

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.