foreign persons not treated as owners.—(a) General rule.—(1) Application of the general rule.—Section 672(f)(1) provides that subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code (the grantor trust rules) shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. Accordingly, the grantor trust rules apply to the extent that any portion of the trust, upon application of the grantor trust rules without regard to section 672(f), is treated as owned by a United States citizen or resident or domestic corporation. The grantor trust rules do not apply to any portion of the trust to the extent that, upon application of the grantor trust rules without regard to section 672(f), that portion is treated as owned by a person other than a United States citizen or resident or domestic corporation, unless the person is described in Sec. 1.672(f)-2(a) (relating to certain foreign corporations treated as domestic corporations), or one of the exceptions set forth in Sec. 1.672(f)-3 is met, (relating to: trusts where the grantor can revest trust assets; trusts where the only amounts distributable are to the grantor or the grantor's spouse; and compensatory trusts). Section 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) Determination of portion based on application of the grantor trust rules.—The determination of the portion of a trust treated as owned by the grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules and section 671 and the regulations thereunder.

(b) Example. The following example illustrates the rules of this section:

Example. (i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.

(ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in Sec. 1.672(f)-3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to B, who is neither a grantor nor a spouse of a grantor, and the trust is not a compensatory trust. Therefore, pursuant to paragraph (a)(1) of this section, A is not treated as an owner under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the owner of the portion of the trust consisting of the Y stock.

(c) Effective date.—The rules of this section are applicable to taxable years of a trust beginning after August 10, 1999.

§ 1.672(f)-2 Certain foreign corporations.—(a) Application of general rule.—Subject to the provisions of paragraph (b) of this section, if the owner of any portion of a trust upon application of the grantor trust rules without regard to section 672(f) is a controlled foreign corporation (as defined in section 957), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552), the corporation will be treated as a domestic corporation for purposes of applying the rules of Sec. 1.672(f)-1.

(b) Gratuitous transfers to United States persons.—(1) Transfer from trust to which corporation made a gratuitous transfer.—If a trust (or portion of a trust) to which a controlled foreign corporation, passive foreign investment company, or foreign personal holding company has made a gratuitous transfer (within the meaning of Sec. 1.671-2(e)(2)), makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation for purposes of Sec. 1.672(f)-4(c), relating to gratuitous transfers from trusts (or portions of trusts) to which a partnership or foreign corporation has made a gratuitous transfer. (2) Transfer from trust over which corporation has a section 678 power.—If a trust (or portion of a trust) that a controlled foreign corporation, passive foreign investment company, or foreign personal holding company is treated as owning under section 678 makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation that had made a gratuitous transfer to the trust (or portion of a trust) and the rules of Sec. 1.672(f)-4(c) apply.

(c) Special rules for passive foreign investment companies.—(1) Application of section 1297.—For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1297, the grantor trust rules apply as if section 672(f) had not come into effect.

(2) References to renumbered Internal Revenue Code section. For taxable years of shareholders beginning on or before December 31, 1997, and taxable years of passive foreign investment companies ending with or within such taxable years of the shareholders, all references in this Sec. 1.672(f)-2 to section 1297 are deemed to be references to section 1296.

(d) Examples. The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust, and CFC is a controlled foreign corporation. The examples are as follows:

Example 1. Application of general rule.—CFC creates and funds FT. CFC is the grantor of FT within the meaning of Sec. 1.671-2(e). CFC has a reversionary interest in FT within the meaning of section 673 that would cause CFC to be treated as the owner of FT upon application of the grantor trust rules without regard to section 672(f). Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of applying the general rule of Sec. 1.672(f)-1. Thus, Sec. 1.672(f)-1 does not prevent CFC from being treated as the owner of FT under section 673.

Example 2. Distribution from trust to which CFC made gratuitous transfer.—A, a nonresident alien, owns 40 percent of the stock of CFC. A's brother B, a resident alien, owns the other 60 percent of the stock of CFC. CFC makes a gratuitous transfer to FT. FT makes a gratuitous transfer to A's daughter, C, who is a resident alien. Under paragraph (b)(1) of this section, CFC will be treated as a foreign corporation for purposes of Sec. 1.672(f)-4(c). For further guidance, see Sec. 1.672(f)-4(g) Example 2 through Example 4.

(e) Effective date.—The rules of this section are generally applicable to taxable years of shareholders of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies beginning after August 10, 1999, and taxable years of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies ending with or within such taxable years of the shareholders.

§ 1.672(f)-3 Exceptions to general rule.—(a) Certain revocable trusts—(1) In general.—Subject to the provisions of paragraph (a)(2) of this section, the general rule of Sec. 1.672(f)-1 does not apply to any portion of a trust for a taxable year of the trust if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person. If the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor, such power is treated as exercisable solely by the grantor. For the definition of grantor, see Sec. 1.671-2(e). For the definition of related or subordinate party, see Sec. 1.672(c)-1. For purposes of this paragraph (a), a related or subordinate party is subservient to the grantor unless the presumption in the last sentence of Sec. 1.672(c)-1 is rebutted by a preponderance of the evidence. A trust (or portion of a trust) that fails to qualify for the exception provided by this paragraph (a) for a particular taxable year of the trust will be subject to the general rule of Sec. 1.672(f)-1 for that taxable year and all subsequent taxable years of the trust.(2) 183-day rule.—For purposes of paragraph (a)(1) of this section, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be.

(3) Grandfather rule for certain revocable trusts in existence on September 19, 1995.—Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of Sec. 1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 676 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any

portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) Examples. The following examples illustrate the rules of this paragraph (a):

Example 1. Grantor is owner. FP1, a foreign person, creates and funds a revocable trust, T, for the benefit of FP1's children, who are resident aliens. The trustee is a foreign bank, FB, that is owned and controlled by FP1 and FP2, who is FP1's brother. The power to revoke T and revest absolutely in FP1 title to the trust property is exercisable by FP1, but only with the approval or consent of FB. The trust instrument contains no standard that FB must apply in determining whether to approve or consent to the revocation of T. There are no facts that would suggest that FB is not subservient to FP1. Therefore, the exception in paragraph (a)(1) of this section is applicable.

Example 2. Death of grantor.—Assume the same facts as in Example 1, except that FP1 dies. After FP1's death, FP2 has the power to withdraw the assets of T, but only with the approval of FB. There are no facts that would suggest that FB is not subservient to FP2. However, the exception in paragraph (a)(1) of this section is no longer applicable, because FP2 is not a grantor of T within the meaning of Sec. 1.671-2(e).

Example 3. Trustee is not related or subordinate party.—Assume the same facts as in Example 1, except that neither FP1 nor any member of FP1's family has any substantial ownership interest or other connection with FB. FP1 can remove and replace FB at any time for any reason. Although FP1 can replace FB with a related or subordinate party if FB refuses to approve or consent to FP1's decision to revest the trust property in himself, FB is not a related or subordinate party. Therefore, the exception in paragraph (a)(1) of this section is not applicable.

Example 4. Unrelated trustee will consent to revocation. FP, a foreign person, creates and funds an irrevocable trust, T. The trustee is a foreign bank, FB, that is not a related or subordinate party within the meaning of Sec. 1.672(c)-1. FB has the discretion to distribute trust income or corpus to beneficiaries of T, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, the exception in paragraph (a)(1) of this section is not applicable, because FP does not have the power to revoke T.

(b) Certain trusts that can distribute only to the grantor or the spouse of the grantor—(1) In general.—The general rule of Sec. 1.672(f)-1 does not apply to any trust (or portion of a trust) if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from such trust (or portion thereof) are amounts distributable to the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of Sec. 1.671-2(e)(2)) are not amounts distributable. For the definition of grantor, see Sec. 1.671-2(e).

(2) Amounts distributable in discharge of legal obligations—(i) In general.—A trust (or portion of a trust) does not fail to satisfy paragraph (b)(1) of this section solely because amounts are distributable from the trust (or portion thereof) in discharge of a legal obligation of the grantor or the spouse of the grantor. Subject to the provisions of paragraph (b)(2)(ii) of this section, an obligation is considered a legal obligation for purposes of this paragraph (b)(2)(i) if it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) Related parties—(A) In general.—Except as provided in paragraph (b)(2)(ii)(B) of this section, an obligation to a person who is a related person for purposes of Sec. 1.643(h)-1(e) (other than an individual who is legally separated from the grantor under a decree of divorce or of separate maintenance) is not a legal obligation

for purposes of paragraph (b)(2)(i) of this section unless it was contracted bona fide and for adequate and full consideration in money or money's worth (see Sec. 20.2043-1 of this chapter).

(B) Exceptions—(1) Amounts distributable in support of certain individuals. Paragraph (b)(2)(ii)(A) of this section does not apply with respect to amounts that are distributable from the trust (or portion thereof) to support an individual who—

(i) Would be treated as a dependent of the grantor or the spouse of the grantor under section 152(a)(1) through (9), without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor; and

(ii) Is either permanently and totally disabled (within the meaning of section 22(e)(3)), or less than 19 years old.

(2) Certain potential support obligations.—The fact that amounts might become distributable from a trust (or portion of a trust) in discharge of a potential obligation under local law to support an individual other than an individual described in paragraph (b)(2)(ii)(B)(1) of this section is disregarded if such potential obligation is not reasonably expected to arise under the facts and circumstances.

(3) Reinsurance trusts. [Reserved]

(3) Grandfather rule for certain section 677 trusts in existence on September 19, 1995. Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of Sec. 1.672(f)-1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) Examples. The following examples illustrate the rules of this paragraph (b):

Example 1. Amounts distributable only to grantor or grantor's spouse.—H and his wife, W, are both nonresident aliens. H is 70 years old, and W is 65. H and W have a 30-year-old child, C, a resident alien. There is no reasonable expectation that H or W will ever have an obligation under local law to support C or any other individual. H creates and funds an irrevocable trust, FT, using only his separate property. H is the grantor of FT within the meaning of Sec. 1.671-2(e). Under the terms of FT, the only amounts distributable (whether income or corpus) from FT as long as either H or W is alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. During H's lifetime, the exception in paragraph (b)(1) of this section is applicable.

Example 2. Effect of grantor's death.—Assume the same facts as in Example 1. H predeceases W. Assume that W would be treated as owning FT under section 678 if the grantor trust rules were applied without regard to section 672(f). The exception in paragraph (b)(1) of this section is no longer applicable, because W is not a grantor of FT within the meaning of Sec. 1.671-2(e).

Example 3. Amounts temporarily distributable to person other than grantor or grantor's spouse.—Assume the same facts as in Example 1, except that C (age 30) is a law student at the time FT is created and the trust instrument provides that, as long as C is in law school, amounts may be distributed from FT to pay C's expenses. Thereafter, the only amounts distributable from FT as long as either H or W is alive will be amounts distributable to H or W. Even assuming there is an enforceable obligation un-

der local law for H and W to support C while he is in school, distributions from FT in payment of C's expenses cannot qualify as distributions in discharge of a legal obligation under paragraph (b)(2) of this section, because C is neither permanently and totally disabled nor less than 19 years old. The exception in paragraph (b)(1) of this section is not applicable. After C graduates from law school, the exception in paragraph (b)(1) still will not be applicable, because amounts were distributable to C during the lifetime of H.

Example 4. Fixed investment trust.—FC, a foreign corporation, invests in a domestic fixed investment trust, DT, that is classified as a trust under Sec. 301.7701-4(c)(1) of this chapter. Under the terms of DT, the only amounts that are distributable from FC's portion of DT are amounts distributable to FC. The exception in paragraph (b)(1) of this section is applicable to FC's portion of DT.

Example 5. Reinsurance trust.—A domestic insurance company, DI, reinsures a portion of its business with an unrelated foreign insurance company, FI. To satisfy state regulatory requirements, FI places the premiums in an irrevocable domestic trust, DT. The trust funds are held by a United States bank and may be used only to pay claims arising out of the reinsurance policies, which are legally enforceable under the local law of the jurisdiction in which FI resides. On the termination of DT, any assets remaining will revert to FI. Because the only amounts that are distributable from DT are distributable either to FI or in discharge of FI's legal obligations within the meaning of paragraph (b)(2)(i) of this section, the exception in paragraph (b)(1) of this section is applicable.

Example 6. Trust that provides security for loan.—FC, a foreign corporation, borrows money from B, an unrelated bank, to finance the purchase of an airplane. FC creates a foreign trust, FT, to hold the airplane as security for the loan from B. The only amounts that are distributable from FT while the loan is outstanding are amounts distributable to B in the event that FC defaults on its loan from B. When FC repays the loan, the trust assets will revert to FC. The loan is a legal obligation of FC within the meaning of paragraph (b)(2)(i) of this section, because it is enforceable under the local law of the country in which FC is incorporated. Paragraph (b)(2)(ii) of this section is not applicable, because B is not a related person for purposes of Sec. 1.643(h)-1(e). The exception in paragraph (b)(1) of this section is applicable.

(c) **Compensatory trusts.**—(1) **In general.**—The general rule of Sec. 1.672(f)-1 does not apply to any portion of—

(i) A nonexempt employees' trust described in section 402(b), including a trust created on behalf of a self-employed individual;

(ii) A trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of Sec. 1.83-3(e); and

(iii) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see Sec. 601.601(d)(2) of this chapter).

(2) **Exceptions.**—The Commissioner may, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see Sec. 601.601(d)(2) of this chapter), designate categories of compensatory trusts to which the general rule of paragraph (c)(1) of this section does not apply.

(d) **Separate accounting for gratuitous transfers to grandfathered trusts after September 19, 1995.** If a trust that was treated as owned by the grantor under section 676 or

677 (other than section 677(a)(3)) on September 19, 1995, contains both amounts held in the trust on September 19, 1995, and amounts that were gratuitously transferred to the trust after September 19, 1995, paragraphs (a)(3) and (b)(3) of this section apply only if the amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of Sec. 1.671-3(a)(2). If the amounts that were gratuitously transferred to the trust after September 19, 1995 are not so accounted for, the general rule of Sec. 1.672(f)-1 applies to the entire trust. If such amounts are so accounted for, and without regard to whether there is physical separation of the assets, the general rule of Sec. 1.672(f)-1 does not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(e) Effective date.—The rules of this section are generally applicable to taxable years of a trust beginning after August 10, 1999. The initial separate accounting required by paragraph (d) of this section must be prepared by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999.

§ 1.672(f)-4 Recharacterization of purported gifts.—(a) In general—(1) Purported gifts from partnerships.—Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States person (United States donee) directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a partnership, the purported gift or bequest must be included in the United States donee's gross income as ordinary income.

(2) Purported gifts from foreign corporations.—Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation. If the foreign corporation is a passive foreign investment company (within the meaning of section 1297), the rules of section 1291 apply. For purposes of section 1012, the United States donee is not treated as having basis in the stock of the foreign corporation. However, for purposes of section 1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders (other than any interest holders who treat the portion of the purported gift attributable to their interest in the foreign corporation in the manner described in paragraph (b)(1) of this section). For purposes of section 902, a United States donee that is a domestic corporation is not treated as owning any voting stock of the foreign corporation.

