

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

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.

[T.D. 8926, 66 FR 1037, Jan. 5, 2001]

#### § 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 dis-

tribute 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