and, on its 2001 and 2002 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2003, I2 realizes its failure to make the alternative depreciation system election in 2001 and files a Form 3115 to change its method of depreciating the remaining adjusted depreciable basis of the 2001 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2001) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section. Instead, I2 must submit a request for a private letter ruling under § 301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2001 Federal tax return.

(3) [Reserved]. For further guidance, see § 1.446–1(e)(3).

(4) *Effective date*—(i) *In general.* Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, *see* § 1.446–1(e) in effect prior to December 30, 2003 (§ 1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets.* With respect to paragraph (e)(2)(ii)(*d*) of this section, paragraph (e)(2)(iii) *Examples 9* through *17* of this section, the addition of the language ''certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section)'' to the last sentence of paragraph (e)(2)(ii)(*a*) of this section, and the removal of all language regarding useful life and the sentence ''On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting'' from paragraph (e)(2)(ii)(*b*) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

(iii) The applicability of paragraph (e) of this section expires on or before January 2, 2007.

■ **Par. 6.** Section 1.1016–3 is amended by:

■ 1. Redesignating paragraph (h) as paragraph (i).

■ 2. Adding new paragraphs (h) and (j).

The additions read as follows:

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

* * * * *

(h) *Application to a change in method of accounting.* [Reserved]. For further guidance, see § 1.1016–3T(h).

* * * * *

(j) *Effective date.* [Reserved]. For further guidance, see § 1.1016–3T(j)(1) and (2).

■ **Par. 7.** Section 1.1016–3T is added to read as follows:

§ 1.1016–3T Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913 (temporary).

(a) through (g) [Reserved]. For further guidance, *see* § 1.1016–3(a) through (g).

(h) *Application to a change in method of accounting.* For purposes of determining whether a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168) is a change in method of accounting under section 446(e) and the regulations under section 446(e), section 1016(a)(2) does not permanently affect a taxpayer's lifetime income.

(i) [Reserved]. For further guidance, see § 1.1016–3(i).

(j) *Effective date*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.1016–3 in effect prior to December 30, 2003 (§ 1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) *Depreciation or amortization changes.* Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168 for taxable years ending on or after December 30, 2003.

(3) The applicability of this section expires on or before January 2, 2007.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 20, 25, and 26

[TD 9102]

RIN 1545–AX96

Definition of Income for Trust Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations revising the definition of income under section 643(b) of the Internal Revenue Code. The regulations are necessary to reflect changes in the definition of trust accounting income under state laws. The final regulations also clarify the situations in which capital gains are included in distributable net income under section 643(a)(3). Conforming amendments are made to regulations affecting ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer taxes. The regulations affect the grantors, beneficiaries, and fiduciaries of trusts.

DATES: *Effective Date:* These regulations are effective January 2, 2004.

Applicability date: Generally, the final regulations are applicable to trusts and estates for taxable years ending after January 2, 2004. *See* revised §§ 1.642(c)–2, 1.642(c)–5, and 1.664–3 for special dates of applicability affecting those sections.

FOR FURTHER INFORMATION CONTACT: Bradford R. Poston at (202) 622–3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 15, 2001, proposed regulations (REG–106513–00) were published in the **Federal Register** [66 FR 10396] containing proposed amendments to the Income Tax

Regulations [26 CFR part 1], the Estate Tax Regulations [26 CFR part 20], the Gift Tax Regulations [26 CFR part 25], and the Generation-Skipping Transfer Tax Regulations [26 CFR part 26] relating to the definition of income for trust purposes. A public hearing was held on the proposed regulations on June 8, 2001. Written comments were received on the proposed regulations. The proposed regulations, with certain changes in response to the comments, are adopted as final regulations.

Summary of Comments and Explanation of Revisions

Definition of Income

The proposed regulations provide that, for purposes of determining what constitutes trust accounting income under section 643(b), trust provisions that depart fundamentally from the traditional concepts of income and principal generally will continue to be disregarded as they have been under the existing regulations. One commentator suggested that, instead of using traditional concepts of income and principal, the benchmark should be whether there is a departure from the duty to administer the trust or estate impartially based upon what is fair and reasonable to all the parties. One commentator suggested eliminating the distinction between trust accounting income and principal. Another suggested that the regulations clarify the consequences of a fundamental departure from traditional concepts of income and principal.

