

(or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts (or estates). In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust (or estate) instrument creates not one but several separate trusts (or estates), as opposed to separate shares in the same trust (or estate) within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:

(1) The filing of returns and payment of tax,

(2) The deduction of personal exemption under section 642(b), and

(3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust (or estate) is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust (or estate) instrument and

the requirements of proper administration require different treatment.

[T. D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, as amended by T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(c)-2 Rules of administration.

(a) *When separate shares come into existence.* A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

(b) *Computation of distributable net income for each separate share—(1) General rule.* The amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

(2) *Section 643(b) income.* This paragraph (b)(2) governs the allocation of the portion of gross income includible in distributable net income that is income within the meaning of section 643(b). Such gross income is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

(3) *Income in respect of a decedent.* This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

(4) *Gross income not attributable to cash.* This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash

received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as section 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.

(5) *Deductions and losses.* Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate.

(c) *Computations and valuations.* For purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section.

[T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(c)-3 Applicability of separate share rule to certain trusts.

(a) The applicability of the separate share rule provided by section 663(c) to trusts other than qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a

separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to: (1) Distribute, apportion, or accumulate income, or (2) distribute corpus to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) For taxable years ending before December 31, 1978, the separate share