

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