Income under section 643(b) is the amount of income determined under the terms of the governing instrument and applicable local law. This concept of income is used as the measure of the amount that must be distributed from a trust in order for the trust to qualify for certain treatment under various provisions of the Internal Revenue Code. Trusts classified as simple trusts, pooled income funds, net income charitable remainder unitrusts, and qualified subchapter S trusts (QSSTs) are required to make distributions measured at least in part by the amount of trust accounting income. A similar concept applies to trusts that qualify for the gift and estate tax marital deductions. Because section 643(b) requires a determination of trust accounting income, it is not possible to ignore any distinctions between trust accounting income and principal as suggested by a commentator.

A trust instrument may provide for any amount to be distributed to beneficiaries currently. Trust provisions that measure the amount of the distribution by reference to income but define income differently from the state statutory definition of income generally will be recognized for state law purposes. However, Internal Revenue Code provisions that require the current distribution of income to qualify the trust for certain federal tax treatment are based on the assumption that the income beneficiary will receive what is traditionally considered to be income. In some situations, such as with QSSTs and marital deduction trusts for spouses who are U.S. citizens, the income beneficiary is permitted to also receive principal distributions as long as all the income is currently distributed. In other situations, as with pooled income funds and net income charitable remainder unitrusts, only the income may be distributed. In all these situations, the determination of income is critical. Thus, the definition of income under the terms of the governing instrument and applicable local law must not depart fundamentally from traditional concepts of income and principal, if the desired federal tax treatment is to be secured.

The IRS and the Treasury Department recognize that state statutes are in the process of changing traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. These statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. Some statutes permit the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets. Other statutes permit the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially. Under the proposed regulations, a trust's definition of income in conformance with applicable state statutes will be respected for federal tax purposes when the state statutes provide for a reasonable apportionment of the total return of the trust.

Some commentators suggested that, even in those states that have not enacted legislation specifically authorizing powers to adjust or a unitrust definition of income, trust instruments containing such provisions should be respected as defining income for purposes of section 643(b). Under a unitrust or power to adjust, items traditionally allocable to principal (such as gains from the sale or exchange of trust assets) may, under certain circumstances, be allocated to income, and items traditionally allocable to income (such as dividends, interest, and rents) may, under certain circumstances, be allocated to principal. The proposed regulations already recognize that gains from the sale or exchange of trust assets may, under certain circumstances, be allocated to income under the terms of the governing instrument. However, § 1.643(b)–1 has always provided that the allocation to principal, under the terms of the governing instrument, of items that traditionally would be allocable to income will not be respected for purposes of section 643(b), and this position is maintained in the final regulations. Accordingly, the IRS and the Treasury Department believe that an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the regulations, a state statute specifically authorizing certain unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement. Further, the IRS and the Treasury Department acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for this purpose.

Two commentators suggested that the permissible range of unitrust percentages should include any percentage permitted by state statutes. The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust's total return. In response to one comment, the range of unitrust percentages has been adjusted in the final regulations to include, rather than exclude, unitrust percentages of 3% and 5%. Also in response to comments, the final regulations state that the periodic redetermination of the fair market value of the trust assets may be done as of a particular date each year or as an average determined on a multiple year basis.

The proposed regulations state that traditionally ordinary income is allocated to income and capital gains are allocated to principal. One commentator pointed out that ordinary income and capital gains are tax concepts and not concepts that have any meaning for purposes of trust accounting income. The final regulations have been revised to state that traditionally items such as dividends, interest, and rents are allocated to income and the proceeds from the sale or exchange of trust assets are allocated to principal.

The proposed regulations refer to a power to make equitable adjustments between income and principal and describe the circumstances under which these adjustments currently are permitted under state law and will be respected for Federal tax purposes. Specifically, state statutes permit adjustments when trust assets are invested under the state's prudent investor standard, the trust instrument refers to income in describing the amount that may or must be paid to a beneficiary, and the trustee, after applying the state statutory rules regarding the allocation of receipts and disbursements between income and principal, is unable to administer the trust impartially. One commentator requested clarification of the requirements a trustee must satisfy to make an adjustment that will be respected for Federal tax purposes. Those requirements are a matter of local law and may differ from state to state; the trustee must meet whatever requirements are imposed by applicable local law on the exercise of this power. One commentator pointed out that state statutes do not include the term equitable in referring to this power and suggested deleting that term. One commentator suggested adding ''generally'' to the statement concerning the circumstances in which these adjustments are permitted because some states may permit these adjustments without enacting a prudent investor standard. These two suggestions are adopted in the final regulations.

