

Example 9. The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is \$9,000,000. During 2000, the \$900,000 balance in Testator's individual retirement account is distributed to the estate. The entire \$900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of income in respect of a decedent must be allocated to A's share.

Example 10. The facts are the same as in *Example 9*, except that the will directs the executor to fund A's share first with X stock valued at \$3,000,000, rather than with the proceeds of the individual retirement account. The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the \$900,000 of gross income attributable to the proceeds from the individual retirement account must be allocated between the two shares to the extent that they could potentially be funded with those proceeds. The maximum amount of A's share that could potentially be funded with the income in respect of decedent is \$1,500,000 (\$4,500,000 value of share less \$3,000,000 to be funded with stock) and the maximum amount of B's share that could potentially be funded with income in respect of decedent is \$4,500,000. Based upon the relative values of these amounts, the gross income attributable to the proceeds of the individual retirement account is allocated \$225,000 (or one-fourth) to A's share and \$675,000 (or three-fourths) to B's share.

Example 11. The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of in-

come to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8849, 64 FR 72543, 72544, Dec. 28, 1999; 65 FR 16317, Mar. 28, 2000]

§ 1.663(c)-6 Effective dates.

Sections 1.663(c)-1 through 1.663(c)-5 are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die on or after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see § 601.601(d)(2)(ii)(b) of this chapter). For trusts other than qualified revocable trusts, § 1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

[T.D. 8849, 64 FR 72545, Dec. 28, 1999; 65 FR 16317, Mar. 28, 2000]

§ 1.664-1 Charitable remainder trusts.

(a) *In general*—(1) *Introduction*—(i) *General description of a charitable remainder trust.* Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain which is not less than 5 percent of the initial net fair market value of all property placed in trust (in the case of a charitable remainder annuity trust) or a fixed percentage which is not less than 5 percent of the net fair market value of the trust assets, valued annually (in the case of a charitable remainder unitrust). A trust created after July 31, 1969, which is a charitable remainder trust, is exempt from all of the taxes imposed by subtitle A of the Code for any taxable year

of the trust, except for a taxable year beginning before January 1, 2007, in which it has unrelated business taxable income. For taxable years beginning after December 31, 2006, an excise tax, treated as imposed by chapter 42, is imposed on charitable remainder trusts that have unrelated business taxable income. See paragraph (c) of this section.

(ii) *Scope.* This section provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries. For the application of certain foundation rules to charitable remainder trusts, see paragraph (b) of this section. If the trust has unrelated business taxable income, see paragraph (c) of this section. For the treatment of distributions to recipients, see paragraph (d) of this section. For the treatment of distributions to charity, see paragraph (e) of this section. For the time limitations for amendment of governing instruments, see paragraph (f) of this section. For transitional rules under which particular requirements are inapplicable to certain trusts, see paragraph (g) of this section. Section 1.664-2 provides rules relating solely to a charitable remainder annuity trust. Section 1.664-3 provides rules relating solely to a charitable remainder unitrust. Section 1.664-4 provides rules governing the calculation of the fair market value of the remainder interest in a charitable remainder unitrust. For rules relating to the filing of returns for a charitable remainder trust, see paragraph (a)(6) of § 1.6012-3 and section 6034 and the regulations thereunder.

(iii) *Definitions.* As used in this section and §§ 1.664-2, 1.664-3, and 1.664-4:

(a) *Charitable remainder trust.* The term *charitable remainder trust* means a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522 and which meets the description of a charitable remainder annuity trust (as described in § 1.664-2) or a charitable remainder unitrust (as described in § 1.664-3).

(b) *Annuity amount.* The term *annuity amount* means the amount described in paragraph (a)(1) of § 1.664-2 which is payable, at least annually, to the bene-

ficiary of a charitable remainder annuity trust.

(c) *Unitrust amount.* The term *unitrust amount* means the amount described in paragraph (a)(1) of § 1.664-3 which is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

(d) *Recipient.* The term *recipient* means the beneficiary who receives the possession or beneficial enjoyment of the annuity amount or unitrust amount.

(e) *Governing instrument.* The term *governing instrument* has the same meaning as in section 508(e) and the regulations thereunder.

(2) *Requirement that the trust must be either a charitable remainder annuity trust or a charitable remainder unitrust.*

A trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. For example, a trust which provides for the payment each year to a noncharitable beneficiary of the greater of a sum certain or a fixed percentage of the annual value of the trust assets is not a charitable remainder trust inasmuch as the trust is neither a charitable remainder annuity trust (for the reason that the payment for the year may be a fixed percentage of the annual value of the trust assets which is not a “sum certain”) nor a charitable remainder unitrust (for the reason that the payment for the year may be a sum certain which is not a “fixed percentage” of the annual value of the trust assets).