(b) Exceptions—(1) Partner or shareholder treats transfer as distribution and gift.—Paragraph (a) of this section does not apply to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that either

(i) A United States citizen or resident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for United States tax purposes as a distribution to such individual and a subsequent gift or bequest to the United States donee; or

(ii) A nonresident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the nonresident alien individual's country of residence as a distribution to such individual and a subsequent gift or bequest to the United States donee, and the United States donee timely complied with the reporting requirements of section 6039F, if applicable.

(2) All beneficial owners of domestic partnership are United States citizens or residents or domestic corporations. Paragraph (a)(1) of this section does not apply to a purported gift or bequest from a domestic partnership if the United States donee can demonstrate to the satisfaction of the Commissioner that all beneficial owners (within the meaning of Sec. 1.1441-1(c)(6)) of the partnership are United States citizens or residents or domestic corporations.

(3) Contribution to capital of corporate United States donee.—Paragraph (a) of this section does not apply to the extent a United States donee that is a corporation can establish that the purported gift or bequest was treated for United States tax purposes as a contribution to the capital of the United States donee to which section 118 applies.

(4) Charitable transfers. Paragraph (a) of this section does not apply if either—

(i) The United States donee is described in section 170(c); or

(ii) The transferor has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), and the transferor made the transfer pursuant to an exempt purpose for which the transferor was created or organized. For purposes of the preceding sentence, a ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

(c) Certain transfers from trusts to which a partnership or foreign corporation has made a gratuitous transfer—(1) Generally treated as distribution from partnership or foreign corporation. Except as provided in paragraphs (c)(2) and (3) of this section, if a United States donee receives a gratuitous transfer (within the meaning of Sec. 1.671-2(e)(2)) from a trust (or portion of a trust) to which a partnership or foreign corporation has made a gratuitous transfer, the United States donee must treat the transfer as a purported gift or bequest from the partnership or foreign corporation that is subject to the rules of paragraph (a) of this section (including the exceptions in paragraphs (b) and (f) of this section). This paragraph (c) applies without regard to who is treated as the grantor of the trust (or portion thereof) under Sec. 1.671-2(e)(4).

(2) Alternative rule.—Except as provided in paragraph (c)(3) of this section, if the United States tax computed under the rules of paragraphs (a) and (c)(1) of this section does not exceed the United States tax that would be due if the United States donee treated the transfer as a distribution from the trust (or portion thereof), paragraph (c)(1) of this section does not apply and the United States donee must treat the transfer as a distribution from the trust (or portion thereof) that is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. For purposes of paragraph (f) of this section, the transfer is treated as a purported gift or bequest from the partnership or foreign corporation that made the gratuitous transfer to the trust (or portion thereof).

(3) Exception.—Neither paragraph (c)(1) of this section nor paragraph (c)(2) of this section applies to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that the transfer represents an amount that is, or has been, taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation. A transfer will be deemed to be made first out of amounts that have not been taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation, unless the United States donee can demonstrate to the satisfaction of the Commissioner that another ordering rule is more appropriate.

(d) Definition of purported gift or bequest—(1) In general.—Subject to the provisions of paragraphs (d)(2) and (3) of this section, a purported gift or bequest for purposes of this section is any transfer of property by a partnership or foreign corporation other than a transfer for fair market value (within the meaning of Sec. 1.671-2(e)(2)(ii)) to a person who is not a partner in the partnership or a shareholder of the foreign corporation (or to a person who is a partner in the partnership or a shareholder of a foreign corporation, if the amount transferred is inconsistent with the partner's interest in the partnership or the shareholder's interest in the corporation, as the case may be). For purposes of this section, the term property includes cash.

(2) Transfers for less than fair market value—(i) Excess treated as purported gift or bequest.—Except as provided in paragraph (d)(2)(ii) of this section, if a transfer described in paragraph (d)(1) of this section is for less than fair market value, the excess of the fair market value of the property transferred over the value of the property received, services rendered, or the right to use property is treated as a purported gift or bequest.

(ii) Exception for transfers to unrelated parties.—No portion of a transfer described in paragraph (d)(1) of this section will be treated as a purported gift or bequest for purposes of this section if the United States donee can demonstrate to the satisfaction of the Commissioner that the United States donee is not related to a partner or shareholder of the transferor within the meaning of Sec. 1.643(h)-1(e) or does not have another relationship with a partner or shareholder of the transferor that establishes a reasonable basis for concluding that the transferor would make a gratuitous transfer to the United States donee.

(e) Prohibition against affirmative use of recharacterization by taxpayers.—A taxpayer may not use the rules of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.

(f) Transfers not in excess of \$10,000.—This section does not apply if, during the taxable year of the United States donee, the aggregate amount of purported gifts or bequests that is transferred to such United States donee directly or indirectly from all partnerships or foreign corporations that are related (within the meaning of section 643(i)) does not exceed \$10,000. The aggregate amount must include gifts or bequests from persons that the United States donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(g) Examples. The following examples illustrate the rules of this section. In each example, the amount that is transferred exceeds \$10,000. The examples are as follows:

Example 1. Distribution from foreign corporation.—FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer of property directly to A's daughter, B, who is a resident alien. Under paragraph (a)(2) of this section, B generally must treat the transfer as a dividend from FC to the extent of FC's earnings and profits and as an amount received in excess of basis thereafter. If FC is a passive foreign investment company, B must treat the amount received as a distribution under section 1291. B will be treated as having the same holding period as A. However, under paragraph (b)(1)(ii) of this section, if B can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B, B may treat the transfer as a gift (provided B timely complied with the reporting requirements of section 6039F, if applicable).

Example 2. Distribution of corpus from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer to a foreign trust, FT, that has no other assets. FT immediately makes a gratuitous transfer in the same amount to A's daughter, B, who is a resident alien. Under paragraph (c)(1) of this section, B must treat the transfer as a transfer from FC that is subject to the rules of paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B must treat the transfer as a dividend from FC unless she can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B and that B timely complied with the reporting requirements of section 6039F, if applicable. The alternative rule in paragraph (c)(2) of this section would not apply as long as the United States tax computed under the rules of paragraph (a)(2) of this section is equal to or greater than the United States tax that would be due if the transfer were treated as a distribution from FT.

Example 3. Accumulation distribution from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC is not a passive foreign investment company (as defined in section 1297). FC makes a gratuitous transfer of 100X to a foreign trust, FT, on January 1, 2001. FT has no other assets on January 1, 2001. Several years later, FT makes a gratuitous transfer of 1000X to A's daughter, B, who is a United States resident. Assume that the section 668 interest charge on accumulation distributions will apply if the transfer is treated as a distribution from FT. Under the alternative rule of paragraph (c)(2) of this section, B must treat the transfer as an accumulation distribution from FT, because the resulting United States tax liability is greater than the United States tax that would be due if the transfer were treated as a transfer from FC that is subject to the rules of paragraph (a) of this section.

Example 4. Transfer from trust that is treated as owned by United States citizen.— Assume the same facts as in Example 3, except that A is a United States citizen. Assume that A treats and reports the transfer to FT as a constructive distribution to himself, followed by a gratuitous transfer to FT, and that A is properly treated as the grantor of FT within the meaning of Sec. 1.671-2(e). A is treated as the owner of FT under section 679 and, as required by section 671 and the regulations thereunder, A includes all of FT's items of income, deductions, and credit in computing his taxable income and credits. Neither paragraph (c)(1) nor paragraph (c)(2) of this section is applicable, because the exception in paragraph (c)(3) of this section applies.

Example 5. Transfer for less than fair market value. FC is a foreign corporation that is wholly owned by A, a nonresident alien. On January 15, 2001, FC transfers property directly to A's daughter, B, a resident alien, in exchange for 90X. The Commissioner later determines that the fair market value of the property at the time of the transfer was 100X. Under paragraph (d)(2)(i) of this section, 10X will be treated as a purported gift to B on January 15, 2001.

(h) Effective date. The rules of this section are generally applicable to any transfer after August 10, 1999, by a partnership or foreign corporation, or by a trust to which a partnership or foreign corporation makes a gratuitous transfer after August 10, 1999.

§ 1.672(f)-5 Special rules.—(a) Transfers by certain beneficiaries to foreign grantor.—(1) In general.—If, but for section 672(f)(5), a foreign person would be treated as the owner of any portion of a trust, any United States beneficiary of the trust is treated as the grantor of a portion of the trust to the extent the United States beneficiary directly or indirectly made transfers of property to such foreign person (without regard to whether the United States beneficiary was a United States beneficiary at the time of

any transfer) in excess of transfers to the United States beneficiary from the foreign person. The rule of this paragraph (a) does not apply to the extent the United States beneficiary can demonstrate to the satisfaction of the Commissioner that the transfer by the United States beneficiary to the foreign person was wholly unrelated to any transaction involving the trust. For purposes of this paragraph (a), the term property includes cash, and a transfer of property does not include a transfer that is not a gratuitous transfer (within the meaning of Sec. 1.671-2(e)(2)). In addition, a gift is not taken into account to the extent such gift would not be characterized as a taxable gift under section 2503(b). For a definition of United States beneficiary, see section 679.

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

Example 1. A, a nonresident alien, contributes property to FC, a foreign corporation that is wholly owned by A. FC creates a foreign trust, FT, for the benefit of A and A's children. FT is revocable by FC without the approval or consent of any other person. FC funds FT with the property received from A. A and A's family move to the United States. Under paragraph (a)(1) of this section, A is treated as a grantor of FT. (A may also be treated as an owner of FT under section 679(a)(4).)

Example 2. B, a United States citizen, makes a gratuitous transfer of \$1 million to B's uncle, C, a nonresident alien. C creates a foreign trust, FT, for the benefit of B and B's children. FT is revocable by C without the approval or consent of any other person. C funds FT with the property received from B. Under paragraph (a)(1) of this section, B is treated as a grantor of FT. (B also would be treated as an owner of FT as a result of section 679.)

(b) Entity characterization.—Entities generally are characterized under United States tax principles for purposes of Secs. 1.672(f)-1 through 1.672(f)-5. See Secs. 301.7701-1 through 301.7701-4 of this chapter. However, solely for purposes of Sec. 1.672(f)-4, a transferor that is a wholly owned business entity is treated as a corporation, separate from its single owner.

(c) Effective date.—The rules in paragraph (a) of this section are applicable to transfers to trusts on or after August 10, 1999. The rules in paragraph (b) of this section are applicable August 10, 1999.

§ 1.673(a)-1 Reversionary interests; income payable to beneficiaries other than certain charitable organizations; general rule.—(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) Except in the case of transfers in trust made after April 22, 1969, a reversionary interest in a charitable trust meeting the requirements of section 673(b) (see Sec. 1.673(b)-1). Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner under section 677(a)(2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See Sec. 1.671-3 and the regulations under section 677. See Sec. 1.673(d)-1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673(c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned to the grantor if he survives that period, or to be paid to the grantor's son if he is already deceased.

(e) See section 671 and Secs. 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.673(b)-1 Income payable to charitable beneficiaries before amendment by Tax Reform Act of 1969.—(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A).

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673(b) will apply. Thus, section 673(b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673(b) will apply if half the

income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673(b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170(b)(1)(A) (i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example. G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170(b)(1)(A)(ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 of the trust income payable to University C for the first 3 years because of the application of section 673(b). However, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to R for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

(d) This section does not apply to transfers in trust made after April 22, 1969.

§ 1.673(c)-1 Reversionary interest after income beneficiary's death.—The subject matter of section 673(c) is covered in paragraph (b) of Sec. 1.673(a)-1.

§ 1.673(d)-1 Postponement of date specified for reacquisition.—Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any portion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example. G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

§ 1.674(a)-1 Power to control beneficial enjoyment; scope of section 674.—(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in Sec. 1.674(b)-1 through 1.674(d)-1. Certain limitations applicable to section 674 (b), (c), and (d) are set forth in Sec. 1.674(d)-2. Section 674(b) describes powers which are excepted regardless of who holds them. Section 674(c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674(d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial enjoyment of the corpus or income unless the power is one of the following.

(1) Miscellaneous powers over either ordinary income or corpus.—(i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674(b)(2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674(b)(3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674(b)(4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674(b)(8)).

(2) Powers of distribution primarily affecting only one beneficiary.—(i) A power to distribute corpus to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674(b)(5)(B));

(ii) A power to distribute income to or for a current income beneficiary or to accumulate it either (a) if accumulated income must either be payable to the beneficiary from whom it was withheld or as described in paragraph (b)(6) of Sec. 1.674(b)-1 (section 674(b)(6)); (b) if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674(b)(1)); or (c) if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674(b)(7)).

(3) Powers of distribution affecting more than one beneficiary.—A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674(c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (section 674(b)(5)(A) and (d)). (These powers include both powers to "sprinkle" income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) of this paragraph can have the latter effect incidentally.)

(c) See section 671 and § 1.671-2 and 1.671-3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

§ 1.674(b)-1 Excepted powers exercisable by any person.—(a) Paragraph (b) (1) through (8) of this section sets forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674(a). Further, with the exception of powers described in paragraph (b)(1) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in paragraph (b) (1) and (3) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in Sec. 1.674(d)-2):

(1) Powers to apply income to support of a dependent. Section 674(b)(1) provides, in effect, that regardless of the general rule of section 674(a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. See section 677(b) and the regulations thereunder.

(2) Powers affecting beneficial enjoyment only after a period.—Section 674(b)(2) provides an exception to section 674(a) if the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See § 1.673(a)-1 and 1.673(b)-1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in Sec. 1.673(d)-1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) Testamentary powers.—Under paragraph (3) of section 674(b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674(a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See Sec. 1.671-3.)

(4) Powers to determine beneficial enjoyment of charitable beneficiaries.—Under paragraph (4) of section 674(b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170(c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674(a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170(c), he is not treated as an owner under section 674 although he retains the power to allocate the income among such organizations.

(5) Powers to distribute corpus.—Paragraph (5) of section 674(b) provides an exception to section 674(a) for powers to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances

of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in [[Page 302]] determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example 1. A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example 2. The facts are the same as in example 1 except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example 3. A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

(6) Powers to withhold income temporarily. (i) Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current in-

come beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:

(a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A));

(b) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor of the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(A) and the flush material following); or

(c) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(B) and the flush material following). (In the application of (a) of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary or is ultimately payable to his appointees or takers in default of appointment, under a power of the type described in (a) of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in (a) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (a) of this subdivision.) In general, the exception in section 674(b)(6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674(b)(6)(B), and (c) of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example 1 of this subparagraph.

(ii) The application of section 674(b)(6) may be illustrated by the following examples:

Example 1. A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674(b)(6)(B) and subdivision (i)(c) of this subparagraph.

Example 2. The facts are the same as in example 1, except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section

674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674(c) and Sec. 1.674(c)-1 for the effect of such a power if it is exercisable only by independent trustees.

Example 3. A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674(b)(6)(A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) Power to withhold income during disability. Section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

(8) Powers to allocate between corpus and income.—Paragraph (8) of section 674(b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674(a).

