

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