(3) *Restrictions on investments.* A trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. In the case of transactions with, or for the benefit of, a disqualified person, see section 4941(d) and the regulations thereunder for rules relating to the definition of self-dealing.

(4) *Requirement that trust must meet definition of and function exclusively as a*

charitable remainder trust from its creation. In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.

(5) *Rules applicable to testamentary transfers*—(i) *Deferral of annuity or unitrust amount.* Notwithstanding subparagraph (4) of this paragraph and §§1.664-2 and 1.664-3, for purposes of sections 2055 and 2106 a charitable remainder trust shall be deemed created at the date of death of the decedent (even though the trust is not funded until the end of a reasonable period of administration or settlement) if the obligation to pay the annuity or unitrust amount with respect to the property passing in trust at the death of the decedent begins as of the date of death of the decedent, even though the requirement to pay such amount is deferred in accordance with the rules provided in this subparagraph. If permitted by applicable local law or authorized by the provisions of the governing instrument, the requirement to pay such amount may be deferred until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable period after such time, the trust must pay (in the case of an underpayment) or must receive from the recipient (in the case of an overpayment) the difference between:

(a) Any annuity or unitrust amounts actually paid, plus interest on such amounts computed at the rate of inter-

est specified in paragraph (a)(5)(iv) of this section, compounded annually, and

(b) The annuity or unitrust amounts payable, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually.

The amounts payable shall be retroactively determined by using the taxable year, valuation method, and valuation dates which are ultimately adopted by the charitable remainder trust. See subdivision (ii) of this subparagraph for rules relating to retroactive determination of the amount payable under a charitable remainder unitrust. See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient.

(ii) For purposes of retroactively determining the amount under subdivision (i)(b) of this subparagraph, the governing instrument of a charitable remainder unitrust may provide that the amount described in subdivision (i)(b) of this subparagraph with respect to property passing in trust at the death of the decedent for the period which begins on the date of death of the decedent and ends on the earlier of the date of death of the last recipient or the end of the taxable year of the trust in which occurs the complete funding of the trust shall be computed by multiplying:

(a) The sum of (1) the value, on the earlier of the date of death of the last recipient or the last day in such taxable year, of the property held in trust which is attributable to property passing to the trust at the death of the decedent, (2) any distributions in respect of unitrust amounts made by the trust or estate before such date, and (3) interest on such distributions computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, from the date of distribution to such date by:

(b)(1) In the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in §1.664-4(e)(6) opposite the number of years in column 1

between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year.

(2) In the case of transfers for which the valuation date is after April 30, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664-4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year. The appropriate adjusted payout rate is determined by using the appropriate Table F contained in § 1.664-4(e)(6) for the section 7520 rate for the month of the valuation date.

(3) If the number of years between the date of death and the date of the earlier of the death of the last recipient or the last day of such taxable year is between periods for which factors are provided, a linear interpolation must be made.

(iii) *Treatment of distributions.* The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664. In the case of a charitable remainder trust which is partially or fully funded during the period of administration of an estate or settlement of a trust (which is not a charitable remainder trust), the treatment of any amount paid, credited, or required to be distributed by the charitable remainder trust shall be governed by the rules of section 664.

(iv) *Rate of interest.* The following rates of interest shall apply for purposes of paragraphs (a)(5) (i) through (ii) of this section:

(a) The section 7520 rate for the month in which the valuation date with respect to the transfer is (or one of the prior two months if elected under § 1.7520-2(b)) after April 30, 1989;

(b) 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) on or after August 9, 1984,

and before May 1, 1989, and not subsequently amended;

(c) 6 percent or 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) after October 24, 1983, and before August 9, 1984; and

(d) 6 percent for instruments executed before October 25, 1983, and not subsequently amended (other than in the case of a reformation under section 2055(e)(3)).

(6) *Examples.* The application of the rules in paragraphs (a)(4) and (a)(5) of this section require the use of actuarial factors contained in §§ 1.664-4T(e) and 1.664-4A and may be illustrated by use of the following examples:

Example 1. On September 19, 1971, H transfers property to a trust over which he retains an inter vivos power of revocation. The trust is to pay W 5 percent of the value of the trust assets, valued annually, for her life, remainder to charity. The trust would satisfy all of the requirements of section 664 if it were irrevocable. For purposes of section 664, the trust is not deemed created in 1971 because H is treated as the owner of the entire trust under subpart E. On May 26, 1975, H predeceases W at which time the trust becomes irrevocable. For purposes of section 664, the trust is deemed created on May 26, 1975, because that is the earliest date on which H is not treated as the owner of the entire trust under subpart E. The trust becomes a charitable remainder trust on May 26, 1975, because it meets the definition of a charitable remainder trust from its creation.

