

Example 5. The facts are the same as in *Example 1*, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is \$10,000, rather than \$12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 6. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 7. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See § 1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 8. The facts are the same as *Example 7*, except Trustee is directed to pay B \$10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as *Example 7*, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of \$1,000,000 and an adjusted basis of \$300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as *Example 9*, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The \$500,000 distribution to A may be treated as including a minimum of \$200,000 of capital gain (and all of the principal amount of \$300,000) and a maximum of \$500,000 of the capital gain (with no principal). Trustee evidences the

treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at \$500,000. During the year, Trust receives \$5,000 of dividend income and realizes \$80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A \$20,000 (4% of \$500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of \$15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in *Example 11*, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire \$80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in *Example 11*, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including \$15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

(f) *Effective date.* This section applies for taxable years of trusts and estates ending after January 2, 2004.

■ **Par. 5.** Section 1.643(b)-1 is revised to read as follows:

§ 1.643(b)-1 Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal