

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).

(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	5,000
Excess of net long-term capital gain over net short-term capital loss	25,000
Total	75,000
Less: Expenses allocable to income from investments in Country X	5,000
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)	3,000
Total	45,000
Less: Expenses allocable to income from investments in Country X (60 percent of \$5,000)	3,000
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)	16,000
Total	20,000
Less: Expenses allocable to income from investments in Country X (40 percent of \$5,000)	2,000
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	18,000
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.

[T.D. 6989, 34 FR 731, Jan. 17, 1969, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 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).

[T.D. 7357, 40 FR 23742, June 2, 1975]

§ 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