Example 2. The facts are the same as in *example 1*, except that H retains the inter vivos power to revoke only one-half of the trust. For purposes of section 664, the trust is deemed created on September 19, 1971, because on that date the grantor is not treated as the owner of the entire trust under subpart E. Consequently, a charitable deduction is not allowable either at the creation of the trust or at H's death because the trust does not meet the definition of a charitable remainder trust from the date of its creation. The trust does not meet the definition of a charitable remainder trust from the date of its creation because the trust is subject to a partial power to revoke on such date.

Example 3. The facts are the same as in *example 1*, except that the residue of H's estate is to be paid to the trust and the trust is required to pay H's debts. The trust is not a charitable remainder trust at H's death because it does not function exclusively as a charitable remainder trust from the date of its creation which, in this case, is the date it becomes irrevocable.

Example 4. (i) In 1971, H transfers property to Trust A over which he retains an inter vivos power of revocation. Trust A, which is not a charitable remainder trust, is to provide income or corpus to W until the death of H. Upon H's death the trust is required by its governing instrument to pay the debts and administration expenses of H's estate, and then to terminate and distribute all of the remaining assets to a separate Trust B which meets the definition of a charitable remainder annuity trust.

(ii) Trust B will be charitable remainder trust from the date of its funding because it will function exclusively as a charitable remainder trust from its creation. For purposes of section 2055, Trust B will be deemed created at H's death if the obligation to pay the annuity amount begins on the date of H's death. For purposes of section 664, Trust B becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless Trust B has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by Trust A, including distributions to a recipient in respect of annuity amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example 5. In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.

For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example 6. (i) On January 1, 1974, H dies testate leaving the residue of his estate to a charitable remainder unitrust. The governing instrument provides that, beginning at H's death, the trustee is to make annual payments to W, on December 31 of each year of 5 percent of the net fair market value of the trust assets, valued as of December 31 of each year, for W's life and to pay the remain-

der to charity at the death of W. The governing instrument also provides that the actual payment of the unitrust amount need not be made until the end of the taxable year of the trust in which occurs the complete funding of the trust. The governing instrument also provides that the amount payable with respect to the period between the date of death and the end of such taxable year shall be computed under the special method provided in subparagraph (5)(ii) of this paragraph. The governing instrument provides that, within a reasonable period after the end of the taxable year of the trust in which occurs the complete funding of the trust, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between the unitrust amounts paid (plus interest at 6 percentage compounded annually) and the amount computed under the special method. The trust is completely funded on September 20, 1976. No amounts were paid before June 30, 1977. The trust adopts a fiscal year of July 1 to June 30. The net fair market value of the trust assets on June 30, 1977, is \$100,000.

(ii) Because no amounts were paid prior to the end of the taxable year in which the trust was completely funded, the amount payable at the end of such taxable year is equal to the net fair market value of the trust assets on the last day of such taxable year (June 30, 1977) multiplied by a factor equal to 1.0 minus the factor in Table D corresponding to the number of years in the period between the date of death and the end of such taxable year. The adjusted payout rate (determined under § 1.664-4A(c)) is 5 percent. Because the last day of the taxable year in which the trust is completely funded in June 30, 1977, there are 3 181/365 years in such period. Because there is no factor given in Table D for such a period, a linear interpolation must be made:

1.0 minus 0.814506 (factor at 5 percent for 4 years)	0.185494
1.0 minus 0.857375 (factor at 5 percent for 3 years)142625
Difference042869
$181+365=X+0.042869$	
$X=0.021258$	
1.0 minus 0.857375 (factor at 5 percent for 3 years)	0.142625
Plus: X021258
Interpolated factor163883

Thus, the amount payable for the period from January 1, 1974, to June 30, 1977, is \$16,388.30 (\$100,000×0.163883). Thereafter, the trust assets must be valued on December 31 of each year and 5 percent of such value paid annually to W for her life.

(7) *Valuation of unmarketable assets—*
 (i) *In general.* If unmarketable assets are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under section 170, 2055, 2106, or 2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is—

(a) Performed exclusively by an independent trustee; or

(b) Determined by a *current qualified appraisal*, as defined in § 1.170A-13(c)(3), from a *qualified appraiser*, as defined in § 1.170A-13(c)(5).

(ii) *Unmarketable assets.* Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

(iii) *Independent trustee.* An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of section 672(c) and the applicable regulations).

(b) *Application of certain foundation rules to charitable remainder trusts.* See section 4947(a)(2) and section 4947(b)(3)(B) and the regulations thereunder for the application to charitable remainder trusts of certain provisions relating to private foundations. See section 508(e) for rules relating to required provisions in governing instruments prohibiting certain activities specified in section 4947(a)(2).

