

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 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 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 in-

come. 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.

[T.D. 9102, 69 FR 18, Jan. 2, 2004]

§ 1.643(a)-4 Extraordinary dividends and taxable stock dividends.

In the case solely of a trust which qualifies under subpart B (section 651 and following) as a "simple trust," there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(e), paragraph (b) of § 1.665(e)-1, and paragraph (b) of § 1.665(e)-1A for the treatment of such dividends upon subsequent distribution.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(a)-5 Tax-exempt interest.

(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions