

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