(c) *Excise tax on charitable remainder trusts—*(1) *In general.* For each taxable year beginning after December 31, 2006, in which a charitable remainder annuity trust or a charitable remainder unitrust has any unrelated business taxable income, an excise tax is imposed on that trust in an amount equal to the amount of such unrelated business taxable income. For this purpose, unrelated business taxable income is as defined in section 512, determined as if

part III, subchapter F, chapter 1, subtitle A of the Internal Revenue Code applied to such trust. Such excise tax is treated as imposed by chapter 42 (other than subchapter E) and is reported and payable in accordance with the appropriate forms and instructions. Such excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary. (See paragraph (d)(2) of this section.) The charitable remainder trust income that is unrelated business taxable income constitutes income of the trust for purposes of determining the character of the distribution made to the beneficiary. Income of the charitable remainder trust is allocated among the charitable remainder trust income categories in paragraph (d)(1) of this section without regard to whether any part of that income constitutes unrelated business taxable income under section 512.

(2) *Examples.* The application of the rules in this paragraph (c) may be illustrated by the following examples:

Example 1. For 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, has \$60,000 of ordinary income, including \$10,000 of gross income from a partnership that constitutes unrelated business taxable income to the trust. The trust has no deductions that are directly connected with that income. For that same year, the trust has administration expenses (deductible in computing taxable income) of \$16,000, resulting in net ordinary income of \$44,000. The amount of unrelated business taxable income is computed by taking gross income from an unrelated trade or business and deducting expenses directly connected with carrying on the trade or business, both computed with modifications under section 512(b). Section 512(b)(12) provides a specific deduction of \$1,000 in computing the amount of unrelated business taxable income. Under the facts presented in this example, there are no other modifications under section 512(b). The trust, therefore, has unrelated business taxable income of \$9,000 (\$10,000 minus the \$1,000 deduction under section 512(b)(12)). Undistributed ordinary income from prior years is \$12,000 and undistributed capital gains from prior years are \$50,000. Under the terms of the trust agreement, the trust is required to pay an annuity of \$100,000 for year 2007 to the noncharitable beneficiary. Because the trust has unrelated business taxable income of \$9,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, \$9,000. The

character of the \$100,000 distribution to the noncharitable beneficiary is as follows: \$56,000 of ordinary income (\$44,000 from current year plus \$12,000 from prior years), and \$44,000 of capital gains. The \$9,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories of income under paragraph (d)(1) of this section. At the beginning of year 2008, the amount of undistributed capital gains is \$6,000, and there is no undistributed ordinary income.

Example 2. During 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, sells real estate generating gain of \$40,000. Because the trust had obtained a loan to finance part of the purchase price of the asset, some of the income from the sale is treated as debt-financed income under section 514 and thus constitutes unrelated business taxable income under section 512. The unrelated debt-financed income computed under section 514 is \$30,000. Assuming the trust receives no other income in 2007, the trust will have unrelated business taxable income under section 512 of \$29,000 (\$30,000 minus the \$1,000 deduction under section 512(b)(12)). Except for section 512(b)(12), no other exceptions or modifications under sections 512-514 apply when calculating unrelated business taxable income based on the facts presented in this example. Because the trust has unrelated business taxable income of \$29,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, \$29,000. The \$29,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories of income under paragraph (d)(1) of this section. Regardless of how the trust's income might be treated under sections 511-514, the entire \$40,000 is capital gain for purposes of section 664 and is allocated accordingly to and within the second of the categories of income under paragraph (d)(1) of this section.

(3) *Effective/applicability date.* This paragraph (c) is applicable for taxable years beginning after December 31, 2006. The rules that apply with respect to taxable years beginning before January 1, 2007, are contained in § 1.664-1(c) as in effect prior to June 24, 2008. (See 26 CFR part 1, § 1.664-1(c)(1) revised as of April 1, 2007.)

(d) *Treatment of annual distributions to recipients—(1) Character of distributions—(i) Assignment of income to categories and classes at the trust level.* (a) A trust's income, including income includible in gross income and other income, is assigned to one of three categories in the year in which it is required to be taken into account by the trust. These categories are—

(1) Gross income, other than gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the ordinary income category);

(2) Gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the capital gains category); and

(3) Other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Internal Revenue Code).

(b) Items within the ordinary income and capital gains categories are assigned to different classes based on the Federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust. For example, for a trust with a taxable year ending December 31, 2004, the ordinary income category may include a class of qualified dividend income as defined in section 1(h)(11) and a class of all other ordinary income, and the capital gains category may include separate classes for short-term and long-term capital gains and losses, such as a short-term capital gain class, a 28-percent long-term capital gain class (gains and losses from collectibles and section 1202 gains), an unrecaptured section 1250 long-term capital gain class (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation), a qualified 5-year long-term capital gain class as defined in section 1(h)(9) prior to amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108-27 (117 Stat. 752), and an all other long-term capital gain class. After items are assigned to a class, the tax rates may change so that items in two or more classes would be taxed at the same rate if distributed to the recipient during a particular year. If the changes to the tax rates are permanent, the undistributed items in those classes are combined into one class. If, however, the changes to the tax rates are only temporary (for example, the new rate for one class will sunset in a future year), the classes are kept separate.

