

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 in-

come 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.

[T.D. 9102, 69 FR 18, Jan. 2, 2004]

§ 1.643(a)-4 Extraordinary dividends and taxable stock dividends.

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.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 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).