

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 quali-

fied 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.

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**§ 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 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