(ii) *Order of distributions.* (a) The categories and classes of income (determined under paragraph (d)(1)(i) of this section) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust shall be made as of the end of that taxable year. The tax rate or rates to be used in computing the recipient's tax on the distribution shall be the tax rates that are applicable, in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and not the tax rates that are applicable to those classes of income in the year the income is received by the trust. The character of the distribution in the hands of the annuity or unitrust recipient is determined by treating the distribution 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 at the trust level—(a) Ordinary income category.* A net 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 and retains its class assignment. 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 section 172 or 642(d).

(b) *Other income category.* A net 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 at the trust level.* 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. First, 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. Second, either—

(a) 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) is used to offset any net gain from the class of short-term capital gain and loss; or

(b) A net loss from the class of short-term capital gain and loss is used to offset any 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 Federal income tax rate.

(v) *Carry forward of net capital gain or loss by the trust.* If, at the end of a taxable year, a trust has, after the application of paragraph (d)(1)(iv) of this section, 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 gain (gains and losses from collectibles and section 1202 gains), unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation), and qualified 5-year gain as defined in section 1(h)(9) prior to amendment by JGTRRA), properly taken into account by the trust before January 1, 2003, and distributed during 2003 is treated as if it were properly taken into account by the trust after May 5, 2003. Long-term capital gain or loss (other than 28-percent gain, unrecaptured section 1250 gain, and qualified 5-year gain), 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 gain. 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 until distributed. Qualified 5-year gain properly taken into account by the trust before January 1, 2003, and deemed distributed during 2003 is subject to the same current tax rate as deemed distributions from the class of all other long-term capital gain realized by the trust after

May 5, 2003. Qualified 5-year gain properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if treated as distributed by the trust in 2003, is subject to the tax rate in effect prior to the amendment of section 1(h)(9) by JGTRRA.

(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 Federal income tax than interest income and is, therefore, a separate class of income in the ordinary income category. The annuity amount is deemed to be distributed from the classes within the ordinary income category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Because during 2003 qualified dividend income is taxed at a lower rate than interest income, the interest income is deemed distributed prior to the qualified dividend income. Therefore, in the hands of the recipient, the 2003 annuity amount has the following characteristics:

Interest income	\$80
Qualified dividend income	20

(iii) The remaining \$30 of qualified dividend income that is not treated as distributed to the recipient in 2003 is carried forward to 2004 as undistributed qualified dividend income.

Example 2. (i) The facts are the same as in Example 1, and at the end of 2004, X has the following classes of income:

Interest income class	\$5
Qualified dividend income class (\$10 from 2004 and \$30 carried forward from 2003)	40
Net short-term capital gain class	15
Net long-term capital loss in 28-percent class	(325)
Net long-term capital gain in unrecaptured section 1250 gain class	175
Net long-term capital gain in all other long-term capital gain class	350

(ii) In 2004, gain in the unrecaptured section 1250 gain class is subject to a 25-percent Federal income tax rate, and gain in the all other long-term capital gain class is subject

to a lower rate. The net long-term capital loss in the 28-percent gain class is used to offset the net capital gains in the other 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. The \$325 net loss in the 28-percent gain class reduces the \$175 net gain in the unrecaptured section 1250 gain class to \$0. The remaining \$150 loss from the 28-percent gain class reduces the \$350 gain in the all other long-term capital gain class to \$200. As in Example 1, qualified dividend income is taxed at a lower rate than interest income during 2004. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2004 annuity amount has the following characteristics:

Interest income	\$ 5
Qualified dividend income	40
Net short-term capital gain	15
Net long-term capital gain in all other long-term capital gain class	40

(iii) The remaining \$160 gain in the all other long-term capital gain class that is not treated as distributed to the recipient in 2004 is carried forward to 2005 as gain in that same class.

Example 3. (i) The facts are the same as in Examples 1 and 2, and at the end of 2005, X has the following classes of income:

Interest income class	\$ 5
Qualified dividend income	20
Net loss in short-term capital gain class	(50)
Net long-term capital gain in 28-percent gain class	10
Net long-term capital gain in unrecaptured section 1250 gain class	135
Net long-term capital gain in all other long-term capital gain class (carried forward from 2004)	160

(ii) There are no long-term capital losses to net against the long-term capital gains. Thus, the net short-term capital loss is used to offset the net capital gains in the classes 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. The \$50 net short-term loss reduces the \$10 net gain in the 28-percent gain class to \$0. The remaining \$40 net loss reduces the \$135 net gain in the unrecaptured section 1250 gain class to \$95. As in Examples 1 and 2, during 2005, qualified dividend income is taxed at a lower rate than interest income; gain in the unrecaptured section 1250 gain class is taxed at 25 percent; and gain in the all other long-term capital gain class is taxed at a rate lower than 25 percent. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the

classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Therefore, in the hands of the recipient, the 2005 annuity amount has the following characteristics:

Interest income	\$ 5
Qualified dividend income	20
Unrecaptured section 1250 gain	75

(iii) The remaining \$20 gain in the unrecaptured section 1250 gain class and the \$160 gain in the all other long-term capital gain class that are not treated as distributed to the recipient in 2005 are carried forward to 2006 as gains in their respective classes.