§ 1.674(c)-1 Excepted powers exercisable only by independent trustees.—Section 674(c) provides an exception to the general rule of section 674(a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674(b) which may be held by any person including an independent trustee. The powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672(c) for definitions of these terms.) An example of the application of section 674(c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See however, the limitations set forth in Sec. 1.674(d)-2.

§ 1.674(d)-1 Excepted powers exercisable by any trustee other than grantor or spouse.—Section 674(d) provides an additional exception to the general rule of sec-

tion 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b) (6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b)(5) of Sec. 1.674(b)-1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in Sec. 1.674(d)-2.

§ 1.674(d)-2 Limitations on exceptions in section 674 (b), (c), and (d).—(a) Power to remove trustee.—A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

(b) Power to add beneficiaries.—The exceptions described in section 674 (b) (5), (6), and (7), (c), and (d), are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

§ 1.675-1 Administrative powers.—(a) General rule.—Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and § 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) Prohibited controls.—The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672(c) for definition of “a related or subordinate party”.

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term powers of administration means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.—If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) Authority of trustee.—The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money’s worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

§ 1.676(a)-1 Power to revest title to portion of trust property in grantor; general rule.—If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and

§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.676(b)-1 Powers exercisable only after a period of time.—Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as the owner of that portion, except as power were a reversionary interest. See § 1.673(a)-1 and 1.673(b)-1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in Sec. 1.673(d)-1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

§ 1.677(a)-1 Income for benefit of grantor; general rule.—(a)(1) Scope. Section 677 deals with the treatment of the grantor of a trust as the owner of a portion of the trust because he has retained an interest in the income from that portion. For convenience, “grantor” and “spouse” are generally referred to in the masculine and feminine genders, respectively, but if the grantor is a woman the reference to “grantor” is to her and the reference to “spouse” is to her husband. Section 677 also deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the income from property transferred in trust after October 9, 1969, is, or may be, distributed to his spouse or applied to the payment of premiums on policies of insurance on the life of his spouse. However, section 677 does not apply when the income of a trust is taxable to a grantor’s spouse under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in case of divorce, etc.). See section 671-1(b).

(2) Cross references.—See section 671 and § 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or a portion of a trust.

(b) Income for benefit of grantor or his spouse; general rule—(1) Property transferred in trust prior to October 10, 1969. With respect to property transferred in trust prior to October 10, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a non-adverse party, or both (without the approval or consent of any adverse party) may be:

(i) Distributed to the grantor;

(ii) Held or accumulated for future distribution to the grantor; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

(2) Property transferred in trust after October 9, 1969.—With respect to property transferred in trust after October 9, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section

674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor, or his spouse, or a nonadverse party, or any combination thereof (without the approval or consent of any adverse party other than the grantor's spouse) may be:

- (i) Distributed to the grantor or the grantor's spouse;
- (ii) Held or accumulated for future distribution to the grantor or the grantor's spouse; or
- (iii) Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

(c) Constructive distribution; cessation of interest.—Under section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively (subject to the exception described in paragraph (e) of this section). In the case of a transfer in trust after October 9, 1969, the grantor is also treated as the owner of a portion of a trust if he has granted or retained any interest which might, without the approval or consent of an adverse party (other than the grantor's spouse), enable his spouse to have the income from the portion at some time, whether or not within the grantor's lifetime, distributed to the spouse either actually or constructively. See paragraph (b)(2) of this section for additional rules relating to the income of a trust prior to the grantor's marriage to a beneficiary. Constructive distribution to the grantor or to his spouse includes payment on behalf of the grantor or his spouse to another in obedience to his or her direction and payment of premiums upon policies of insurance on the grantor's, or his spouse's, life (other than policies of insurance irrevocably payable for charitable purposes specified in section 170(c)). If the grantor (in the case of property transferred prior to Oct. 10, 1969) or the grantor and his spouse (in the case of property transferred after Oct. 9, 1969) are divested permanently and completely of every interest described in this paragraph, the grantor is not treated as an owner under section 677 after that divesting. The word "interest" as used in this paragraph does not include the possibility that the grantor or his spouse might receive back from a beneficiary an interest in a trust by inheritance. Further, with respect to transfers in trust prior to October 10, 1969, the word "interest" does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust as a surviving spouse under a statutory right of election or a similar right.

(d) Discharge of legal obligation of grantor or his spouse.—Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969). However, see § 1.677(b)-1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or grantor's spouse is legally obligated to support. See Sec. 301.7701-4(e) of this chapter for rules on the classification of and application of section 677 to an environmental remediation trust.

(e) Exception for certain discretionary rights affecting income. The last sentence of section 677(a) provides that a grantor shall not be treated as the owner when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time during which a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See § 1.673(a)-1 and 1.673(b)-1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor’s discretion income or corpus may be paid to B or to the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969), the grantor is not treated as an owner with respect to the ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in Sec. 1.673(d)-1 are applicable in determining whether the grantor should be treated as an owner during the period following the postponement.

(f) Accumulation of income.—If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor, or his spouse in the case of property transferred in trust after October 9, 1969, or a nonadverse party, may be, distributed to the grantor (or his spouse in the case of property transferred in trust after Oct. 9, 1969), the grantor is treated as the owner of the trust from its inception. If income attributable to transfers after October 9, 1969 is accumulated in any taxable year during the grantor’s lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor’s death.

(g) Examples.—The application of section 677(a) may be illustrated by the following examples:

Example 1. G creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has the following items of gross income and deductions:

Dividends	\$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the \$5,000 of dividends, \$200 income expense, and \$100 corpus expense in the computation of his taxable income for 1970. He should not include the \$1,000 capital gain since that is not attributable to the portion of the trust that he owns. See Sec. 1.671-3(b). The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and

following), part I, subchapter J, chapter 1 of the Code. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

Example 2. G creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive \$5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retained no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust had the following items of income and deductions:

Dividends	\$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. See Sec. 1.671-3(b). Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of \$5,000. Accordingly, G includes dividends of \$5,208.33 and income expenses of \$208.33 in computing his taxable income, determined in the following manner:

Total dividends	\$10,000.00
Less: Expenses allocable to income	<u>400.00</u>
Distributable income of the trust	<u>9,600.00</u>
Portion of dividends attributable to G (5,000/9,600 × \$10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600 × \$400)	<u>208.33</u>
Amount of income subject to discretionary right	5,000.00

In accordance with Sec. 1.671-3(c), G also takes into account \$104.17 (5,000/9,600 × \$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of subparts A through D.

§ 1.677(b)-1 Trusts for support.—(a) Section 677(b) provides that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person other than the grantor (except when he is acting as trustee or cotrustee) be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse in the case of income from property transferred in trust after October 9, 1969), such as the child of the grantor, whom the grantor or his spouse is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes. In the case of property transferred to a trust before October 10, 1969, for

the benefit of the grantor's spouse, the grantor may be treated as the owner to the extent income of the current year is actually applied for the support or maintenance of his spouse.

(b) If any amount applied or distributed for the support of a beneficiary, including the grantor's spouse in the case of property transferred in trust before October 10, 1969, whom the grantor is legally obligated to support is paid out of corpus or out of income other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a)(2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Accordingly, the grantor may be taxed on an accumulation distribution or a capital gain distribution under subpart D (section 665 and following) of such part I. Those provisions are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of \$10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of \$5,000 and incurred expenses of \$1,000 during that year but subsequent to January 1, he will take into account dividends of \$5,000 and expenses of \$1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the \$6,000 (\$10,000 less distributable income of \$4,000 (dividends of \$5,000 less expenses of \$1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or non-adverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

§ 1.678(a)-1 Person other than grantor treated as substantial owner; general rule.—(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving and obligation of support). The holder of such a power also is

treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and § 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678(a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see Sec. 1.678(c)-1 subject to the limitation of section 678(b)). Section 678 does not apply if the power is not exercisable solely by himself. However, see Sec. 1.662(a)-4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

§ 1.678(b)-1 If grantor is treated as the owner. Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under sections 671 to 677, inclusive.

§ 1.678(c)-1 Trusts for support.—(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of Sec. 1.677(b)-1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The general rule in section 678(a) (and not the exception in section 678(c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678(c) is concerned with the taxability of income subject to a power described in section 678(a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678(a), the taxability of such income being governed by other provisions of the Code. See Sec. 1.662(a)-4.

§ 1.678(d)-1 Renunciation of power.—Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

§ 1.679-0 Outline of major topics.—This section lists the major paragraphs contained in § 1.679-1 through 1.679-7 as follows:

§ 1.679-1 U.S. transferor treated as owner of foreign trust.

- (a) In general.
- (b) Interaction with sections 673 through 678.
- (c) Definitions.
 - (1) U.S. transferor.
 - (2) U.S. person.
 - (3) Foreign trust.
 - (4) Property.
 - (5) Related person.
 - (6) Obligation.

(d) Examples.

§ 1.679-2 Trusts treated as having a U.S. beneficiary.

(a) Existence of U.S. beneficiary.

(1) In general.

(2) Benefit to a U.S. person

(i) In general.

(ii) Certain unexpected beneficiaries.

(iii) Examples.

(3) Changes in beneficiary's status.

(i) In general.

(ii) Examples.

(4) General rules.

(i) Records and documents.

(ii) Additional factors.

(iii) Examples.

(b) Indirect U.S. beneficiaries.

(1) Certain foreign entities.

(2) Other indirect beneficiaries.

(3) Examples.

(c) Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary.

(1) Trusts acquiring a U.S. beneficiary.

(2) Trusts ceasing to have a U.S. beneficiary.

(3) Examples.

§ 1.679-3 Transfers.

(a) In general.

(b) Transfers by certain trusts.

(1) In general.

(2) Example.

(c) Indirect transfers.

(1) Principal purpose of tax avoidance.

(2) Principal purpose of tax avoidance deemed to exist.

(3) Effect of disregarding intermediary.

(i) In general.

(ii) Special rule.

(iii) Effect on intermediary.

(4) Related parties.

(5) Examples.

- (d) Constructive transfers.
 - (1) In general.
 - (2) Examples.
- (e) Guarantee of trust obligations.
 - (1) In general.
 - (2) Amount transferred.
 - (3) Principal repayments.
 - (4) Guarantee.
 - (5) Examples.
- (f) Transfers to entities owned by a foreign trust.
 - (1) General rule.
 - (2) Examples.

§ 1.679-4 Exceptions to general rule.

- (a) In general.
- (b) Transfers for fair market value.
 - (1) In general.
 - (2) Special rule.
 - (i) Transfers for partial consideration.
 - (ii) Example.
- (c) Certain obligations not taken into account.
- (d) Qualified obligations.
 - (1) In general.
 - (2) Additional loans.
 - (3) Obligations that cease to be qualified.
 - (4) Transfers resulting from failed qualified obligations.
 - (5) Renegotiated loans.
 - (6) Principal repayments.
 - (7) Examples.

§ 1.679-5 Pre-immigration trusts.

- (a) In general.
- (b) Special rules.
 - (1) Change in grantor trust status.
 - (2) Treatment of undistributed income.
- (c) Examples.

§ 1.679-6 Outbound migrations of domestic trusts.

- (a) In general.
- (b) Amount deemed transferred.
- (c) Example.

§ 1.679-7 Effective dates.

- (a) In general.
- (b) Special rules.

§ 1.679-1 U.S. transferor treated as owner of foreign trust.—(a) In general. A U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred if there is a U.S. beneficiary of any portion of the trust, unless an exception in Sec. 1.679-4 applies to the transfer.

(b) Interaction with sections 673 through 678.—The rules of this section apply without regard to whether the U.S. transferor retains any power or interest described in sections 673 through 677. If a U.S. transferor would be treated as the owner of a portion of a foreign trust pursuant to the rules of this section and another person would be treated as the owner of the same portion of the trust pursuant to section 678, then the U.S. transferor is treated as the owner and the other person is not treated as the owner.

(c) Definitions.—The following definitions apply for purposes of this section and § 1.679-2 through 1.679-7:

(1) U.S. transferor.—The term U.S. transferor means any U.S. person who makes a transfer (as defined in Sec. 1.679-3) of property to a foreign trust.

(2) U.S. person.—The term U.S. person means a United States person as defined in section 7701(a)(30), a nonresident alien individual who elects under section 6013(g) to be treated as a resident of the United States, and an individual who is a dual resident taxpayer within the meaning of Sec. 301.7701(b)-7(a) of this chapter.

(3) Foreign trust.—Section 7701(a)(31)(B) defines the term foreign trust. See also Sec. 301.7701-7 of this chapter.

(4) Property.—The term property means any property including cash.

(5) Related person.—A person is a related person if, without regard to the transfer at issue, the person is—

(i) A grantor of any portion of the trust (within the meaning of Sec. 1.671-2(e)(1));

(ii) An owner of any portion of the trust under sections 671 through 679;

(iii) A beneficiary of the trust; or

(iv) A person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner or beneficiary of the trust.

(6) Obligation.—The term obligation means any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other evidence of indebtedness, and, to the extent not previously described, any annuity contract.

(d) Examples. The following examples illustrate the rules of paragraph (a) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's father, who is a resident alien, D is A's uncle, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1. Interaction with section 678. A creates and funds FT. FT may provide for the education of B by paying for books, tuition, room and board. In addition, C has the power to vest the trust corpus or income in himself within the meaning of section 678(a)(1). Under paragraph (b) of this section, A is treated as the owner of the portion of FT attributable to the property transferred to FT by A and C is not treated as the owner thereof.

Example 2. U.S. person treated as owner of a portion of FT. D creates and funds FT for the benefit of B. D retains a power described in section 676 and Sec. 1.672(f)-3(a)(1). A transfers property to FT. Under sections 676 and 672(f), D is treated as the owner of the portion of FT attributable to the property transferred by D. Under paragraph (a) of this section, A is treated as the owner of the portion of FT attributable to the property transferred by A.

§ 1.679-2 Trusts treated as having a U.S. beneficiary.—(a) Existence of U.S. beneficiary—(1) In general.—The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis. A foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor—

(i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

(ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.(2) Benefit to a U.S. person—(i) In general.—For purposes of paragraph (a)(1) of this section, income or corpus may be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event.

(ii) Certain unexpected beneficiaries.—Notwithstanding paragraph (a)(2)(i) of this section, for purposes of paragraph (a)(1) of this section, a person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. The preceding sentence does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person. A class of beneficiaries generally does not include heirs who will benefit from the trust under the laws of intestate succession in the event that the named beneficiaries (or members of the named class) have all deceased (whether or not stated as a named class in the trust instrument).

(iii) Examples. The following examples illustrate the rules of paragraphs (a)(1) and (2) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1. Distribution of income to U.S. person.—A transfers property to FT. The trust instrument provides that all trust income is to be distributed currently to B. Under paragraph (a)(1) of this section, FT is treated as having a U.S. beneficiary.

Example 2. Income accumulation for the benefit of a U.S. person.—In 2001, A transfers property to FT. The trust instrument provides that from 2001 through 2010, the trustee of FT may distribute trust income to C or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of B and C, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to C. Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to B, a U.S. person, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of A's tax

years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 3. Corpus held for the benefit of a U.S. person.—The facts are the same as in Example 2, except that from 2001 through 2011, all trust income must be distributed to C. In 2011, the trust will terminate and the trustee may distribute the trust corpus to either or both of B and C, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust corpus must be distributed to C. Because during each of A's tax years from 2001 through 2011 trust corpus is held for possible future distribution to B, a U.S. person, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of those years. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 4. Distribution upon U.S. transferor's death.—A transfers property to FT. The trust instrument provides that all trust income must be distributed currently to C and, upon A's death, the trust will terminate and the trustee may distribute the trust corpus to either or both of B and C. Because B may receive a distribution of corpus upon the termination of FT, and FT could terminate in any year, FT is treated as having a U.S. beneficiary in the year of the transfer and in subsequent years.

Example 5. Distribution after U.S. transferor's death.—The facts are the same as in Example 4, except the trust instrument provides that the trust will not terminate until the year following A's death. Upon termination, the trustee may distribute the trust assets to either or both of B and C, in the trustee's discretion. All trust assets are invested in the stock of X, a foreign corporation, and X makes no distributions to FT. Although no U.S. person may receive a distribution until the year after A's death, and FT has no realized income during any year of its existence, during each year in which A is living corpus may be held for future distribution to B, a U.S. person. Thus, under paragraph (a)(1) of this section FT is treated as having a U.S. beneficiary during each of A's tax years from 2001 through the year of A's death.

Example 6. Constructive benefit to U.S. person.—A transfers property to FT trust instrument provides that no income or corpus may be paid directly to a U.S. person. However, the trust instrument provides that trust corpus may be used to satisfy B's legal obligations to a third party by making a payment directly to the third party. Under paragraphs (a)(1) and (2) of this section, FT is treated as having a U.S. beneficiary.

Example 7. U.S. person with negligible contingent interest.—A transfers property to FT. The trust instrument provides that all income is to be distributed currently to C, and upon C's death, all corpus is to be distributed to whomever of C's three children is then living. All of C's children are nonresident aliens. Under the laws of intestate succession that would apply to FT, if all of C's children are deceased at the time of C's death, the corpus would be distributed to A's heirs. A's living relatives at the time of the transfer consist solely of two brothers and two nieces, all of whom are nonresident aliens, and two first cousins, one of whom, E, is a U.S. citizen. Although it is possible under certain circumstances that E could receive a corpus distribution under the applicable laws of intestate succession, for each year the trust is in existence A is able to demonstrate to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that E's contingent interest in FT is so remote as to be negligible. Provided that paragraph (a)(4) of this section does not require a different result, FT is not treated as having a U.S. beneficiary.

Example 8. U.S. person with non-negligible contingent interest.—A transfers property to FT. The trust instrument provides that all income is to be distributed currently to D, A's uncle, who is a nonresident alien, and upon A's death, the corpus is to be distributed to D if he is then living. Under the laws of intestate succession that would

apply to FT, B and C would share equally in the trust corpus if D is not living at the time of A's death. A is unable to demonstrate to the satisfaction of the Commissioner that B's contingent interest in the trust is so remote as to be negligible. Under paragraph (a)(2)(ii) of this section, FT is treated as having a U.S. beneficiary as of the year of the transfer.

Example 9. U.S. person as member of class of beneficiaries.—A transfers property to FT. The trust instrument provides that all income is to be distributed currently to D, A's uncle, who is a nonresident alien, and upon A's death, the corpus is to be distributed to D if he is then living. If D is not then living, the corpus is to be distributed to D's descendants. D's grandson, E, is a resident alien. Under paragraph (a)(2)(ii) of this section, FT is treated as having a U.S. beneficiary as of the year of the transfer.

Example 10. Trustee's discretion in choosing beneficiaries.—A transfers property to FT. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of, any person who is pursuing the academic study of ancient Greek, in the trustee's discretion. Because it is possible that a U.S. person will receive distributions of income or corpus, or will have income accumulated for his benefit, FT is treated as having a U.S. beneficiary. This result applies even if, during a tax year, no distributions or accumulations are actually made to or for the benefit of a U.S. person. A may not invoke paragraph (a)(2)(ii) of this section because a U.S. person could benefit pursuant to a grant of discretion in the trust instrument.

Example 11. Appointment of remainder beneficiary.—A transfers property to FT. The trust instrument provides that the trustee may distribute current income to C, or may accumulate income, and, upon termination of the trust, trust assets are to be distributed to C. However, the trust instrument further provides that D, A's uncle, may appoint a different remainder beneficiary. Because it is possible that a U.S. person could be named as the remainder beneficiary, and because corpus could be held in each year for the future benefit of that U.S. person, FT is treated as having a U.S. beneficiary for each year.

Example 12. Trust not treated as having a U.S. beneficiary.—A transfers property to FT. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of C. Upon termination of the trust, all income and corpus must be distributed to C. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Because no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, either directly or indirectly, a U.S. person, and if the trust is terminated no part of the income or corpus of the trust could be paid to or for the benefit of, either directly or indirectly, a U.S. person, FT is not treated as having a U.S. beneficiary.

Example 13. U.S. beneficiary becomes non-U.S. person.—In 2001, A transfers property to FT. The trust instrument provides that, as long as B remains a U.S. resident, no distributions of income or corpus may be made from the trust to B. The trust instrument further provides that if B becomes a nonresident alien, distributions of income (including previously accumulated income) and corpus may be made to him. If B remains a U.S. resident at the time of FT's termination, all accumulated income and corpus is to be distributed to C. In 2007, B becomes a nonresident alien and remains so thereafter. Because income may be accumulated during the years 2001 through 2007 for the benefit of a person who is a U.S. person during those years, FT is treated as having a U.S. beneficiary under paragraph (a)(1) of this section during each of those years. This result applies even though B cannot receive distributions from FT during the years he is a resident alien and even though B might remain a resident alien who is not enti-

tled to any distribution from FT. Provided that paragraph (a)(4) of this section does not require a different result and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no other U.S. persons are reasonably expected to benefit from the trust, FT is not treated as having a U.S. beneficiary under paragraph (a)(1) of this section during tax years after 2007.

(3) Changes in beneficiary's status—(i) In general.—For purposes of paragraph (a)(1) of this section, the possibility that a person that is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person for purposes of paragraph (a)(1) of this section until the tax year of the U.S. transferor in which that individual actually becomes a U.S. person. However, if a person who is not a U.S. person becomes a U.S. person for the first time more than 5 years after the date of a transfer to the foreign trust by a U.S. transferor, that person is not treated as a U.S. person for purposes of applying paragraph (a)(1) of this section with respect to that transfer.

(ii) Examples.—The following examples illustrate the rules of paragraph (a)(3) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1. Non-U.S. beneficiary becomes U.S. person. In 2001, A transfers property to FT. The trust instrument provides that all income is to be distributed currently to C and that, upon the termination of FT, all corpus is to be distributed to C. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Under paragraph (a)(3)(i) of this section, FT is not treated as having a U.S. beneficiary during the tax years of A in which C remains a nonresident alien. If C first becomes a resident alien in 2004, FT is treated as having a U.S. beneficiary commencing in that year under paragraph (a)(3) of this section. See paragraph (c) of this section regarding the treatment of A upon FT's acquisition of a U.S. beneficiary.

Example 2. Non-U.S. beneficiary becomes U.S. person more than 5 years after transfer. The facts are the same as in Example 1, except C first becomes a resident alien in 2007. FT is treated as not having a U.S. beneficiary under paragraph (a)(3)(i) of this section with respect to the property transfer by A. However, if C had previously been a U.S. person during any prior period, the 5-year exception in paragraph (a)(3)(i) of this section would not apply in 2007 because it would not have been the first time C became a U.S. person.

(4) General rules—(i) Records and documents.—Even if, based on the terms of the trust instrument, a foreign trust is not treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the trust may nevertheless be treated as having a U.S. beneficiary pursuant to paragraph (a)(1) of this section based on the following—

- (A) All written and oral agreements and understandings relating to the trust;
- (B) Memoranda or letters of wishes;
- (C) All records that relate to the actual distribution of income and corpus; and
- (D) All other documents that relate to the trust, whether or not of any purported legal effect.

(ii) Additional factors.—For purposes of determining whether a foreign trust is treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the following additional factors are taken into account—

(A) If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

(B) If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and

(C) If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.

(iii) Examples.—The following examples illustrate the rules of paragraph (a)(4) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1. Amendment pursuant to local law. A creates and funds FT for the benefit of C. The terms of FT (which, according to the trust instrument, cannot be amended) provide that no part of the income or corpus of FT may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, either during the existence of FT or at the time of its termination. However, pursuant to the applicable foreign law, FT can be amended to provide for additional beneficiaries, and there is an oral understanding between A and the trustee that B can be added as a beneficiary. Under paragraphs (a)(1) and (a)(4)(ii)(B) of this section, FT is treated as having a U.S. beneficiary.

Example 2. Actions in violation of the terms of the trust. A transfers property to FT. The trust instrument provides that no U.S. person can receive income or corpus from FT during the term of the trust or at the termination of FT. Notwithstanding the terms of the trust instrument, a letter of wishes directs the trustee of FT to provide for the educational needs of B, who is about to begin college. The letter of wishes contains a disclaimer to the effect that its contents are only suggestions and recommendations and that the trustee is at all times bound by the terms of the trust as set forth in the trust instrument. Under paragraphs (a)(1) and (a)(4)(ii)(C) of this section, FT is treated as having a U.S. beneficiary.

(b) Indirect U.S. beneficiaries—(1) Certain foreign entities.—For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of—

(i) A controlled foreign corporation, as defined in section 957(a);

(ii) A foreign partnership, if a U.S. person is a partner of such partnership; or

(iii) A foreign trust or estate, if such trust or estate has a U.S. beneficiary (within the meaning of paragraph (a)(1) of this section).

(2) Other indirect beneficiaries.—For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of a U.S. person through an

intermediary, such as an agent or nominee, or by any other means where a U.S. person may obtain an actual or constructive benefit.

(3) Examples.—The following examples illustrate the rules of this paragraph (b). Unless otherwise noted, A is a resident alien. B is A's son and is a resident alien. FT is a foreign trust. The examples are as follows:

Example 1. Trust benefiting foreign corporation.—A transfers property to FT. The beneficiary of FT is FC, a foreign corporation. FC has outstanding solely 100 shares of common stock. B owns 49 shares of the FC stock and FC2, also a foreign corporation, owns the remaining 51 shares. FC2 has outstanding solely 100 shares of common stock. B owns 49 shares of FC2 and nonresident alien individuals own the remaining 51 FC2 shares. FC is a controlled foreign corporation (as defined in section 957(a), after the application of section 958(a)(2)). Under paragraphs (a)(1) and (b)(1)(i) of this section, FT is treated as having a U.S. beneficiary.

Example 2. Trust benefiting another trust.—A transfers property to FT. The terms of FT permit current distributions of income to B. A transfers property to another foreign trust, FT2. The terms of FT2 provide that no U.S. person can benefit either as to income or corpus, but permit current distributions of income to FT. Under paragraph (a)(1) of this section, FT is treated as having a U.S. beneficiary and, under paragraphs (a)(1) and (b)(1)(iii) of this section, FT2 is treated as having a U.S. beneficiary.

Example 3. Trust benefiting another trust after transferor's death.—A transfers property to FT. The terms of FT require that all income from FT be accumulated during A's lifetime. In the year following A's death, a share of FT is to be distributed to FT2, another foreign trust, for the benefit of B. Under paragraphs (a)(1) and (b)(1)(iii) of this section, FT is treated as having a U.S. beneficiary beginning with the year of A's transfer of property to FT.

Example 4. Indirect benefit through use of debit card.—A transfers property to FT. The trust instrument provides that no U.S. person can benefit either as to income or corpus. However, FT maintains an account with FB, a foreign bank, and FB issues a debit card to B against the account maintained by FT and B is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, FT is treated as having a U.S. beneficiary.

Example 5. Other indirect benefit.—A transfers property to FT. FT is administered by FTC, a foreign trust company. FTC forms IBC, an international business corporation formed under the laws of a foreign jurisdiction. IBC is the beneficiary of FT. IBC maintains an account with FB, a foreign bank. FB issues a debit card to B against the account maintained by IBC and B is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, FT is treated as having a U.S. beneficiary.

(c) Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary—

(1) Trusts acquiring a U.S. beneficiary.—If a foreign trust to which a U.S. transferor has transferred property is not treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) for any taxable year of the U.S. transferor, but the trust is treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) in any subsequent taxable year, the U.S. transferor is treated as having additional income in the first such taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary. The amount of the additional income is equal to the trust's undistributed net income, as defined in section 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of section 668, providing for an interest charge on accumulation distributions from foreign trusts.

(2) Trusts ceasing to have a U.S. beneficiary.—If, for any taxable year of a U.S. transferor, a foreign trust that has received a transfer of property from the U.S. transferor ceases to be treated as having a U.S. beneficiary, the U.S. transferor ceases to be treated as the owner of the portion of the trust attributable to the transfer beginning in the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary (unless the U.S. transferor is treated as an owner thereof pursuant to sections 673 through 677). The U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amount of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer to which paragraph (a)(1) of this section applied. For rules regarding the recognition of gain on transfers to foreign trusts, see section 684.

(3) Examples. The rules of this paragraph (c) are illustrated by the following examples. A is a resident alien, B is A's son, and FT is a foreign trust. The examples are as follows:

Example 1. Trust acquiring U.S. beneficiary.—(i) In 2001, A transfers stock with a fair market value of \$100,000 to FT. The stock has an adjusted basis of \$50,000 at the time of the transfer. The trust instrument provides that income may be paid currently to, or accumulated for the benefit of, B and that, upon the termination of the trust, all income and corpus is to be distributed to B. At the time of the transfer, B is a nonresident alien. A is not treated as the owner of any portion of FT under sections 673 through 677. FT accumulates a total of \$30,000 of income during the taxable years 2001 through 2003. In 2004, B moves to the United States and becomes a resident alien. Assume paragraph (a)(4) of this section is not applicable under the facts and circumstances.

(ii) Under paragraph (c)(1) of this section, A is treated as receiving an accumulation distribution in the amount of \$30,000 in 2004 and immediately transferring that amount back to the trust. The accumulation distribution is subject to the rules of section 668, providing for an interest charge on accumulation distributions.

(iii) Under paragraphs (a)(1) and (3) of this section, beginning in 2005, A is treated as the owner of the portion of FT attributable to the stock transferred by A to FT in 2001 (which includes the portion attributable to the accumulated income deemed to be retransferred in 2004). Example 2. Trust ceasing to have U.S. beneficiary.

(i) The facts are the same as in Example 1. In 2008, B becomes a nonresident alien. On the date B becomes a nonresident alien, the stock transferred by A to FT in 2001 has a fair market value of \$125,000 and an adjusted basis of \$50,000.

(ii) Under paragraph (c)(2) of this section, beginning in 2009, FT is not treated as having a U.S. beneficiary, and A is not treated as the owner of the portion of the trust attributable to the prior transfer of stock. For rules regarding the recognition of gain on the termination of ownership status, see section 684.

