

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

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.

[T.D. 9102, 69 FR 19, Jan. 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.

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

**§ 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