

pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument

and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

■ **Par. 6.** In § 1.651(a)–2, paragraph (d) is added to read as follows:

§ 1.651(a)–2 Income required to be distributed currently.

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(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

■ **Par. 7.** In § 1.661(a)–2, paragraph (f) is revised to read as follows:

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

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(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

■ **Par. 8.** Section 1.664–3 is amended as follows:

■ 1. Paragraphs (a)(1)(i)(b)(3) and (4) are revised.

■ 2. Paragraph (a)(1)(i)(b)(5) is removed. The revisions read as follows:

§ 1.664–3 Charitable remainder unitrust.

(a) * * *

(1) * * * (i) * * *

(b) * * *

(3) For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b)

and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(4) The rules in paragraph (a)(1)(i)(b)(1) and (2) of this section are applicable for taxable years ending after April 18, 1997. The rule in the first sentence of paragraph (a)(1)(i)(b)(3) is applicable for taxable years ending after April 18, 1997. The rules in the second, fourth, and fifth sentences of paragraph (a)(1)(i)(b)(3) are applicable for taxable years ending after January 2, 2004. The rule in the third sentence of paragraph (a)(1)(i)(b)(3) is applicable for sales or exchanges that occur after April 18, 1997. The rule in the sixth sentence of paragraph (a)(1)(i)(b)(3) is applicable for trusts created after January 2, 2004.

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PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

■ **Par. 9.** The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

■ **Par. 10.** Section 20.2056(b)–5 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§ 20.2056(b)–5 Marital deduction; life estate with power of appointment in surviving spouse.

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