§ 1.679-3 Transfers.—(a) In general.—A transfer means a direct, indirect, or constructive transfer.

(b) Transfers by certain trusts—(1) In general.—If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.

(2) Example.—The following example illustrates this paragraph (b):

Example. In 2001, A, a U.S. citizen, creates and funds DT, a domestic trust. A has the power to revest absolutely in himself the title to the property in DT and is

treated as the owner of DT pursuant to section 676. In 2004, DT transfers property to FT, a foreign trust. A is treated as having transferred the property to FT in 2004 for purposes of this section.

(c) Indirect transfers—(1) Principal purpose of tax avoidance. A transfer to a foreign trust by any person (intermediary) to whom a U.S. person transfers property is treated as an indirect transfer by a U.S. person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax.

(2) Principal purpose of tax avoidance deemed to exist.—For purposes of paragraph (c)(1) of this section, a transfer is deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if—

(i) The U.S. person is related (within the meaning of paragraph (c)(4) of this section) to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust; and

(ii) The U.S. person cannot demonstrate to the satisfaction of the Commissioner that—(A) The intermediary has a relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;

(B) The intermediary acted independently of the U.S. person;

(C) The intermediary is not an agent of the U.S. person under generally applicable United States agency principles; and

(D) The intermediary timely complied with the reporting requirements of section 6048, if applicable.

(3) Effect of disregarding intermediary—(i) In general.—Except as provided in paragraph (c)(3)(ii) of this section, if a transfer is treated as an indirect transfer pursuant to paragraph (c)(1) of this section, then the intermediary is treated as an agent of the U.S. person, and the property is treated as transferred to the foreign trust by the U.S. person in the year the property is transferred, or made available, by the intermediary to the foreign trust. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the foreign trust.

(ii) Special rule.—If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the foreign trust under generally applicable United States agency principles, the property will be treated as transferred to the foreign trust in the year the U.S. person transfers the property to the intermediary. The fair market value of the property transferred will be determined as of the date of the transfer by the U.S. person to the intermediary.

(iii) Effect on intermediary.—If a transfer of property is treated as an indirect transfer under paragraph (c)(1) of this section, the intermediary is not treated as having transferred the property to the foreign trust.

(4) Related parties.—For purposes of this paragraph (c), a U.S. transferor is treated as related to a U.S. beneficiary of a foreign trust if the U.S. transferor and the beneficiary are related for purposes of section 643(i)(2)(B), with the following modifications—

(i) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), “at least 10 percent” is used instead of “more than 50 percent” each place it appears; and

(ii) The principles of section 267(b)(10), using “at least 10 percent” instead of “more than 50 percent,” apply to determine whether two corporations are related.

(5) Examples. The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Principal purpose of tax avoidance.—A, a U.S. citizen, creates and funds FT, a foreign trust, for the benefit of A’s children, who are U.S. citizens. In 2004, A decides to transfer an additional 1000X to the foreign trust. Pursuant to a plan with a principal purpose of avoiding the application of section 679, A transfers 1000X to I, a foreign person. I subsequently transfers 1000X to FT. Under paragraph (c)(1) of this section, A is treated as having made a transfer of 1000X to FT.

Example 2. U.S. person unable to demonstrate that intermediary acted independently.—A, a U.S. citizen, creates and funds FT, a foreign trust, for the benefit of A’s children, who are U.S. citizens. On July 1, 2004, A transfers XYZ stock to D, A’s uncle, who is a nonresident alien. D immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2007, D transfers the ABC stock to FT. A is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that D acted independently of A in making the transfer to FT. Under paragraph (c)(1) of this section, A is treated as having transferred the ABC stock to FT. Under paragraph (c)(3) of this section, D is treated as an agent of A, and the transfer is deemed to have been made on January 1, 2007.

Example 3. Indirect loan to foreign trust.—A, a U.S. citizen, previously created and funded FT, a foreign trust, for the benefit of A’s children, who are U.S. citizens. On July 1, 2004, A deposits 500X with FB, a foreign bank. On January 1, 2005, FB loans 450X to FT. A is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that FB has a relationship with FT that establishes a reasonable basis for concluding that FB would make a loan to FT or that FB acted independently of A in making the loan. Under paragraph (c)(1) of this section, A is deemed to have transferred 450X directly to FT on January 1, 2005. Under paragraph (c)(3) of this section, FB is treated as an agent of A. For possible exceptions with respect to qualified obligations of the trust, and the treatment of principal repayments with respect to obligations of the trust that are not qualified obligations, see Sec. 1.679-4.

Example 4. Loan to foreign trust prior to deposit of funds in foreign bank.—The facts are the same as in Example 3, except that A makes the 500X deposit with FB on January 2, 2005, the day after FB makes the loan to FT. The result is the same as in Example 3.

(d) Constructive transfers—(1) In general.—For purposes of paragraph (a) of this section, a constructive transfer includes any assumption or satisfaction of a foreign trust’s obligation to a third party.

(2) Examples. The rules of this paragraph (d) are illustrated by the following examples.—In each example, A is a U.S. citizen and FT is a foreign trust. The examples are as follows:

Example 1. Payment of debt of foreign trust. FT owes 1000X to Y, an unrelated foreign corporation, for the performance of services by Y for FT. In satisfaction of FT’s liability to Y, A transfers to Y property with a fair market value of 1000X. Under paragraph (d)(1) of this section, A is treated as having made a constructive transfer of the property to FT.

Example 2. Assumption of liability of foreign trust. FT owes 1000X to Y, an unrelated foreign corporation, for the performance of services by Y for FT. A assumes FT's liability to pay Y. Under paragraph (d)(1) of this section, A is treated as having made a constructive transfer of property with a fair market value of 1000X to FT.

(e) Guarantee of trust obligations—(1) In general.—If a foreign trust borrows money or other property from any person who is not a related person (within the meaning of Sec. 1.679-1(c)(5)) with respect to the trust (lender) and a U.S. person (U.S. guarantor) that is a related person with respect to the trust guaranties (within the meaning of paragraph (e)(4) of this section) the foreign trust's obligation, the U.S. guarantor is treated for purposes of this section as a U.S. transferor that has made a transfer to the trust on the date of the guarantee in an amount determined under paragraph (e)(2) of this section. To the extent this paragraph causes the U.S. guarantor to be treated as having made a transfer to the trust, a lender that is a U.S. person shall not be treated as having transferred that amount to the foreign trust.

(2) Amount transferred.—The amount deemed transferred by a U.S. guarantor described in paragraph (e)(1) of this section is the guaranteed portion of the adjusted issue price of the obligation (within the meaning of Sec. 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of Sec. 1.1273-1(c)).

(3) Principal repayments.—If a U.S. person is treated under this paragraph (e) as having made a transfer by reason of the guarantee of an obligation, payments of principal to the lender by the foreign trust with respect to the obligation are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property deemed transferred by the U.S. guarantor.

(4) Guarantee.—For purposes of this section, the term guarantee.—(i) Includes any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another's obligation;

(ii) Encompasses any form of credit support, and includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability; and

(iii) Includes an arrangement reflected in a comfort letter, regardless of whether the arrangement gives rise to a legally enforceable obligation. If an arrangement is contingent upon the occurrence of an event, in determining whether the arrangement is a guarantee, it is assumed that the event has occurred.

(5) Examples. The rules of this paragraph (e) are illustrated by the following examples. In all of the examples, A is a U.S. resident and FT is a foreign trust. The examples are as follows:

Example 1. Foreign lender. X, a foreign corporation, loans 1000X of cash to FT in exchange for FT's obligation to repay the loan. A guarantees the repayment of 600X of FT's obligation. Under paragraph (e)(2) of this section, A is treated as having transferred 600X to FT. Example 2. Unrelated U.S. lender. The facts are the same as in Example 1, except X is a U.S. person that is not a related person within the meaning of Sec. 1.679-1(c)(5). The result is the same as in Example 1.

(f) Transfers to entities owned by a foreign trust—(1) General rule.—If a U.S. person is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to a foreign trust, any transfer of property by the U.S. person to an entity in which the foreign trust holds an ownership interest is treated as a transfer of such property by the U.S. person to the foreign trust followed by a transfer of the property from the foreign trust to the entity owned by the foreign trust, unless the U.S. person demonstrates to the satisfaction of

the Commissioner that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity.

(2) Examples. The rules of this paragraph (f) are illustrated by the following examples. In all of the examples, A is a U.S. citizen, FT is a foreign trust, and FC is a foreign corporation. The examples are as follows:

Example 1. Transfer treated as transfer to trust.—A creates and funds FT, which is treated as having a U.S. beneficiary under Sec. 1.679-2. FT owns all of the outstanding stock of FC. A transfers property directly to FC. Because FT is the sole shareholder of FC, A is unable to demonstrate to the satisfaction of the Commissioner that the transfer is properly attributable to A's ownership interest in FC. Accordingly, under this paragraph (f), A is treated as having transferred the property to FT, followed by a transfer of such property by FT to FC. Under Sec. 1.679-1(a), A is treated as the owner of the portion of FT attributable to the property treated as transferred directly to FT. Under Sec. 1.367(a)-1T(c)(4)(ii), the transfer of property by FT to FC is treated as a transfer of the property by A to FC.

Example 2. Transfer treated as transfer to trust.—The facts are the same as in Example 1, except that FT is not treated as having a U.S. beneficiary under Sec. 1.679-2. Under this paragraph (f), A is treated as having transferred the property to FT, followed by a transfer of such property by FT to FC. A is not treated as the owner of FT for purposes of Sec. 1.679-1(a). For rules regarding the recognition of gain on the transfer, see section 684.

Example 3. Transfer not treated as transfer to trust.—A creates and funds FT. FC has outstanding solely 100 shares of common stock. FT owns 50 shares of FC stock, and A owns the remaining 50 shares. On July 1, 2001, FT and A each transfer 1000X to FC. A is able to demonstrate to the satisfaction of the Commissioner that A's transfer to FC is properly attributable to A's ownership interest in FC. Accordingly, under this paragraph (f), A's transfer to FC is not treated as a transfer to FT.

§ 1.679-4 Exceptions to general rule.—(a) In general.—Section 1.679-1 does not apply to—

- (1) Any transfer of property to a foreign trust by reason of the death of the transferor;
- (2) Any transfer of property to a foreign trust described in sections 402(b), 404(a)(4), or 404A;
- (3) Any transfer of property to a foreign trust described in section 501(c)(3) (without regard to the requirements of section 508(a)); and
- (4) Any transfer of property to a foreign trust to the extent the transfer is for fair market value.

(b) Transfers for fair market value.—(1) In general.—For purposes of this section, a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. For purposes of this section, a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in Sec. 301.7701-4(c) of this chapter, liquidating trusts described in Sec. 301.7701-4(d) of this chapter, or environmental remediation trusts described in Sec. 301.7701-4(e) of this chapter is considered to be a transfer for fair market value.

(2) Special rule—(i) Transfers for partial consideration.—For purposes of this section, if a person transfers property to a foreign trust in exchange for property having a fair market value that is less than the fair market value of the property transferred, the exception in paragraph (a)(4) of this section applies only to the extent of the fair market value of the property received.

(ii) Example. This paragraph (b) is illustrated by the following example:

Example. A, a U.S. citizen, transfers property that has a fair market value of 1000X to FT, a foreign trust, in exchange for 600X of cash. Under this paragraph (b), Sec. 1.679-1 applies with respect to the transfer of 400X (1000X less 600X) to FT.

(c) Certain obligations not taken into account.—Solely for purposes of this section, in determining whether a transfer by a U.S. transferor that is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to the foreign trust is for fair market value, any obligation (as defined in Sec. 1.679-1(c)(6)) of the trust or a related person (as defined in Sec. 1.679-1(c)(5)) that is not a qualified obligation within the meaning of paragraph (d)(1) of this section shall not be taken into account.

(d) Qualified obligations.—(1) In general.—For purposes of this section, an obligation is treated as a qualified obligation only if—(i) The obligation is reduced to writing by an express written agreement;

(ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation);

(iii) All payments on the obligation are denominated in U.S. dollars;

(iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin (see Sec. 601.601(d)(2) of this chapter));

(v) The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year for the year of the transfer and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to for purposes of Sec. 301.6501(c)-1(d) of this chapter; and

(vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

(2) Additional loans.—If, while the original obligation is outstanding, the U.S. transferor or a person related to the trust (within the meaning of Sec. 1.679-1(c)(5)) directly or indirectly obtains another obligation issued by the trust, or if the U.S. transferor directly or indirectly obtains another obligation issued by a person related to the trust, the original obligation is deemed to have the maturity date of any such subsequent obligation in determining whether the term of the original obligation exceeds the specified 5-year term. In addition, a series of obligations issued and repaid by the trust (or a person related to the trust) is treated as a single obligation if the transactions giving rise to the obligations are structured with a principal purpose to avoid the application of this provision.

(3) Obligations that cease to be qualified.—If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation (e.g., renegotiation of the

terms of the obligation causes the term of the obligation to exceed five years), the U.S. transferor is treated as making a transfer to the trust in an amount equal to the original obligation's adjusted issue price (within the meaning of Sec. 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of Sec. 1.1273-1(c)) as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation is separately tested to determine if it is a qualified obligation.

(4) Transfers resulting from failed qualified obligations.—In general, a transfer resulting from a failed qualified obligation is deemed to occur on the date of the subsequent event that causes the obligation to no longer be a qualified obligation. However, based on all of the facts and circumstances, the Commissioner may deem a transfer to have occurred on any date on or after the issue date of the original obligation. For example, if at the time the original obligation was issued, the transferor knew or had reason to know that the obligation would not be repaid, the Commissioner could deem the transfer to have occurred on the issue date of the original obligation.

(5) Renegotiated loans.—Any loan that is renegotiated, extended, or revised is treated as a new loan, and any transfer of funds to a foreign trust after such renegotiation, extension, or revision under a pre-existing loan agreement is treated as a transfer subject to this section.

(6) Principal repayments.—The payment of principal with respect to any obligation that is not treated as a qualified obligation under this paragraph is taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(7) Examples.—The rules of this paragraph (d) are illustrated by the following examples. In the examples, A and B are U.S. residents and FT is a foreign trust. The examples are as follows:

Example 1. Demand loan.—A transfers 500X to FT in exchange for a demand note that permits A to require repayment by FT at any time. A is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to FT. Because FT's obligation to A could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, Sec. 1.679-1 applies with respect to the full 500X transfer to FT.

Example 2. Private annuity.—A transfers 4000X to FT in exchange for an annuity from the foreign trust that will pay A 100X per year for the rest of A's life. A is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to FT. Because FT's obligation to A could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, Sec. 1.679-1 applies with respect to the full 4000X transfer to FT.

Example 3. Loan to unrelated foreign trust.—B transfers 1000X to FT in exchange for an obligation of the trust. The term of the obligation is fifteen years. B is not a related person (as defined in Sec. 1.679-1(c)(5)) with respect to FT. Because B is not a related person, the fair market value of the obligation received by B is taken into account for purposes of determining whether B's transfer is eligible for the fair market value excep-

tion of paragraph (a)(4) of this section, even though the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section.