One commentator suggested clarifying that the definition of income in the regulations also applies to spray and sprinkle trusts. The final regulations provide that allocations apportioning the total return of the trust pursuant to the state statute will be respected regardless of whether the trust has one or more income beneficiaries and irrespective of whether income must or may be paid out each year. The commentator also suggested that allocations pursuant to one apportionment method should be respected even if a different apportionment method was used in prior years. The final regulations provide that, as long as the trust complies with the requirements of state statutes for switching between methods authorized by the statute, then, when the trust switches between permitted methods: (i) The method used in any year will be respected for Federal tax purposes; (ii) the switch will not constitute a recognition event under section 1001; and (iii) neither the grantor nor any beneficiary will have any gift tax consequences. This provision does not apply to switches between methods not specifically authorized by state statute.

It has been questioned whether the changes to § 1.643(b)–1 affect the amount of income required to be distributed by QSSTs. Section 1.1361–1(j) provides that QSSTs are required to distribute income as defined in § 1.643(b)–1. Therefore, no amendment to the QSST regulations is necessary for the new provisions of § 1.643(b)–1 to be applicable to QSSTs.

The proposed regulations provide that an allocation of capital gains to income will be respected if made either (i) pursuant to the terms of the governing instrument and applicable local law, or (ii) pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law, or by the governing instrument if not inconsistent with local law. One commentator suggested that in the phrase ''pursuant to the terms of the governing instrument and applicable local law,'' the term ''and'' be replaced with ''or.'' The phrase with the term ''and'' is consistent with the statutory language of section 643(b), and, therefore, no change has been made.

One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently. One commentator suggested changing the phrase ''if not inconsistent with local law'' because powers to allocate capital gains to income will almost always be inconsistent with the default provisions of state law. Accordingly, the phrase has been changed to ''if not prohibited by local law.''

Pooled Income Funds

Several commentators were concerned about the provision in the proposed regulations that long-term capital gain does not qualify for the income tax charitable deduction available to pooled income funds (PIFs), if the amount of income payable to the noncharitable beneficiaries may be either a unitrust amount or an amount that could include unrealized appreciation in the value of trust assets pursuant to the exercise of a trustee's power to adjust. One commentator suggested that, if income is defined as a unitrust amount or is subject to the trustee's power of adjustment, the provision in the proposed regulation invalidly limits the amount that can be paid to the noncharitable beneficiaries of the PIF.

This regulatory provision places no prohibition on paying to the noncharitable beneficiaries an amount of income determined under the governing instrument and applicable local law, even if that income is a unitrust amount or is determined pursuant to a power of adjustment that takes into account unrealized appreciation. Rather, this regulatory provision addresses whether long-term capital gains recognized during a year but not distributed during that year are permanently set aside for a charitable purpose as required by section 642(c)(3) to allow the PIF to claim a charitable deduction for these amounts. If income is defined as a unitrust amount, a future payment of income to the noncharitable beneficiaries may be attributable to long-term capital gains realized, but not distributed, in the current year. If income is determined pursuant to a power of adjustment that takes into account unrealized appreciation, a portion of the capital gain recognized during a year may be attributable to appreciation that was the basis for a distribution to the noncharitable beneficiaries in a prior year. In both situations, the long-term capital gains are not permanently set aside for charitable purposes and therefore do not qualify for the charitable deduction in computing the PIF's income tax liability.

Some commentators were concerned that PIFs need to be able to distribute more than the traditional amounts of income to remain useful vehicles for charitable giving. They suggest that PIFs should be able to define trust accounting income as traditional income plus any realized capital gains for the year but the total amount defined as income cannot exceed a specified percentage. Thus, the annual payout would be the lesser of a unitrust amount or trust accounting income defined to include gains from the appreciation of assets sold by the trust during the year.

Distinct statutory provisions govern PIFs and charitable remainder unitrusts (CRUTs). The provisions applicable to each type of trust are specifically designed to achieve statutory objectives based on the nature of the charitable and noncharitable interests in each type of trust. The commentators' suggestion is, in effect, to permit PIFs to operate in the same manner as a net income CRUT, but without applying any of the other CRUT requirements to these funds. There is no authority for incorporating certain provisions applicable to CRUTs into the provisions applicable to PIFs.

Nevertheless, the power to adjust authorized by many state statutes currently applies to PIFs administered in those states. If permitted under the terms of the governing instrument and state statutes, a trustee may use the power to make adjustments by allocating to income a portion of the sales proceeds from trust assets in order to treat the income and remainder beneficiaries impartially. The proper exercise of a power to adjust may provide the income beneficiaries with amounts in excess of the amount of traditional income. The final regulations provide that, for a PIF, the amount of proceeds from the sale of assets that may be allocated to income pursuant to a power to adjust is limited to the amount by which those proceeds exceed the fair market value of those assets as of the date those assets were contributed to or purchased by the PIF. This provision ensures that amounts attributable to the fair market value of assets on the date contributed to the PIF cannot be reallocated to income under a power to adjust. In addition, long-term capital gains from the sale or exchange of trust assets do not qualify for the charitable deduction under section 642(c)(3) to the extent that any sales proceeds are distributed to the income beneficiaries.

One commentator suggested that the "or" in the phrase "under the terms of the governing instrument or applicable local law" should be changed to "and" to be consistent with the statutory definition of income under section 643(b). This change has been made.

Charitable Remainder Trusts

Several commentators were concerned about the requirement in the proposed regulations that net income CRUTs under sections 664(d)(2) and 664(d)(3) contain their own definition of income if applicable state law provides that income is a unitrust amount. The purpose of this proposed requirement was to avert potential problems with qualification of a net income CRUT in a state that defines income as a unitrust amount. Some commentators pointed out that state statutes provide alternative definitions of income and all that should be necessary is that the trust use a definition of income, whether contained in the terms of the governing instrument or applicable local law, that is not a unitrust amount. Therefore, the requirement that the trust contain its own definition of income has been eliminated from the final regulations.

Several commentators were concerned about the provision in the proposed regulations that the allocation of post-contribution capital gain to income, if permitted under the terms of the governing instrument and applicable local law, may not be discretionary with the trustee. Some suggested eliminating the prohibition on discretionary powers held by the trustee. Some suggested that a discretionary power should be permitted if held by an independent trustee. Some requested clarification that this prohibition does not apply to a trustee's power to allocate receipts to income or principal pursuant to state law.

The provision in the proposed regulations has no effect on the determination of trust accounting income under applicable state law that grants the trustee a power to reasonably apportion the total return of the trust. The provision is directed at discretion given the trustee under the terms of the governing instrument to allocate capital gains to income in some years and not others. Allowing the trustee this type of discretion is inconsistent with the requirements for net income CRUTs as explained in the legislative history. The settlor has the option of providing in the trust that the trustee is to distribute the lesser of the stated percentage payout or trust income. However, this option must be adopted in the trust instrument and not left to the discretion of the trustee. See H.R. Conf. Rep. No. 91–782, at 296 (1969), reprinted in 1969–3 C.B. 644, 655. A power to allocate capital gains to income in some years and not others in the trustee's sole discretion is similar to having the discretionary ability to pay out either the trust income or the stated percentage payout each year, regardless of their relative values. Thus, the final regulations continue to provide that, for CRUTs, post-contribution capital gains may be included in the definition of income under the terms of the governing instrument or applicable local law, but not pursuant to a trustee's discretionary power granted by the trust instrument, rather than by state statute, to allocate capital gains to income.

Capital Gains and Distributable Net Income

Section 643(a)(3) provides that gains from the sale or exchange of capital assets generally are excluded from distributable net income (DNI) to the extent that these gains are allocated to corpus. However, capital gains allocated to corpus are included in DNI if they are either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. In certain situations it is easily ascertained whether capital gains are paid to a beneficiary. For example, if the trust instrument provides that the proceeds from the sale of a certain asset are to be paid to a beneficiary upon sale, then any capital gain recognized upon the sale of that asset is paid to the beneficiary and is includible in DNI. However, the circumstances in which recognized capital gain determines the amount to be distributed to a beneficiary during the year are relatively rare.

More frequently, the trustee is authorized by the trust instrument to make discretionary distributions of principal or, by the recently-enacted state statutes, to pay the income beneficiary a unitrust amount. In these circumstances, the amount of realized capital gain during the year does not affect the amount distributed to a beneficiary, and because money is fungible, it is difficult to ascertain whether capital gains are actually paid to the beneficiary. With respect to these situations, the proposed regulations attempt to clarify the circumstances in which capital gains are treated as distributed to a beneficiary and therefore are includable in DNI. The proposed regulations provide that capital gains will be treated as part of a distribution to a beneficiary, if the trustee allocates capital gains to the distribution pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law) to treat capital gains in this manner, provided the allocation power is exercised in a reasonable and consistent manner, and is evidenced on the trust's books, records, and tax returns.

