

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