Example 4. Transfer for an obligation with term in excess of 5 years.—A transfers property that has a fair market value of 5000X to FT in exchange for an obligation of the trust. The term of the obligation is ten years. A is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to FT. Because the term of the obligation is greater than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, Sec. 1.679-1 applies with respect to the full 5000X transfer to FT.

Example 5. Transfer for a qualified obligation.—The facts are the same as in Example 4, except that the term of the obligation is 3 years. Assuming the other requirements of paragraph (d)(1) of this section are satisfied, the obligation is a qualified obligation and its adjusted issue price is taken into account for purposes of determining whether A's transfer is eligible for the fair market value exception of paragraph (a)(4) of this section.

Example 6. Effect of subsequent obligation on original obligation.—A transfers property that has a fair market value of 1000X to FT in exchange for an obligation that satisfies the requirements of paragraph (d)(1) of this section. A is a related person (as defined in Sec. 1.679-1(c)(5)) with respect to FT. Two years later, A transfers an additional 2000X to FT and receives another obligation from FT that has a maturity date four years from the date that the second obligation was issued. Under paragraph (d)(2) of this section, the original obligation is deemed to have the maturity date of the second obligation. Under paragraph (a) of this section, A is treated as having made a transfer in an amount equal to the original obligation's adjusted issue price (within the meaning of Sec. 1.1275-1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of Sec. 1.1273-1(c)) as of the date of issuance of the second obligation. The second obligation is tested separately to determine whether it is a qualified obligation for purposes of applying paragraph (a) of this section to the second transfer.

§ 1.679-5 Pre-immigration trusts.—(a) In general.—If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after directly or indirectly transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency starting date an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer.

(b) Special rules.—(1) Change in grantor trust status.—For purposes of paragraph (a) of this section, if a nonresident alien individual who is treated as owning any portion of a trust under the provisions of subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, subsequently ceases to be so treated, the individual is treated as having made the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by the individual.

(2) Treatment of undistributed income.—For purposes of paragraph (a) of this section, the property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred. Undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the amount of the property deemed transferred.

(c) Examples. The rules of this section are illustrated by the following examples:

Example 1. Nonresident alien becomes resident alien.—On January 1, 2002, A, a nonresident alien individual, transfers property to a foreign trust, FT. On January 1, 2006, A becomes a resident of the United States within the meaning of section 7701(b)(1)(A) and has a residency starting date of January 1, 2006, within the meaning of section 7701(b)(2)(A). Under paragraph (a) of this section, A is treated as a U.S. transferor and is deemed to transfer the property to FT on January 1, 2006. Under paragraph (b)(2) of this section, the property deemed transferred to FT on January 1, 2006, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property originally transferred.

Example 2. Nonresident alien loses power to revest property.—On January 1, 2002, A, a nonresident alien individual, transfers property to a foreign trust, FT. A has the power to revest absolutely in himself the title to such property transferred and is treated as the owner of the trust pursuant to sections 676 and 672(f). On January 1, 2008, the terms of FT are amended to remove A's power to revest in himself title to the property transferred, and A ceases to be treated as the owner of FT. On January 1, 2010, A becomes a resident of the United States. Under paragraph (b)(1) of this section, for purposes of paragraph (a) of this section A is treated as having originally transferred the property to FT on January 1, 2008. Because this date is within five years of A's residency starting date, A is deemed to have made a transfer to the foreign trust on January 1, 2010, his residency starting date. Under paragraph (b)(2) of this section, the property deemed transferred to the foreign trust on January 1, 2010, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property deemed transferred.

§ 1.679-6 Outbound migrations of domestic trusts.—(a) In general.—Subject to the provisions of paragraph (b) of this section, if an individual who is a U.S. person transfers property to a trust that is not a foreign trust, and such trust becomes a foreign trust while the U.S. person is alive, the U.S. individual is treated as a U.S. transferor and is deemed to transfer the property to a foreign trust on the date the domestic trust becomes a foreign trust.

(b) Amount deemed transferred.—For purposes of paragraph (a) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property previously transferred. Undistributed net income for periods prior to the migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the U.S. person.

(c) Example. The following example illustrates the rules of this section.—For purposes of the example, A is a resident alien, B is A's son, who is a resident alien, and DT is a domestic trust. The example is as follows:

Example. Outbound migration of domestic trust.—On January 1, 2002, A transfers property to DT, for the benefit of B. On January 1, 2003, DT acquires a foreign trustee who has the power to determine whether and when distributions will be made to B. Under section 7701(a)(30)(E) and § 301.7701-7(d)(ii)(A) of this chapter, DT becomes a foreign trust on January 1, 2003. Under paragraph (a) of this section, A is treated as transferring property to a foreign trust on January 1, 2003. Under paragraph (b) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred.

§ 1.679-7 Effective dates.—(a) In general.—Except as provided in paragraph (b) of this section, the rules of § 1.679-1, 1.679-2, 1.679-3, and 1.679-4 apply with respect to transfers after August 7, 2000.

(b) Special rules.—(1) The rules of Sec. 1.679-4(c) and (d) apply to an obligation issued after February 6, 1995, whether or not in accordance with a pre-existing arrangement or understanding. For purposes of the rules of Sec. 1.679-4(c) and (d), if an obligation issued on or before February 6, 1995, is modified after that date, and the modification is a significant modification within the meaning of Sec. 1.1001-3, the obligation is treated as if it were issued on the date of the modification. However, the penalty provided in section 6677 applies only to a failure to report transfers in exchange for obligations issued after August 20, 1996.

(2) The rules of Sec. 1.679-5 apply to persons whose residency starting date is after August 7, 2000.

(3) The rules of Sec. 1.679-6 apply to trusts that become foreign trusts after August 7, 2000.

§ 1.681(a)-1 Limitation on charitable contributions deductions of trusts; scope of section 681.—Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1) (A) and (B), under the following circumstances:

(a) To the extent that the deduction is allocable to “unrelated business income”;

(b) For taxable years beginning before January 1, 1970, if the trust has engaged in a prohibited transaction;

(c) For taxable years beginning before January 1, 1970, if income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries. Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in § 1.681(a)-2 through 1.681(c)-1. For definition of the term “income,” see section 643(b) and Sec. 1.643(b)-1.

§ 1.681(a)-2 Limitation on charitable contributions deduction of trusts with trade or business income.—(a) In general.—No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust’s unrelated business income for the taxable year. For the purpose of section 681(a) the term unrelated business income of a trust means an amount which would be computed as the trust’s unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term unrelated trade or business includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to “unrelated business income”, a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1) (A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) Determination of amounts allocable to unrelated business income.—In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust, determined without the deduction for personal exemption under section 642(b), the charitable contributions deduction under section 642(c), or the deduction for distributions to beneficiaries under section 661(a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b)(11) if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3).

(c) Examples.—(1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a charitable organization qualifying under section 170(b)(1)(A) (see subparagraph (2) of this paragraph):

Example 1. The X trust has income of \$50,000.—There is included in this amount a net profit of \$31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). The trustee pays each beneficiary \$25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) is \$30,000 (\$31,000 less the deduction of \$1,000 allowed by section 512(b)(12)). The deduction otherwise allowable under section 642(c) is \$25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b)(2) of this section) is \$15,000, that is, an amount which bears the same ratio to \$25,000 as \$30,000 bears to \$50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is \$15,000 reduced by \$6,000 (20 percent of \$30,000, the charitable contributions deduction which would be allowable under section 512(b)(11)), or \$9,000.

Example 2. Assume the same facts as in example 1, except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays \$40,000 to A and \$10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is \$10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b)(2) of this section is \$6,000, that is, an amount which bears the same ratio to \$10,000 as \$30,000 bears to \$50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b)(11) (\$6,000, determined as in example 1), no portion of it is disallowed as a deduction.

Example 3. Assume the same facts as in example 1, except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays \$31,000 to the Y charity and \$19,000 to A. The deduction otherwise allowable under section 642(c) is \$31,000. Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512(b)(11) is \$30,000 (\$31,000 less the deduction of \$1,000 allowed by section 512(b)(12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is \$24,000 (\$30,000 less \$6,000).

Example 4. (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of \$50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of \$50,000 includes \$10,000 capital gains, \$30,000 (\$31,000 less the \$1,000 deduction allowed under section 512(b)(12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) and other income of \$9,000. The trustee pays each beneficiary \$20,000.

(ii) The deduction otherwise allowable under section 642(c) is \$30,000 (\$20,000 paid to Y charity and \$10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is \$15,000, that is, an amount which bears the same ratio to \$20,000 (the amount paid to Y charity) as \$30,000 bears to \$40,000 (\$50,000 less \$10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is \$15,000 reduced by \$6,000 (the charitable contributions deduction which would be allowable under section 512(b)(11)), or \$9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a charitable organization qualifying under section 170(b)(1)(A), then the deduction allowable under section 512(b)(11) would be computed at a rate of 30 percent.

§ 1.681(b)-1 Cross reference.—For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4). See also 26 CFR 1.681(b)-1 and 1.681(c)-1 (rev. as of Apr. 1, 1974) for provisions applying before January 1, 1970.

§ 1.682(a)-1 Income of trust in case of divorce, etc.—(a) In general.—(1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in Sec. 1.682(b)-1 be referred to as the "wife" and the obligor spouse from whom she is divorced or legally separated as the "husband". (See section 7701(a)(17).) Thus, under section 682(a) income of a trust:

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband, is includible in her gross income and is not includible in his gross income.

(2) Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

(3) Section 682(a) is designed to produce uniformity as between cases in which, without section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682(a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example 1. Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

Example 2. H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of \$100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers \$100,000 of property to W, the \$100,000 is not income to W nor deductible by H.

(b) Alimony trust income designated for support of minor children.—Section 682(a) does not require the inclusion in the wife's income of trust income which the

terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See Sec. 1.71-1.

§ 1.682(b)-1 Application of trust rules to alimony payments.—(a) For the purpose of the application of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations. A wife treated as a beneficiary of a trust under this section is also treated as the beneficiary of such trust for purposes of the tax imposed by section 56 (relating to the minimum tax for tax preferences). For rules relating to the treatment of items of tax preference with respect to a beneficiary of a trust, see Sec. 1.58-3.

(b) A periodic payment includible in the wife's gross income under Section 71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of \$5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the \$5,000 distributable on December 31, 1954, \$4,000 is payable out of income and \$1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in 1955, since under section 662 the \$4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the \$1,000 payment out of corpus is also to be included in her income for 1954.

§ 1.682(c)-1 Definitions.—For definitions of the terms "husband" and "wife" as used in section 682, see section 7701(a)(17) and the regulations thereunder.

§ 1.683-1 Applicability of provisions; general rule.—Part I (section 641 and following), subchapter J, chapter 1 of the Code, applies to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954 the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

§ 1.683-2 Exceptions.—(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of

1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (ii) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 (for purposes of the credit for dividends received on or before December 31, 1964) and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

(c) The application of this section may be illustrated by the following examples:

Example 1. (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i.e., received after July 31, 1954). See section 7851(a)(1)(C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with respect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount distributed to him is includible in his gross income is made under the Internal Revenue Code of 1939. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and therefore within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example 2. (i) A simple trust reports on the basis of a fiscal year ending July 31.— It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3,

and July 5, 1954, each a date in this taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example 3. A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

§ 1.683-3 Application of the 65-day rule of the Internal Revenue Code of 1939.—If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See 26 CFR (1939) 39.162-2 (c) and (d) (Regulations 118).

§ 1.684-1 Recognition of gain on transfers to certain foreign trusts and estates.—(a) Immediate recognition of gain—(1) In general. Any U.S. person who transfers property to a foreign trust or foreign estate shall be required to recognize gain at the time of the transfer equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the U.S. transferor unless an exception applies under the provisions of Sec. 1.684-3. The amount of gain recognized is determined on an asset-by-asset basis.

(2) No recognition of loss.—Under this section a U.S. person may not recognize loss on the transfer of an asset to a foreign trust or foreign estate. A U.S. person may not offset gain realized on the transfer of an appreciated asset to a foreign trust or foreign estate by a loss realized on the transfer of a depreciated asset to the foreign trust or foreign estate.

(b) Definitions.—The following definitions apply for purposes of this section:

(1) U.S. person.—The term U.S. person means a United States person as defined in section 7701(a)(30), and includes a nonresident alien individual who elects under section 6013(g) to be treated as a resident of the United States.

(2) U.S. transferor.—The term U.S. transferor means any U.S. person who makes a transfer (as defined in Sec.—1.684-2) of property to a foreign trust or foreign estate.

(3) Foreign trust.—Section 7701(a)(31)(B) defines foreign trust. See also Sec. 301.7701-7 of this chapter.

(4) Foreign estate.—Section 7701(a)(31)(A) defines foreign estate.

(c) Reporting requirements.—A U.S. person who transfers property to a foreign trust or foreign estate must comply with the reporting requirements under section 6048.

(d) Examples. The following examples illustrate the rules of this section. In all examples, A is a U.S. person and FT is a foreign trust. The examples are as follows:

Example 1. Transfer to foreign trust.—A transfers property that has a fair market value of 1000X to FT. A's adjusted basis in the property is 400X. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any por-

tion of FT. Under paragraph (a)(1) of this section, A recognizes gain at the time of the transfer equal to 600X.

Example 2. Transfer of multiple properties.—A transfers property Q, with a fair market value of 1000X, and property R, with a fair market value of 2000X, to FT. At the time of the transfer, A's adjusted basis in property Q is 700X, and A's adjusted basis in property R is 2200X. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any portion of FT. Under paragraph (a)(1) of this section, A recognizes the 300X of gain attributable to property Q. Under paragraph (a)(2) of this section, A does not recognize the 200X of loss attributable to property R, and may not offset that loss against the gain attributable to property Q.

Example 3. Transfer for less than fair market value.—A transfers property that has a fair market value of 1000X to FT in exchange for 400X of cash. A's adjusted basis in the property is 200X. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any portion of FT. Under paragraph (a)(1) of this section, A recognizes gain at the time of the transfer equal to 800X.

Example 4. Exchange of property for private annuity.—A transfers property that has a fair market value of 1000X to FT in exchange for FT's obligation to pay A 50X per year for the rest of A's life. A's adjusted basis in the property is 100X. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any portion of FT. A is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though A might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code.

Example 5. Transfer of property to related foreign trust in exchange for qualified obligation.—A transfers property that has a fair market value of 1000X to FT in exchange for FT's obligation to make payments to A during the next four years. FT is related to A as defined in Sec. 1.679-1(c)(5). The obligation is treated as a qualified obligation within the meaning of Sec. 1.679-4(d), and no person is treated as owning any portion of FT. A's adjusted basis in the property is 100X. A is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though A might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code. Section 1.684-3(d) provides rules relating to transfers for fair market value to unrelated foreign trusts.

§ 1.684-2 Transfers.—(a) In general.—A transfer means a direct, indirect, or constructive transfer.

(b) Indirect transfers.—(1) In general.—Section 1.679-3(c) shall apply to determine if a transfer to a foreign trust or foreign estate, by any person, is treated as an indirect transfer by a U.S. person to the foreign trust or foreign estate.