Commentators requested guidance on several issues concerning the treatment of capital gains as part of a distribution to a beneficiary. These issues include clarification that one trustee may exercise the discretion differently for different trusts and that the treatment of capital gains from the sale of different types of assets may be different. Examples have been added to the final regulations to address these situations. In addition, some commentators were concerned about how a trustee may show consistency in the first year, whether the treatment in future years may be changed based on something other than a change in the definition of income, and whether existing trusts may establish a different treatment based on the rules in the final regulations.

In some respects, the proposed regulations merely clarify how a trustee may demonstrate that capital gain has been paid to a beneficiary and therefore is includible in DNI under section 643(a)(3). This determination is relevant when distributions are made to beneficiaries that exceed the amount of DNI determined without regard to the capital gains. In the past this situation arose when mandatory or discretionary payments of principal were made. Because of the changes to the definition of income under state statutes, the number and variety of situations in which this determination is relevant are increasing. In implementing a different method for determining income under a state statute, the trustee may establish a pattern for including or not including capital gains in DNI to the extent that the amount of income so determined is greater than the amount of DNI determined without regard to the capital gains. This choice may be made irrespective of the trustee's practice under a prior legal definition of income regarding the treatment of capital gains as part of DNI when discretionary or mandatory distributions of principal were made from the trust.

Two commentators requested examples of the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law. The circumstances in which a power to adjust is exercisable may vary among states and may be determined by the powers of the trustee to make distributions of income and principal under the terms of the governing instrument. For example, if a trust instrument does not permit the trustee to distribute any corpus and the power to adjust under local law may be exercised only with respect to receipts from the sale of trust assets, the amount allocated to income under the power to adjust may have to be from the realized appreciation in the value of the assets that were sold. On the other hand, if the trust instrument permits discretionary distributions of principal and the power to adjust under local law may be exercised only with respect to appreciation in the value of trust assets, the power to adjust may be similar to a unitrust amount that is payable irrespective of whether appreciated assets are sold during the year. Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus, the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises a power to adjust.

It has been pointed out that *Examples 6* through *8* in § 1.643(a)–3(e) of the proposed regulations, which are essentially identical to examples in the existing regulations, may no longer be consistent with the rules in the proposed regulations. In the final regulations, the corresponding examples, now *Examples 7* through *10*, have been updated to take into account the new rules. One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.

Trusts Qualifying for Gift and Estate Tax Marital Deductions

The proposed regulations provide that a spouse will be treated as entitled to receive all net income from a trust, as required for the trust to qualify for the gift and estate tax marital deductions under § 20.2056(b)–5(a)(1) of the Estate Tax Regulations and § 25.2523(e)–1(f)(1) of the Gift Tax Regulations, if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)–1. Thus, a spouse who, as the income beneficiary, is entitled in accordance with the state statute and the governing instrument to a unitrust amount of no less than 3% and no more than 5% would be entitled to all the income from the trust for purposes of qualifying the trust for the marital deduction.

Several commentators suggested that a trust that provides for a unitrust payment to the spouse should satisfy the income standard even in states that have not enacted legislation defining income as a unitrust amount or providing that a right to income may be satisfied by such a payment. The income distribution requirement that must be satisfied for a trust to qualify for the gift and estate tax marital deductions ensures that the spouse receives what is traditionally considered to be income from the assets held in trust. As previously discussed, the IRS and the Treasury Department believe that only if applicable state law has authorized a departure from traditional concepts of income and principal should such a departure be respected for Federal tax purposes. A state statute specifically authorizing certain unitrust amounts in satisfaction of an income interest or certain powers to adjust in conformance with the provisions of § 1.643(b)–1 would meet this standard. However, in the absence of a state statute, or, for example, a decision of the highest court of the state applicable to all trusts administered under that state's law, the applicable state law requirement will not be satisfied.

It has also been suggested that, in some circumstances, the proposed regulations would allow the spouse to receive less than all the traditional trust income, and therefore would conflict with the section 2056 statutory requirement that the spouse receive all trust income. For example, a spouse who, in accordance with the state statute, receives a 4% unitrust amount would receive less than all the traditional income generated by the trust, if the trust's total dividends, interest, rents, etc. for the year exceed 4%. However, that spouse would receive more than the amount of traditional income earned by the trust in any year that the trust's total dividends, interest, rents, etc. do not exceed 4%. The regulations are intended to strike a reasonable balance between the marital deduction statutory requirements and the many state statutes intended to facilitate the investment of trust assets while ensuring equitable treatment for the income and remainder beneficiaries. Indeed, Congress contemplated that, in appropriate circumstances, an annuity could be treated as satisfying the statutory income distribution requirement. The flush language following section 2056(b)(7)(B)(ii) specifically authorizes regulations that treat an annuity ''in a manner similar to an income interest in property.'' The IRS and Treasury Department believe that these regulations implement this statutory authorization in a reasonable manner by recognizing allocations under state statutes that provide for a reasonable apportionment of the total return of the trust.