Example 4. (i) The facts are the same as in Examples 1, 2 and 3, and at the end of 2006, X has the following classes of income:

Interest income class	\$ 95
Qualified dividend income class	10
Net loss in short-term capital gain class	(20)
Net long-term capital loss in 28-percent gain class	(350)
Net long-term capital gain in unrecaptured section 1250 gain class (carried forward from 2005)	20
Net long-term capital gain in all other long-term capital gain class (carried forward from 2005)	160

(ii) A net long-term capital loss in one class is used to offset the net capital gains in the other classes 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. The \$350 net loss in the 28-percent gain class reduces the \$20 net gain in the unrecaptured section 1250 gain class to \$0. The remaining \$330 net loss reduces the \$160 net gain in the all other long-term capital gain class to \$0. As in Examples 1, 2 and 3, during 2006, qualified dividend income is taxed at a lower rate than interest income. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2006 annuity amount has the following characteristics:

Interest income	\$ 95
Qualified dividend income	5

(iii) The remaining \$5 of qualified dividend income that is not treated as distributed to the recipient in 2006 is carried forward to 2007 as qualified dividend income. The \$20 net loss in the short-term capital gain class and the \$170 net loss in the 28-percent gain class are carried forward to 2007 as net losses in their respective classes.

Example 5. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2002. The annual annuity amount is \$100. Except for qualified 5-year gain of \$200 realized before May 6, 2003, but not distributed, X has no other gains or

losses carried over from former years. X's income for the 2007 tax year is as follows:

Interest income class	\$ 10
Net gain in short-term capital gain class	5
Net long-term capital gain in 28-percent gain class	5
Net long-term capital gain in unrecaptured section 1250 gain class	10
Net long-term capital gain in all other long-term capital gain class	10

(ii) The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In 2007, gains distributed to a recipient from both the qualified 5-year gain class and the all other long-term capital gains class are taxed at a 15/5 percent tax rate. Since after December 31, 2008, gains distributed from the qualified 5-year gain class will be taxed at a lower rate than gains distributed from the other classes of long-term capital gain and loss, distributions from the qualified 5-year gain class are made after distributions from the other classes of long-term capital gain and loss. In the hands of the recipient, the 2007 annuity amount has the following characteristics:

Interest income	\$10
Short-term capital gain	5
28-percent gain	5
Unrecaptured section 1250 gain	10
All other long-term capital gain	10
Qualified 5-year gain (taxed as all other long-term capital gain)	60

(iii) The remaining \$140 of qualified 5-year gain that is not treated as distributed to the recipient in 2007 is carried forward to 2008 as qualified 5-year gain.

(ix) *Effective dates.* The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent gain (gains and losses from collectibles and section 1202 gains); second, unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998. The rules in this paragraph (d)(1) that provide for the netting of capital gains and losses are applicable for taxable years ending on or after December 31, 1998. The rule in the second sentence of paragraph (d)(1)(vi) of this section is applicable for taxable years ending on or after December 31, 1998. The rule in the third sentence of paragraph (d)(1)(vi) of this section is applicable for distributions made in

taxable years ending on or after December 31, 1998. All other provisions of this paragraph (d)(1) are applicable for taxable years ending after November 20, 2003.

(2) *Allocation of deductions.* Items of deduction of the trust for a taxable year of the trust which are deductible in determining taxable income (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) which are directly attributable to one or more classes of items within a category of income (determined under paragraph (d)(1)(i)(a) of this section) or to corpus shall be allocated to such classes of items or to corpus. All other allowable deductions for such taxable year which are not directly attributable to one or more classes of items within a category of income or to corpus (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) shall be allocated among the classes of items within the category (excluding classes of items with net losses) on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto under the first sentence of this subparagraph, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two sentences (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) may be allocated in any manner. All taxes imposed by chapter 42 of the Code (including without limitation taxes treated under section 664(c)(2) as imposed by chapter 42) and, for taxable years beginning prior to January 1, 2007, all taxes imposed by subtitle A of the Code for which the trust is liable because it has unrelated business taxable income, shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of items described in paragraph (d)(1)(i)(a)(3) of this section shall be allocated to corpus. The deductions allowable to a trust under sections 642(b), 642(c), 661, and 1202 are not allowed in determining the amount or character of any class of items within a category of income de-

scribed in paragraph (d)(1)(i)(a) of this section or to corpus.