(2) Examples. The following examples illustrate the rules of this paragraph (b). In all examples, A is a U.S. citizen, FT is a foreign trust, and I is A's uncle, who is a nonresident alien. The examples are as follows:

Example 1. Principal purpose of tax avoidance.—A creates and funds FT for the benefit of A's cousin, who is a nonresident alien. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any portion of FT. In 2004, A decides to transfer additional property with a fair market value of 1000X and an adjusted basis of 600X to FT. Pursuant to a plan with a principal purpose of avoiding the application of section 684, A transfers the property to I. I subsequently transfers the property to FT. Under paragraph (b) of this section and Sec. 1.679-3(c), A is treated as having transferred the property to FT.

Example 2. U.S. person unable to demonstrate that intermediary acted independently.—A creates and funds FT for the benefit of A's cousin, who is a nonresident alien. FT has no U.S. beneficiary within the meaning of Sec. 1.679-2, and no person is treated as owning any portion of FT. On July 1, 2004, A transfers property with a fair market value of 1000X and an adjusted basis of 300X to I, a foreign person. On January 1, 2007, at a time when the fair market value of the property is 1100X, I transfers the property to FT. A is unable to demonstrate to the satisfaction of the Commissioner, under Sec. 1.679-3(c)(2)(ii), that I acted independently of A in making the transfer to FT. Under paragraph (b) of this section and Sec. 1.679-3(c), A is treated as having transferred the property to FT. Under paragraph (b) of this section and Sec. 1.679-3(c)(3), I is treated as an agent of A, and the transfer is deemed to have been made on January 1, 2007. Under Sec. 1.684-1(a), A recognizes gain equal to 800X on that date.

(c) Constructive transfers.—Section 1.679-3(d) shall apply to determine if a transfer to a foreign trust or foreign estate is treated as a constructive transfer by a U.S. person to the foreign trust or foreign estate.

(d) Transfers by certain trusts.—(1) In general.—If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.

(2) Examples. The following examples illustrate the rules of this paragraph (d). In all examples, A is a U.S. person, DT is a domestic trust, and FT is a foreign trust. The examples are as follows:

Example 1. Transfer by a domestic trust.—On January 1, 2001, A transfers property which has a fair market value of 1000X and an adjusted basis of 200X to DT. A retains the power to revoke DT. On January 1, 2003, DT transfers property which has a fair market value of 500X and an adjusted basis of 100X to FT. At the time of the transfer, FT has no U.S. beneficiary as defined in Sec. 1.679-2 and no person is treated as owning any portion of FT. A is treated as having transferred the property to FT and is required to recognize gain of 400X, under Sec. 1.684-1, at the time of the transfer by DT to FT.

Example 2. Transfer by a foreign trust.—On January 1, 2001, A transfers property which has a fair market value of 1000X and an adjusted basis of 200X to FT1. At the time of the transfer, FT1 has a U.S. beneficiary as defined in Sec. 1.679-2 and A is treated as the owner of FT1 under section 679. On January 1, 2003, FT1 transfers property which has a fair market value of 500X and an adjusted basis of 100X to FT2. At the time of the transfer, FT2 has no U.S. beneficiary as defined in Sec. 1.679-2 and no person is treated as owning any portion of FT2. A is treated as having transferred the property to FT2 and is required to recognize gain of 400X, under Sec. 1.684-1, at the time of the transfer by FT1 to FT2.

(e) Deemed transfers when foreign trust no longer treated as owned by a U.S. person.—(1) In general. If any portion of a foreign trust is treated as owned by a U.S. person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, and such portion ceases to be treated as owned by that person under such subpart (other than by reason of an actual transfer of property from the trust to which Sec. 1.684-2(d) applies), the U.S. person shall be treated as having transferred, immediately before (but on the same date that) the trust is no longer treated as owned by that U.S. person, the assets of such portion to a foreign trust.

(2) Examples. The following examples illustrate the rules of this paragraph (e). In all examples, A is a U.S. citizen and FT is a foreign trust. The examples are as follows:

Example 1. Loss of U.S. beneficiary.—(i) On January 1, 2001, A transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to FT. At the time of the transfer, FT has a U.S. beneficiary within the meaning of Sec. 1.679-2, and A is treated as owning FT under section 679. Under Sec. 1.684-3(a), Sec. 1.684-1 does not cause A to recognize gain at the time of the transfer.

(ii) On July 1, 2003, FT ceases to have a U.S. beneficiary as defined in Sec. 1.679-2(c) and as of that date neither A nor any other person is treated as owning any portion of FT. Pursuant to Sec. 1.679-2(c)(2), if FT ceases to be treated as having a U.S. beneficiary, A will cease to be treated as owner of FT beginning on the first day of the first taxable year following the last taxable year in which there was a U.S. beneficiary. Thus, on January 1, 2004, A ceases to be treated as owner of FT. On that date, the fair market value of the property is 1200X and the adjusted basis is 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT on January 1, 2004, and must recognize 850X of gain at that time under § 1.684-1.

Example 2. Death of grantor.—(i) The initial facts are the same as in paragraph (i) of Example 1.

(ii) On July 1, 2003, A dies, and as of that date no other person is treated as the owner of FT. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT immediately before his death, and generally is required to recognize 850X of gain at that time under Sec. 1.684-1. However, an exception may apply under Sec. 1.684-3(c).

Example 3. Release of a power.—(i) On January 1, 2001, A transfers property that has a fair market value of 500X and an adjusted basis of 200X to FT. At the time of the transfer, FT does not have a U.S. beneficiary within the meaning of Sec. 1.679-2. However, A retains the power to revoke the trust. A is treated as the owner of the trust under section 676 and, therefore, under Sec. 1.684-3(a), A is not required to recognize gain under Sec. 1.684-1 at the time of the transfer.

(ii) On January 1, 2007, A releases the power to revoke the trust and, as of that date, neither A nor any other person is treated as owning any portion of FT. On that date, the fair market value of the property is 900X, and its adjusted basis is 200X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT on January 1, 2007, and must recognize 700X of gain at that time.

(f) Transfers to entities owned by a foreign trust.—Section 1.679-3(f) provides rules that apply with respect to transfers of property by a U.S. person to an entity in which a foreign trust holds an ownership interest.

§ 1.684-3 Exceptions to general rule of gain recognition.—(a) Transfers to grantor trusts.—The general rule of gain recognition under Sec. 1.684-1 shall not apply to any transfer of property by a U.S. person to a foreign trust to the extent that any person is treated as the owner of the trust under section 671. Section 1.684-2(e) provides rules regarding a subsequent change in the status of the trust.

(b) Transfers to charitable trusts.—The general rule of gain recognition under Sec. 1.684-1 shall not apply to any transfer of property to a foreign trust that is described in section 501(c)(3) (without regard to the requirements of section 508(a)).

(c) Certain transfers at death.—The general rule of gain recognition under Sec. 1.684-1 shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under section 1014(a).

(d) Transfers for fair market value to unrelated trusts.—The general rule of gain recognition under Sec. 1.684-1 shall not apply to any transfer of property for fair market value to a foreign trust that is not a related foreign trust as defined in Sec. 1.679-1(c)(5). Section 1.671-2(e)(2)(ii) defines fair market value.

(e) Transfers to which section 1032 applies.—The general rule of gain recognition under Sec. 1.684-1 shall not apply to any transfer of stock (including treasury stock) by a domestic corporation to a foreign trust if the domestic corporation is not required to recognize gain on the transfer under section 1032.

(f) Certain distributions to trusts.—For purposes of this section, a transfer does not include a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in Sec. 301.7701-4(c) of this chapter, liquidating trusts described in Sec. 301.7701-4(d) of this chapter, or environmental remediation trusts described in Sec. 301.7701-4(e) of this chapter.

(g) Examples. The following examples illustrate the rules of this section. In all examples, A is a U.S. citizen and FT is a foreign trust. The examples are as follows:

Example 1. Transfer to owner trust.—In 2001, A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to FT. At the time of the transfer, FT has a U.S. beneficiary within the meaning of Sec. 1.679-2, and A is treated as owning FT under section 679. Under paragraph (a) of this section, Sec. 1.684-1 does not cause A to recognize gain at the time of the transfer. See Sec. 1.684-2(e) for rules that may require A to recognize gain if the trust is no longer owned by A.

Example 2. Transfer of property at death: Basis determined under section 1014(a).

(i) The initial facts are the same as Example 1.

(ii) A dies on July 1, 2004.—The fair market value at A's death of all property transferred to FT by A is 1500X. The basis in the property is 400X. A retained the power to revoke FT, thus, the value of all property owned by FT at A's death is includible in A's gross estate for U.S. estate tax purposes. Pursuant to paragraph (c) of this section, A is not required to recognize gain under Sec. 1.684-1 because the basis of the property in the hands of the foreign trust is determined under section 1014(a).

Example 3. Transfer of property at death: Basis not determined under section 1014(a).

(i) The initial facts are the same as Example 1.

(ii) A dies on July 1, 2004. The fair market value at A's death of all property transferred to FT by A is 1500X. The basis in the property is 400X. A retains no power over FT, and FT's basis in the property transferred is not determined under section 1014(a). Under Sec. 1.684-2(e)(1), A is treated as having transferred the property to FT immediately before his death, and must recognize 1100X of gain at that time under Sec. 1.684-1.

Example 4. Transfer of property for fair market value to an unrelated foreign trust.—A sells a house with a fair market value of 1000X to FT in exchange for a 30-year note issued by FT. A is not related to FT as defined in Sec. 1.679-1(c)(5). FT is not treated as owned by any person. Pursuant to paragraph (d) of this section, A is not required to recognize gain under Sec. 1.684-1.

§ 1.684-4 Outbound migrations of domestic trusts.—(a) In general.—If a U.S. person transfers property to a domestic trust, and such trust becomes a foreign trust, and neither trust is treated as owned by any person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, the trust shall be treated for purposes of this section as having transferred all of its assets to a foreign trust and the trust is required to

recognize gain on the transfer under Sec. 1.684-1(a). The trust must also comply with the rules of section 6048.

(b) Date of transfer.—The transfer described in this section shall be deemed to occur immediately before, but on the same date that, the trust meets the definition of a foreign trust set forth in section 7701(a)(31)(B).

(c) Inadvertent migrations.—In the event of an inadvertent migration, as defined in Sec. 301.7701-7(d)(2) of this chapter, a trust may avoid the application of this section by complying with the procedures set forth in Sec. 301.7701-7(d)(2) of this chapter.

(d) Examples. The following examples illustrate the rules of this section. In all examples, A is a U.S. citizen, B is a U.S. citizen, C is a nonresident alien, and T is a trust. The examples are as follows:

Example 1. Migration of domestic trust with U.S. beneficiaries.—A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to T, a domestic trust, for the benefit of A's children who are also U.S. citizens. B is the trustee of T. On January 1, 2001, while A is still alive, B resigns as trustee and C becomes successor trustee under the terms of the trust. Pursuant to § 301.7701-7(d) of this chapter, T becomes a foreign trust. T has U.S. beneficiaries within the meaning of Sec. 1.679-2 and A is, therefore, treated as owning FT under section 679. Pursuant to Sec. 1.684-3(a), neither A nor T is required to recognize gain at the time of the migration. Section 1.684-2(e) provides rules that may require A to recognize gain upon a subsequent change in the status of the trust.

Example 2. Migration of domestic trust with no U.S. beneficiaries.—A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to T, a domestic trust for the benefit of A's mother who is not a citizen or resident of the United States. T is not treated as owned by another person. B is the trustee of T. On January 1, 2001, while A is still alive, B resigns as trustee and C becomes successor trustee under the terms of the trust. Pursuant to Sec. 301.7701-7(d) of this chapter, T becomes a foreign trust, FT. FT has no U.S. beneficiaries within the meaning of Sec. 1.679-2 and no person is treated as owning any portion of FT. T is required to recognize gain of 600X on January 1, 2001. Paragraph (c) of this section provides rules with respect to an inadvertent migration of a domestic trust.

§ 1.684-5 Effective date.—Sections 1.684-1 through 1.684-4 apply to transfers of property to foreign trusts and foreign estates after August 7, 2000.

§ 1.691(a)-1 Income in respect of a decedent.—(a) Scope of section 691. In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute "income in respect of a Decedent"; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credit in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract; and (6) special provisions relating to installment obligations transmitted at death when prior law applied to the transmission.

(b) General definition.—In general, the term income in respect of a decedent refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes:

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death. See sections 736 and 753 and the regulations thereunder for "income in respect of a decedent" in the case of a deceased partner.

(c) Prior decedent.—The term income in respect of a decedent also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example 2 of paragraph (b) of Sec. 1.691(a)-2.

(d) Items excluded from gross income.—Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

(e) Cross reference.—For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691(c), see paragraph (c) of Sec. 1.691(c)-1.

§ 1.691(a)-2 Inclusion in gross income by recipients.—(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of:

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right. These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements methods.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method.

Example 1. The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two install-

ments received by it, and the legatee must include in his gross income each of the three installments received by him.

Example 2. A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow's gross income but must be included in the gross income of the son.

Example 3. The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

Example 4. A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of \$100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for \$500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

Example 5. (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had an interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

§ 1.691(a)-3 Character of gross income.—(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent (or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis

of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

(b) The application of paragraph (a) of this section may be illustrated by the following:

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), in the same manner as if such person had held the property for the period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to several taxable years, as in effect for taxable years beginning before January 1, 1964, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

§ 1.691(a)-4 Transfer of right to income in respect of a decedent.—(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see Sec. 1.691(a)-5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income. In this situation, a transfer within the meaning of section 691(a)(2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received. If the transferee described in subparagraphs (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

§ 1.691(a)-5 Installment obligations acquired from decedent.—(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death. See Sec. 1.691(e)-1 for special provisions relating to the filing of an election to have the provisions of section 691(a)(4) apply in the case of installment obligations in respect of which section 44(d) of the Internal Revenue Code of 1939 (or corresponding provisions of prior law) would have applied but for the filing of a bond referred to therein.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691(a)(2) and paragraph (a) of Sec. 1.691(a)-4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross income of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term "transfer" in section 691(a)(2) and paragraph (a) of Sec. 1.691(a)-4 includes the satisfaction of an installment obligation at other than face value.

(c) The application of this section may be illustrated by the following example:

Example. An heir of a decedent is entitled to collect an installment obligation with a face value of \$100, a fair market value of \$80, and a basis in the hands of the decedent of \$60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691(a)(1). In this case, the amount includible would be \$40 (\$100 less \$60). If the heir collects the obligation at \$90, an amount other

than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691(a)(2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be \$30 (\$90 less \$60).