Trusts Exempt From Generation-Skipping Transfer Tax

The proposed regulations expand the rules concerning changes that may be made to trusts that are exempt from the generation-skipping transfer tax because they were irrevocable on September 25, 1985, without causing the loss of the trusts' exempt status. If such an exempt trust is administered in conformance with applicable state law that permits a unitrust amount to be paid to the income beneficiary or permits adjustments between income and principal to ensure impartiality, and that meets the requirements of § 1.643(b)–1, its exempt status will not be affected.

One commentator requested that the final regulations also provide that administration of an exempt trust as described in these regulations will not cause any trust beneficiary to be treated as making a gift and will not result in any taxable exchange by the trust or any of its beneficiaries. Another commentator requested that the final regulations clarify that changing the situs of a trust from a state with only a traditional definition of income to a state that permits unitrusts or powers to adjust will not affect the exempt status of the trust. *Examples 11* and *12* have been revised to address these and similar concerns. The same conclusions apply to a change of situs in the opposite direction, from a state that permits unitrusts or the power to adjust to a state that has only the traditional definition of income.

Effective Dates

The proposed regulations provide that the final regulations apply for taxable years that begin on or after January 2, 2004. Commentators suggested that, as a number of states have already enacted statutes permitting the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets or providing the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially, the effective date provision should be changed to allow trustees to take advantage of these statutes for periods beginning before the date of the publication of the final regulations. As an alternative, one commentator suggested that the IRS issue guidance allowing trustees to rely on the proposed regulations prior to the publication of the final regulations.

The final regulations, in general, will become effective for taxable years of trusts and estates ending after January 2, 2004. In addition, taxpayers may rely on the provisions of the final regulations for any taxable years in which a trust or estate is governed by a state statute authorizing a unitrust payment in satisfaction of the income interest of the income beneficiaries or granting the trustee a power to adjust between income and principal, in each case as described in the final regulations.

With respect to CRUTs, the prohibition of a trustee's discretionary power, granted solely by the governing instrument and not by applicable state statute, to allocate to income sales proceeds attributable to appreciation in the value of the asset after the date it was contributed to the trust or purchased by the trust is applicable to trusts created after January 2, 2004.

With respect to PIFs, the provision concerning the failure of net long-term capital gain to qualify for the charitable deduction if the income beneficiaries, under the terms of the governing instrument and the state statute, may receive a unitrust amount or an amount based on unrealized appreciation in the value of the fund's assets is applicable to taxable years of PIFs beginning after January 2, 2004. However, provided income has not already been determined in such a manner, the fund's governing instrument may be amended or reformed to eliminate this possibility. A judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Bradford R. Poston and Mary Berman of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

26 CFR Part 26

Generation-skipping transfer taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR parts 1, 20, 25, and 26 are amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

■ **Par. 2.** Section 1.642(c)–2 is amended as follows:
■ 1. Paragraph (c) is amended by adding two sentences after the first sentence.
■ 2. Paragraph (e) is added immediately following paragraph (d).

The additions read as follows:

§ 1.642(c)–2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

* * * * *

(c) * * * No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of either: an amount equal to a fixed percentage of the fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis); or any amount that takes into account unrealized appreciation in the value of the fund's assets. In addition, no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income within the meaning of § 1.642(c)–5(a)(5)(i). * * *

* * * * *

(e) *Effective dates.* Generally, the second sentence of paragraph (c) of this section, concerning the loss of any charitable deduction for long-term capital gains if the fund's income may be determined by a fixed percentage of the fair market value of the fund's assets or by any amount that takes into account unrealized appreciation in the value of the fund's assets, applies for taxable years beginning after January 2, 2004. In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

* * * * *

■ **Par. 3.** In § 1.642(c)–5, paragraph (a)(5)(i) is revised to read as follows:

§ 1.642(c)–5 Definition of pooled income fund.