(3) *Allocation of income among recipients.* If there are two or more recipients, each will be treated as receiving his pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

Example. X transfers \$40,000 to a charitable remainder annuity trust which is to pay \$3,000 per year to X and \$2,000 per year to Y for a term of 5 years. During the first taxable year the trust has \$3,000 of ordinary income, \$500 of capital gain, and \$500 of tax-exempt income after allocation of all expenses. X is treated as receiving ordinary income of \$1,800 ($\$3,000/\$5,000 \times \$3,000$), capital gain of \$300 ($\$3,000/\$5,000 \times \500), tax exempt income of \$300 ($\$3,000/\$5,000 \times \500), and corpus of \$600 ($\$3,000/\$5,000 \times [\$5,000 - \$4,000]$). Y is treated as receiving ordinary income of \$1,200 ($\$2,000/\$5,000 \times \$3,000$), capital gain of \$200 ($\$2,000/\$5,000 \times \500), tax exempt income of \$200 ($\$2,000/\$5,000 \times \500), and corpus of \$400 ($\$2,000/\$5,000 \times [\$5,000 - \$4,000]$).

(4) *Year of inclusion—(i) General rule.* To the extent required by this paragraph, the annuity or unitrust amount is includible in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income to the extent required by this paragraph shall be included in his taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed.

(ii) *Payments resulting from incorrect valuations.* Notwithstanding subdivision (i) of this subparagraph, any payments which are made or required to be distributed by a charitable remainder trust pursuant to paragraph (a)(5) of this section, under paragraph (f)(3) of this section because of an amendment to the governing instrument, or under paragraphs (a)(1) of §§ 1.664-2 and 1.664-3 because of an incorrect valuation, shall, to the extent required by this paragraph, be included in the gross income of the recipient in his taxable year in which or with which ends the

taxable year of the trust in which the amount is paid, credited, or required to be distributed. For rules relating to required adjustments of underpayments and overpayments of the annuity or unitrust amounts in respect of payments made prior to the amendment of a governing instrument, see paragraph (f)(3) of this section. There is allowable to a recipient a deduction from gross income for any amounts repaid to the trust because of an overpayment during the reasonable period of administration or settlement or until the trust is fully funded, because of an amendment, or because of an incorrect valuation, to the extent such amounts were included in his gross income. See section 1341 and the regulations thereunder for rules relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right.

(iii) *Rules applicable to year of recipient's death.* If the taxable year of the trust does not end with or within the last taxable year of the recipient because of the recipient's death, the extent to which the annuity or unitrust amount required to be distributed to him is included in the gross income of the recipient for his last taxable year, or in the gross income of his estate, is determined by making the computations required under this paragraph for the taxable year of the trust in which his last taxable year ends. (The last sentence of subdivision (i) of this subparagraph does not apply to such amounts.) The gross income for the last taxable year of a recipient on the cash basis includes (to the extent required by this paragraph) amounts actually distributed to the recipient before his death. Amounts required to be distributed which are distributed to his estate, are included (to the extent required by this paragraph) in the gross income of the estate as income in respect of a decedent under section 691.

(5) *Distributions in kind.* The annuity or unitrust amount may be paid in cash or in other property. In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of property. The basis of the property in

the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed. The application of these rules may be illustrated by the following example:

Example. On January 1, 1971, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive \$5,000 per year. During 1971, the trust receives \$500 of ordinary income. On December 31, 1971, the trust distributed cash of \$500 and a capital asset of the trust having a fair market value of \$4,500 and a basis of \$2,200. The trust is deemed to have realized a capital gain of \$2,300. X treats the distribution of \$5,000 as being ordinary income of \$500, capital gain of \$2,300 and trust corpus of \$2,200. The basis of the distributed property is \$4,500 in the hands of X.

(e) *Other distributions—(1) Character of distributions.* An amount distributed by the trust to an organization described in section 170(c) other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified in paragraph (d)(1)(i)(a) of this section in an order inverse to that prescribed in such paragraph. The character of such amount shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined.

(2) *Distributions in kind.* In the case of a distribution of an amount to which subparagraph (1) of this paragraph applies, no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed.

(f) *Effective date—(1) General rule.* The provisions of this section are effective with respect to transfers in trust made after July 31, 1969. Any trust created (within the meaning of applicable local law) prior to August 1, 1969, is not a charitable remainder trust even if it otherwise satisfies the definition of a charitable remainder trust.