§ 1.691(b)-1 Allowance of deductions and credit in respect to decedents.—(a) Under section 691(b) the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid:

(1) As a deduction by the estate; or

(2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent (or the prior decedent). Similar treatment is given to the foreign tax credit provided by section 33. For the purposes of subparagraph (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to any income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691(a)(1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 1.691(c)-1 Deduction for estate tax attributable to income in respect of a decedent.—(a) In general.—A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent's estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see Sec. 1.691(a)-1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see Sec. 1.691(b)-1). But see section 691(d) and paragraph (b) of Sec. 1.691(d)-1 for computation of the special value of a survivor's annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value.—This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example 2, paragraph (e) of Sec. 1.691(d)-1. For purposes of this section, the term estate tax means the tax imposed under section 2001 or 2101 (or the corresponding provisions of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) Prior decedent.—If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) Amounts deemed to be income in respect of a decedent.—For purposes of allowing the deduction under section 691(c), the following items are also considered to be income in respect of a decedent under section 691(a):

(1) The value for estate tax purposes of stock options in respect of which amounts are includible in gross income under section 421(b) (prior to amendment by section 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, or under section 422(c)(1), 423(c), or 424(c)(1), whichever is applicable, in the case of taxable years ending after December 31, 1963. See section 421(d)(6) (prior to amendment by sec. 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, and section 421(c)(2), in the case of taxable years ending after December 31, 1963.

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691(d).

(d) Examples. Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in

a case not completed at the time of his death, which fee was valued in his estate at \$1,000, and to accrued bond interest, which was valued in his estate at \$500. In all, \$1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate \$150 for business expenses for which his estate was liable and \$50 for taxes accrued on certain property which he owned. In all, \$200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was \$185,000 and, considering deductions of \$15,000 and an exemption of \$60,000, his taxable estate amounted to \$110,000. The estate tax on this amount is \$23,700 from which is subtracted a \$75 credit for State death taxes leaving an estate tax liability of \$23,625. In the year following the closing of X's estate, the fee in the amount of \$1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year, \$260 on account of the estate tax attributable to such income, computed as follows:

(1) (i)	Value of income described in section 691(a)(1) included in computing gross estate	\$1,500
(ii)	Deductions in computing gross estate for claims 200 representing deductions described in section 691(b)	<u>200</u>
(iii)	Net value of items described in section 691(a)(1) ...	<u>1,300</u>
(2) (i)	Estate tax	23,625
(ii)	Less: Estate tax computed without including \$1,300 (item (1)(iii)) in gross estate	<u>23,235</u>
(iii)	Portion of estate tax attributable to net value of items described in section 691(a)(1)	390
(3) (i)	Value in gross estate of items described in section 691(a)(1) received in taxable year (fee).....	1,000
(ii)	Value in gross estate of all income items described in section 691(a)(1) (item (1)(i)).....	1,500
(iii)	Part of estate tax deductible on account of receipt of \$1,200 fee (1,000/1,500 of \$390).....	260

Although \$1,200 was later collected as the fee, only the \$1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only \$500, the estate tax deductible on the receipt of such amount would be 500/1,500 of \$390, or \$130. With respect to taxable years ending before January 1, 1964, see paragraph(d)(3) of Sec. 1.421-5 for a similar example involving a restricted stock option. With respect to taxable years ending after December 31, 1963, see paragraph (c)(3) of Sec. 1.421-8 for a similar example involving a stock option subject to the provisions of part II of subchapter D.

Example 2. Assume that in example 1 the fee valued at \$1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at \$1,000 in Y's estate, that the net value in Y's estate of items described in section 691 (a)(1) was \$5,000 and that the estate tax imposed on Y's estate attributable to such net value was \$550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of \$550, or \$110. When the son collects the \$1,200 fee, he will receive for the same taxable year a deduction of

\$110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of \$260 (as computed in example 1) with respect to the estate tax imposed on the estate of decedent X.

§ 1.691(c)-2 Estates and trusts.—(a) In the case of an estate or trust, the deduction prescribed in section 691(c) is determined in the same manner as described in Sec. 1.691(c)-1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year:

(i) Such income shall be excluded in determining the income in respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691(c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691(c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and § 1.652(b)-2 and 1.662(b)-2. However, for this purpose, distributable net income as defined in section 643 (a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691(c) and this section. Distributable net income as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J, chapter 1 of the Code, such as the deduction provided by section 651 or 661, or subpart D, part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691(c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691(c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691(c)(1)(B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

Example. (1) The fiduciary of an estate receives taxable interest of \$5,500 and income in respect of a decedent of \$4,500 during the taxable year. Neither the will of the

decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is \$1,500. In his discretion, the fiduciary distributes \$2,000 (falling within sections 661(a) and 662(a)) to a beneficiary during that year. On these facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of \$1,200 and \$300, computed as follows:

(2) Distributable net income computed under section 643(a) without regard to the estate tax deduction under section 691(c) is \$10,000, computed as follows:

Taxable interest	\$5,500
Income in respect of a decedent.....	<u>4,500</u>
Total	10,000

(3) Inasmuch as the distributable net income of \$10,000 exceeds the amount of \$2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661(a) and the amount taxable to the beneficiary under section 662(a) is \$2,000.

(4) The character of the amounts distributed to the beneficiary under section 662 (b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income	\$5,500	\$4,500	\$10,000
Amount deemed distributed under section 662(b)	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of \$300 ($900/4,500 \times \$1,500$) and the estate will be entitled to an estate tax deduction of \$1,200 ($3,600/4,500 \times \$1,500$).

(6) The taxable income of the estate is \$6,200, computed as follows:

Gross income	\$10,000
Less:	
Distributions to the beneficiary.....	\$2,000
Estate tax deduction under section 691(c) 1,200	
Personal exemption.....	<u>600</u>
Taxable income	<u>6,200</u>

§ 1.691(d)-1 Amounts received by surviving annuitant under joint and survivor annuity contract.—(a) In general.—Under section 691(d), annuity payments received by a surviving annuitant under a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section 691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72(c)(4).

(b) Special value for surviving annuitant’s payments.—Section 691(d) provides a special value for the surviving annuitant’s payments to determine the amount of the estate tax deduction provided for in section 691(c)(1)(A). This special value is determined by multiplying:

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d)(1)(i) of this section) by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant. This special value is used for the purpose of determining the net value for estate tax purposes (see section 691(c)(2)(B) and paragraph (a)(1) of Sec. 1.691(c)-1) and for the purpose of determining the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)-1).

(c) Amount of deduction.—The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of Sec. 1.691(c)-1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691(d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

(d) Definitions. (1) For purposes of section 691(d) and this section:

(i) The term life expectancy period means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in Sec. 1.72-9 (but without making any adjustment under paragraph (a)(2) of Sec. 1.72-5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor's annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includable in the deceased annuitant's gross estate.

(2) The determination of the "life expectancy period" of the survivor for purposes of section 691(d) may be illustrated by the following example:

Example. H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W's life expectancy determined as of the date of H's death is 15 years as determined from Table I in Sec. 1.72-9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691(d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15 1/2 years.

(e) Examples. The application of section 691(d) and this section may be illustrated by the following examples:

Example 1. (1) H and W, husband and wife, purchased a joint and survivor annuity contract for \$203,800 providing for monthly payments of \$1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed \$152,850 and W contributed \$50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H's age at his nearest birthday was 70 and W's age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on Janu-

ary 28, 1957, W receives her monthly payments of \$1,000. The value of the annuity at the date of H's death is \$159,000 (see paragraph (d)(1)(iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d)(1)(iv) of this section) is \$119,250 (152,850/203,800 of \$159,000). As of the date of H's death, W's age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year (12 × \$1,000)	\$12,000
Life expectancy of H and W as of the annuity starting date (see section 72(c)(3)(A) and Table II of Sec. 1.72-9 (male, age 70; female, age 67)).....	19.7
Expected return as of the annuity starting date, January 1, 1954 (\$12,000 × 19.7 as determined under section 72(c)(3)(A) and paragraph (b) of Sec. 1.72-5)	\$236,400
Investment in the contract as of the annuity starting date Jan. 1, 1954 (see section 72(c)(1) and paragraph (a) of Sec. 1.72-6).....	\$203,800
Exclusion ratio (203,800/236,400 as determined under section 72(b) and Sec. 1.72-4) (percent).....	86.2
Exclusion per year under section 72 (\$12,000 × 86.2 percent)	\$10,344
Excludable during W's life expectancy period (\$10,344 × 15)	\$155,160

(3) For the purpose of computing the deduction for estate tax under section 691(c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691(d)(1) is \$2,880. This amount is arrived at in accordance with the formula contained in section 691(d)(2), as follows:

Value of annuity at the date of H's death	\$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example).....	\$155,160
Excess	\$3,840
Ratio which value of annuity for estate tax purposes bears to 75 value of annuity at date of H's death (119,250/159,000) (percent)	75
Value for estate tax purposes (75 percent of \$3,840).....	\$2,880

This amount (\$2,880) is included in the items of income under section 691(a)(1) for the purpose of determining the estate tax attributable to each item under section 691(c)(1)(A). The estate tax determined to be attributable to the item of \$2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example 2 of this paragraph).

Example 2. Assume, in addition to the facts contained in example 1 of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at

\$1,000, and to accrued bond interest, which was valued at \$500. Taking into consideration the annuity payments of example 1, valued at \$2,880, a total of \$4,380 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate \$280 for business expenses for which his estate was liable and \$100 for taxes accrued on certain property which he owned. In all, \$380 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was \$404,250 and considering deductions of \$15,000, a marital deduction of \$119,250 (assuming the annuity to be the only qualifying gift) and an exemption of \$60,000, his taxable estate amounted to \$210,000. The estate tax on this amount is \$53,700 from which is subtracted a \$175 credit for State death taxes, leaving an estate tax liability of \$53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period, \$14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1) (i)	Value of income described in section 691(a)(1) included in computing gross estate	\$4,380.00
(ii)	Deductions in computing gross estate for claims representing deductions described in section 691(b)	<u>380.00</u>
(iii)	Net value of items described in section 691(a) (1) ..	<u>4,000.00</u>
(2) (i)	Estate tax	53,525.00
(ii)	Less: estate tax computed without including \$4,000 (item 53,189.00 (1) (iii)) in gross estate and by reducing marital deduction by \$2,880 (portion of item (1)(iii) allowed as a marital deduction) ..	<u>53,189.00</u>
(iii)	Portion of estate tax attributable to net value of income items	<u>336.00</u>
(3) (i)	Value in gross estate of income attributable to annuity payments	2,880.00
(ii)	Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	4,380.00
(iii)	Part of estate tax attributable to annuity income 2,880/4,380 of \$336)	220.93
(iv)	Deduction each year on account of estate tax attributable to annuity income (\$220.93/15 (life expectancy period))	14.73

§ 1.691(e)-1 Installment obligations transmitted at death when prior law applied.—(a) In general.—(1) Application of prior law.—Under section 44(d) of the Internal Revenue Code of 1939 and corresponding provisions of prior law, gains and losses on account of the transmission of installment obligations at the death of a holder of such obligations were required to be reported in the return of the decedent for the year of his death. However, an exception to this rule was provided if there was filed with the Commissioner a bond assuring the return as income of any payment in satisfaction of these obligations in the same proportion as would have been returnable as income by the decedent had he lived and received such payments. Obligations in respect of which such bond was filed are referred to in this section as “obligations assured by bond”.

(2) Application of present law.—Section 691(a)(4) of the Internal Revenue Code of 1954 (effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954) in effect makes the exception which under prior law applied to obligations assured by bond the general rule for obligations transmitted at death, but contains no requirement for a bond. Section 691(e)(1) provides that if the holder of the installment obligation makes a proper election, the provisions of section 691(a)(4) shall apply in the case of obligations assured by bond. Section 691(e)(1) further provides that the estate tax deduction provided by section 691(c)(1) is not allowable for any amount included in gross income by reason of filing such an election.

(b) Manner and scope of election.—(1) In general.—The election to have obligations assured by bond treated as obligations to which section 691(a)(4) applies shall be made by the filing of a statement with respect to each bond to be released, containing the following information:

(i) The name and address of the decedent from whom the obligations assured by bond were transmitted, the date of his death, and the internal revenue district in which the last income tax return of the decedent was filed.

(ii) A schedule of all obligations assured by the bond on which is listed—(a) The name and address of the obligors, face amount, date of maturity, and manner of payment of each obligation,

(b) The name, identifying number (provided under section 6109 and the regulations thereunder), and address of each person holding the obligations, and

(c) The name, identifying number, and address, of each person who at the time of the election possesses an interest in each obligation, and a description of such interest.

(iii) The total amount of income in respect of the obligations which would have been reportable as income by the decedent if he had lived and received such payment.

(iv) The amount of income referred to in subdivision (iii) of this subparagraph which has previously been included in gross income.

(v) An unqualified statement, signed by all persons holding the obligations, that they elect to have the provisions of section 691(a)(4) apply to such obligations and that such election shall be binding upon them, all current beneficiaries, and any person to whom the obligations may be transmitted by gift, bequest, or inheritance.

(vi) A declaration that the election is made under the penalties of perjury.

(2) Filing of statement. The statement with respect to each bond to be released shall be filed in duplicate with the district director of internal revenue for the district in which the bond is maintained. The statement shall be filed not later than the time prescribed for filing the return for the first taxable year (including any extension of time for such filing) to which the election applies.

(3) Effect of election. The election referred to in subparagraph (1) of this paragraph shall be irrevocable. Once an election is made with respect to an obligation assured by bond, it shall apply to all payments made in satisfaction of such obligation which were received during the first taxable year to which the election applies and to all such payments received during each taxable year thereafter, whether the recipient is the person who made the election, a current beneficiary, or a person to whom the obligation may be transmitted by gift, bequest, or inheritance. Therefore, all payments received to which the election applies shall be treated as payments made on installment obligations to which section 691(a)(4) applies. However, the estate tax deduction pro-

vided by section 691(c) is not allowable for any such payment. The application of this subparagraph may be illustrated by the following example:

Example. A, the holder of an installment obligation, died in 1952. The installment obligation was transmitted at A's death to B who filed a bond on Form 1132 pursuant to paragraph (c) of Sec. 39.44-5 of Regulations 118 (26 CFR part 39, 1939 ed.) for the necessary amount. On January 1, 1965, B, a calendar year taxpayer, filed an election under section 691(e) to treat the obligation assured by bond as an obligation to which section 691(a)(4) applies, and B's bond was released for 1964 and subsequent taxable years. B died on June 1, 1965, and the obligation was bequeathed to C. On January 1, 1966, C received an installment payment on the obligation which had been assured by the bond. Because B filed an election with respect to the obligation assured by bond, C is required to treat the proper proportion of the January 1, 1966, payment and all subsequent payments made in satisfaction of this obligation as income in respect of a decedent. However, no estate tax deduction is allowable to C under section 691(c)(1) for any estate tax attributable to the inclusion of the value of such obligation in the estate of either A or B.

(c) Release of bond.—If an election according to the provisions of paragraph (b) of this section is filed, the liability under any bond filed under section 44(d) of the 1939 Code (or the corresponding provisions of prior law) shall be released with respect to each taxable year to which such election applies. However, the liability under any such bond for an earlier taxable year to which the election does not apply shall not be released until the district director of internal revenue for the district in which the bond is maintained is assured that the proper portion of each installment payment received in such taxable year has been reported and the tax thereon paid.

§ 1.691(f)-1 Cross reference.—See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

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