(a) * * *

(5) * * *

(i) The term *income* has the same meaning as it does under section 643(b) and the regulations thereunder, except that income generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)–1. In exercising a power to adjust, the trustee must allocate to principal, not to income, the proceeds from the sale or exchange of any assets contributed to the fund by any donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution to the fund or of the purchase price of those assets purchased by the fund. This definition of income applies for taxable years beginning after January 2, 2004.

* * * * *

■ **Par. 4.** Section 1.643(a)–3 is revised to read as follows:

§ 1.643(a)–3 Capital gains and losses.

(a) *In general.* Except as provided in § 1.643(a)–6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)–3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

(c) *Charitable contributions included in distributable net income.* If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) *Capital losses.* Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

(e) *Examples.* The following examples illustrate the rules of this section:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in *Example 1*, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in *Example 1*, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

Example 4. The facts are the same as in *Example 1*, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. The facts are the same as in *Example 1*, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 6. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 7. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See § 1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 8. The facts are the same as *Example 7*, except Trustee is directed to pay B $10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as *Example 7*, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as *Example 9*, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The $500,000 distribution to A may be treated as including a minimum of $200,000 of capital gain (and all of the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in *Example 11*, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in *Example 11*, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

(f) *Effective date.* This section applies for taxable years of trusts and estates ending after January 2, 2004.

■ **Par. 5.** Section 1.643(b)–1 is revised to read as follows:

§ 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 distribute 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.

■ **Par. 6.** In § 1.651(a)–2, paragraph (d) is added to read as follows:

§ 1.651(a)–2 Income required to be distributed currently.

* * * * *

(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

■ **Par. 7.** In § 1.661(a)–2, paragraph (f) is revised to read as follows:

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

* * * * *

(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

■ **Par. 8.** Section 1.664–3 is amended as follows:

■ 1. Paragraphs (a)(1)(i)(*b*)(*3*) and (*4*) are revised.

■ 2. Paragraph (a)(1)(i)(b)(*5*) is removed.

The revisions read as follows:

§ 1.664–3 Charitable remainder unitrust.

(a) * * *

(1) * * * (i) * * *

(*b*) * * *

(*3*) For purposes of this paragraph (a)(1)(i)(*b*), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(*4*) The rules in paragraph (a)(1)(i)(*b*)(*1*) and (*2*) of this section are applicable for taxable years ending after April 18, 1997. The rule in the first sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for taxable years ending after April 18, 1997. The rules in the second, fourth, and fifth sentences of paragraph (a)(1)(i)(*b*)(*3*) are applicable for taxable years ending after January 2, 2004. The rule in the third sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for sales or exchanges that occur after April 18, 1997. The rule in the sixth sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for trusts created after January 2, 2004.

* * * * *

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

■ **Par. 9.** The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

■ **Par. 10.** Section 20.2056(b)–5 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§ 20.2056(b)–5 Marital deduction; life estate with power of appointment in surviving spouse.

* * * * *

(f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)–1 of this chapter.

* * * * *

■ **Par. 11.** Section 20.2056(b)–7 is amended by adding a new sentence to the end of paragraph (d)(1) to read as follows:

§ 20.2056(b)–7 Election with respect to life estate for surviving spouse.

* * * * *

(d) * * * (1) * * * A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of § 1.643(b)–1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

* * * * *

■ **Par. 12.** Section 20.2056(b)–10 is amended by adding a new sentence at the end of the section to read as follows:

§ 20.2056(b)–10 Effective dates.

* * * In addition, the rule in the last sentence of § 20.2056(b)–5(f)(1) and the rule in the last sentence of § 20.2056(b)–7(d)(1) regarding the effect on the spouse's right to income if applicable local law provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust are applicable with respect to trusts for taxable years ending after January 2, 2004.

■ **Par. 13.** Section 20.2056A–5 is amended by adding a new sentence in paragraph (c)(2) after the third sentence to read as follows:

§ 20.2056A–5 Imposition of section 2056A estate tax.

* * * * *

(c) * * *

(2) * * * However, distributions made to the surviving spouse as the income beneficiary in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount), or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)–1 of this chapter. * * *

* * * * *

■ **Par. 14.** Section 20.2056A–13 is revised to read as follows:

§ 20.2056A–13 Effective dates.

Except as provided in this section, the provisions of §§ 20.2056A–1 through 20.2056A–12 are applicable with respect to estates of decedents dying after August 22, 1995. The rule in the fourth sentence of § 20.2056A–5(c)(2) regarding unitrusts and distributions of income to the surviving spouse in conformance with applicable local law is applicable to trusts for taxable years ending after January 2, 2004.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

■ **Par. 15.** The authority citation for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

■ **Par. 16.** Section 25.2523(e)–1 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§ 25.2523(e)–1 Marital deduction; life estate with power of appointment in donee spouse.

* * * * *

(f) * * * (1) * * * In addition, the spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as defined or determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)–1 of this chapter.

* * * * *

■ **Par. 17.** Section 25.2523(h)–2 is amended by adding a new sentence to the end of the section to read as follows:

§ 25.2523(h)–2 Effective dates.

* * * In addition, the rule in the last sentence of § 25.2523(e)–1(f)(1) regarding the determination of income under applicable local law applies to trusts for taxable years ending after January 2, 2004.

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

■ **Par. 18.** The authority citation for part 26 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

■ **Par. 19.** Section 26.2601–1 is amended as follows:

■ 1. The second and third sentences of paragraph (b)(4)(i) are revised to read as follows.

■ 2. Paragraph (b)(4)(i)(D)(*2*) is amended by adding a new sentence to the end of the paragraph.

■ 3. Paragraph (b)(4)(i)(E) is amended by adding *Examples 11* and *12.*

■ 4. Paragraph (b)(4)(ii) is revised to read as follows.

The additions and revisions read as follows:

§ 26.2601–1 Effective dates.

* * * * *

(b) * * *

(4) * * *(i) * * * In general, unless specifically provided otherwise, the rules contained in this paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of section 1001.

* * * * *

(D) * * *

(*2*) * * * In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)–1 of this chapter.

(E) * * *

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

Example 12. Equitable adjustments under state statute. The facts are the same as in *Example 11,* except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

(ii) *Effective dates.* The rules in this paragraph (b)(4) are generally applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(*2*) of this section and *Example 11* and *Example 12* in paragraph (b)(4)(i)(E) of this section regarding the administration of a trust and the determination of income in conformance with applicable state law applies to trusts for taxable years ending after January 2, 2004.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: December 16, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9104]

RIN 1545–AY82

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of qualified research under section 41(d) for the credit for increasing research activities. These final regulations reflect changes to section 41(d) made by the Tax Reform Act of 1986.

DATES: *Effective Dates:* These regulations are effective January 2, 2004.

Applicability Dates: For dates of applicability of these regulations, *see* § 1.41–4(e) and Effective Dates under **SUPPLEMENTARY INFORMATION.**

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1998, the Treasury Department and the IRS published in the **Federal Register** (63 FR 66503) a notice of proposed rulemaking (REG–10570–97, 1998–2 C.B. 729) under section 41 (1998 proposed regulations) relating to the credit for increasing research activities (research credit). The 1998 proposed regulations addressed, in relevant part, (1) the definition of qualified research under section 41(d), (2) the application of the exclusions from the definition of qualified research, and (3) the application of the shrinking-back rule. Comments responding to the 1998 proposed regulations were received and a public hearing was held on April 29, 1999.

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 280) final regulations relating, in relevant part, to the definition of qualified research under section 41(d) (TD 8930). In response to taxpayer concerns regarding TD 8930, on January 31, 2001, the Treasury Department and the IRS published Notice 2001–19 (2001–10 I.R.B. 784), announcing that the Treasury Department and the IRS would review TD 8930 and reconsider comments previously submitted in connection with the finalization of TD 8930. Notice 2001–19 also provided that, upon the completion of the review, the Treasury Department and the IRS would announce changes to the regulations, if any, in the form of proposed regulations.

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 66362) a notice of proposed rulemaking (REG–112991–01) reflecting the Treasury Department and the IRS' review of TD 8930 (2001 proposed regulations). Comments responding to the 2001 proposed regulations were received and a public hearing was held on March 27, 2002. After considering the comments received and the statements made at the public hearing, portions of the 2001 proposed regulations are adopted as revised by this Treasury Decision.

Explanation of Provisions

This document amends 26 CFR part 1 to provide revised rules for the research credit under section 41. These final regulations generally retain the provisions of the 2001 proposed regulations but clarify the provisions relating to the requirement in section 41(d)(1)(C) that qualified research be research ''substantially all of the activities of which constitute elements of a process of experimentation.'' These final regulations, however, do not contain final rules for research with respect to computer software ''which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer'' for purposes of section 41(d)(4)(E).

Process of Experimentation—In General

The Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085) (the 1986 Act), which narrowed the definition of the term *qualified research,* amended the definition of qualified research by adding a process of experimentation requirement. Section 41(d)(1) provides