

as being made from each category in the following order:

(1) First, from ordinary income to the extent of the sum of the trust's ordinary income for the taxable year and its undistributed ordinary income for prior years.

(2) Second, from capital gain to the extent of the trust's capital gains determined under paragraph (d)(1)(iv) of this section.

(3) Third, from other income to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years.

(4) Finally, from trust corpus (with corpus defined for this purpose as the net fair market value of the trust assets less the total undistributed income (but not loss) in paragraphs (d)(1)(i)(a)(1) through (3) of this section)).

(b) If the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. If two or more classes within the same category are subject to the same current tax rate, but at least one of those classes will be subject to a different tax rate in a future year (for example, if the current rate sunsets), the order of that class in relation to other classes in the category with the same current tax rate is determined based on the future rate or rates applicable to those classes. Within each category, if there is more than one type of income in a class, amounts treated as distributed from that class are to be treated as consisting of the same proportion of each type of income as the total of the current and undistributed income of that type bears to the total of the current and undistributed income of all types of income included in that class. For example, if rental income and interest income are subject to the same current and future Federal income tax rate and therefore are in the same class, a distribution from that class will be treated as consisting of a proportional amount of rental income and interest income.

(iii) *Treatment of losses*—(a) *Ordinary income category*. An ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss. Any excess loss is then used to reduce the current and undistributed ordinary income from other classes, in turn, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If any of the loss exists after all the current and undistributed ordinary income from all classes has been offset, the excess is carried forward indefinitely to reduce ordinary income for future years. For purposes of this section, the amount of current income and prior years' undistributed income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d).

(b) *Other income category*. A loss in the other income category for the current year is used to reduce undistributed income in this category for prior years and any excess is carried forward indefinitely to reduce other income for future years.

(iv) *Netting of capital gains and losses*. Capital gains of the trust are determined on a cumulative net basis under the rules of this paragraph (d)(1) without regard to the provisions of section 1212. For each taxable year, current and undistributed gains and losses within each class are netted to determine the net gain or loss for that class, and the classes of capital gains and losses are then netted against each other in the following order. A net loss from the class of short-term capital gain and loss offsets the net gain from each class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. A net loss from a class of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset net gain from each other class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. A net loss from all the classes of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) offsets any net gain from the class of short-term capital gain and loss.

(v) *Carry forward of net capital gain or loss*. If, at the end of a taxable year, a trust has, after the application of paragraph (d)(1)(iv), any net loss or any net gain that is not treated as distributed under paragraph (d)(1)(ii)(a)(2) of this section, the net gain or loss is carried over to succeeding taxable years and retains its character in succeeding taxable years as gain or loss from its particular class.

(vi) *Special transitional rules*. To be eligible to be included in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Long-term capital gain or loss properly taken into account by the trust before January 1, 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss properly taken into account by the trust on or after January 1, 1997, and before May 7, 1997, if not treated as distributed in 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss (other than 28-percent rate gain as defined in section 1(h)(4), unrecaptured section 1250 gain as defined in section 1(h)(6), and qualified 5-year gain as defined in section 1(h)(9) prior to its amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752)), properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if not treated as distributed during 2003, is included in the class of all other long-term capital gains and losses. Qualified 5-year gain properly taken into account by the trust after December 31, 2000, and before May 6, 2003, if not treated as distributed by the trust in 2003 or a prior year, must be maintained in a separate class within the capital gains category.

(vii) *Application of section 643(a)(7)*. For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see § 1.643(a)-8.

(viii) *Examples*. The following examples illustrate the rules in this paragraph (d)(1):

Example 1. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2003. The annual annuity amount is \$100. X's income for the 2003 tax year is as follows:

| | |
|---------------------------------|------|
| Interest income | \$80 |
| Qualified dividend income | 50 |
| Capital gains and losses | 0 |
| Tax-exempt income | 0 |

(ii) In 2003, the year this income is received by the trust, qualified dividend income is subject to a different rate of