from the sale or exchange of capital assets in preceding taxable years not included in the computation of distributable net income of any year, reduced by such losses taken into account in a subsequent preceding taxable year in computing undistributed capital gain but not reduced by such losses taken into account in determining the deduction under section 1211. See section 1212(b)(2) and the regulations thereunder. For example, assume that a trust had a net long-term capital loss in 1970 of $5,000. During the years 1971 through 1975, the trust had no capital gains or capital losses. In 1976, it has a long-term capital gain of $8,000, which it allocates to corpus and does not distribute to a beneficiary, but has no taxes attributable to such gain. The undistributed capital gain for 1976 is $8,000−$5,000, or $3,000, even though all or a part of the $5,000 loss was claimed under section 1211 as a deduction in years 1970 through 1975.

(b) Foreign trusts. Distributable net income for a taxable year of a foreign trust created by a U.S. person includes capital gains in excess of capital losses for such year (see §1.643(a)–6(a)(3)). Thus, a foreign trust created by a U.S. person can never have any undistributed capital gain.

Example. A trust on the calendar year basis made the following accumulations. For purposes of this example, the undistributed net income is the same as income under applicable local law. No income was accumulated prior to 1970.

<table>
<thead>
<tr>
<th>Year</th>
<th>Undistributed net income</th>
<th>Undistributed capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>None</td>
<td>$10,000</td>
</tr>
<tr>
<td>1970</td>
<td>$1,000</td>
<td>3,000</td>
</tr>
<tr>
<td>1971</td>
<td>None</td>
<td>4,000</td>
</tr>
</tbody>
</table>

The trust has distributable net income in 1972 of $2,000 and recognizes capital gains of $4,500 that are allocable to corpus. On December 31, 1972, the trustee makes a distribution of $20,000 to the beneficiary. There is an accumulation distribution of $18,000 ($20,000 distribution less $2,000 d.n.i.) that consists of undistributed net income of $1,000 (see §1.666(a)-1A) and a capital gain distribution of $7,000. The capital gain distribution is computed as follows:

Accumulation distribution ....................................... $18,000
Less: Undistributed net income ............................. 1,000
Balance .................................................... 17,000

Capital gain distribution (undistributed capital gain of the trust for 1972 ($3,000 from 1970 and $4,000 from 1971)) .................. 7,000
Balance (corpus) ..................................... 10,000

No undistributed capital gain is deemed distributed from 1969 because 1969 is a year prior to the first year in which income is accumulated (1970). The accumulation distribution is not deemed to consist of any part of the capital gains recognized in 1972.

§ 1.665(g)–2A Application of separate share rule.

(a) In general. If the separate share rule of section 663(c) is applicable for any taxable year of a trust, subpart D is applied as if each share were a separate trust except as provided in paragraph (c) of this section and in §1.668(a)–1A(c). Thus, the amounts of an “accumulation distribution”, “undistributed net income”, “undistributed capital gain”, and “capital gain distribution” are computed separately for each share.

(b) Allocation of taxes—undistributed net income. The “taxes imposed on the trust attributable to the undistributed net income” are allocated as follows:

(1) There is first allocated to each separate share that portion of the
§ 1.665(g)-2A  

"taxes imposed on the trust attributable to the undistributed net income" (as defined in §1.665(d)-1A(b)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(i) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a) (5), (6), and (7); and

(ii) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the "taxes imposed on the trust" that bears the same relation to the total of such credits that the capital gain allocable to the separate share with respect to which the credit is allowed bear to the total of such capital gain of the trust.

(d) Termination of a separate share. (1) If upon termination of a separate share, an amount is properly paid, credited, or required to be distributed by the trust under section 661(a)(2) to a beneficiary from such share, an accumulation distribution will be deemed to have been made to the extent of such amount. In determining the distributable net income of such share, only those items of income and deduction for the taxable year of the trust in which such share terminates, properly allocable to such share, shall be taken into consideration.

(2) No accumulation distribution will be deemed to have been made upon the termination of a separate share to the extent that the property constituting such share, or a portion thereof, continues to be held as a part of the same trust. The undistributed net income, undistributed capital gain, and the taxes imposed on the trust attributable to such items, if any, for all preceding taxable years (reduced by any amounts deemed distributed under sections 666(a) and 669(a) by reason of any accumulation distribution of undistributed net income or undistributed capital gain in prior years or the current taxable year), which were allocable to the terminating share, shall be treated as being applicable to the trust itself. However, no adjustment will be made to the amounts deemed distributed under sections 666 and 669 by reason of an accumulation distribution of undistributed net income or undistributed capital gain from the surviving share or shares made in years prior to the year in which the terminating share was added to such surviving share or shares.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. A trust was established under the will of X for the benefit of his wife and upon her death the property was to continue in the same trust for his two sons, Y and Z. The separate share rule is applicable to this...
trust. The trustee had discretion to pay or accumulate the income to the wife, and after her death was to pay each son's share to him after he attained the age of 25. When the wife died, Y was 23 and Z was 28.

1) Upon the death of X's widow, there is no accumulation distribution. The entire trust is split into two equal shares, and therefore the undistributed net income and the undistributed capital gain of the trust are split into two shares.

2) The distribution to Z of his share after his mother's death is an accumulation distribution of his separate share of one-half of the undistributed net income and undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§ 1.671–1 Grantors and others treated as substantial owners

(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675);

4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See §1.662(a)–4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of