(2) *Transfers to pre-1970 trusts.* Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c)

receives an irrevocable remainder interest in such trust, shall, for purposes of subparagraphs (1) and (3) of this paragraph, be deemed transferred to a trust created on the date of such transfer provided that the transfer occurs after July 31, 1969, and prior to October 18, 1971, and the transferred property and any undistributed income therefrom is severed and placed in a separate trust before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings begun before December 31, 1972, which are required to sever such property, become final.

(3) *Amendment of post-1969 trusts.* A trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, which is not a charitable remainder trust at the date of its creation, may be treated as a charitable remainder trust from the date it would be deemed created under § 1.664-1(a) (4) and (5)(i) for all purposes: *Provided*, That all the following requirements are met:

(i) At the time of the creation of the trust, the governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust.

(ii) The governing instrument of the trust is amended so that the trust will meet the definition of a charitable remainder trust and, if applicable, will meet the requirement of paragraph (a)(5)(i) of this section that obligation to make payment of the annuity or unitrust amount with respect to property passing at death begin as of the date of death, before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. In the case of a trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, the provisions of section 508(d)(2)(A) shall not apply if the governing instrument of the trust is amended so as to comply with the requirements of section 508(e) before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which

are begun before December 31, 1972, and which are required to amend its governing instrument, become final. Notwithstanding the provisions of paragraphs (a)(3) and (a)(4) of §§ 1.664-2 and 1.664-3, the governing instrument may grant to the trustee a power to amend the governing instrument for the sole purpose of complying with the requirements of this section and § 1.664-2 or § 1.664-3: *Provided*, That at the creation of the trust, the governing instrument (a) provides for the payment of a unitrust amount described in § 1.664-3(a)(1)(i) or an annuity which meets the requirements of paragraph (a)(2) of § 1.664-2 or § 1.664-3, (b) designates the recipients of the trust and the period for which the amount described in (a) of this subdivision (ii) is to be paid, and (c) provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust. The mere granting of such a power is not sufficient to meet the requirements of this subparagraph that the governing instrument be amended in the manner and within the time limitations of this subparagraph.

(iii)(a) Where the amount of the distributions which would have been made by the trust to a recipient if the amended provisions of such trust had been in effect from the time of creation of such trust exceeds the amount of the distributions made by the trust prior to its amendment, the trust pays an amount equal to such excess to the recipient.

(b) Where the amount of distributions made to the recipient prior to the amendment of the trust exceeds the amount of the distributions which would have been made by such trust if the amended provisions of such trust had been in effect from the time of creation of such trust, such excess is repaid to the trust by the recipient.

See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient. A deduction for a transfer to a charitable remainder trust shall not be allowed until the requirements of this paragraph are met and then only if the deduction is claimed on a

timely filed return (including extensions) or on a claim for refund filed within the period of limitations prescribed by section 6511(a).

(4) *Valuation of unmarketable assets.* The rules contained in paragraph (a)(7) of this section are applicable for trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit a valuation method that satisfies the requirements of paragraph (a)(7) of this section for taxable years beginning on or after December 10, 1998.

(g) *Transitional effective date.* Notwithstanding any other provision of this section, § 1.664-2 or § 1.664-3, the requirement of paragraph (a)(5)(i) of this section that interest accrue on overpayments and underpayments, the requirement of paragraph (a)(5)(ii) of this section that the unitrust amount accruing under the formula provided therein cease with the death of the last recipient, and the requirement that the governing instrument of the trust contain the provisions specified in paragraph (a)(1)(iv) of § 1.664-2 (relating to computation of the annuity amount in certain circumstances), paragraph (a)(1)(v) of § 1.664-3 (relating to computation of the unitrust amount in certain circumstances), paragraphs (b) of §§ 1.664-2 and 1.664-3 (relating to additional contributions), and paragraph (a)(1)(iii) of § 1.664-3 (relating to incorrect valuations), paragraphs (a)(6)(iv) of §§ 1.664-2 and 1.664-3 (relating to alternative remaindermen) shall not apply to:

(1) A will executed on or before December 31, 1972, if:

(i) The testator dies before December 31, 1975, without having republished the will after December 31, 1972, by codicil or otherwise.

(ii) The testator at no time after December 31, 1972, had the right to change the provisions of the will which pertain to the trust, or

(iii) The will is not republished by codicil or otherwise before December 31, 1975, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, or

(2) A trust executed on or before December 31, 1972, if:

(i) The grantor dies before December 31, 1975, without having amended the trust after December 31, 1972,

(ii) The trust is irrevocable on December 31, 1972, or

(iii) The trust is not amended before December 31, 1975, and the grantor is on such date and at all times thereafter under a mental disability to change the terms of the trust.

[T.D. 7202, 37 FR 16913, Aug. 23, 1972]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.664-1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

§ 1.664-2 Charitable remainder annuity trust.

(a) *Description.* A charitable remainder annuity trust is a trust which complies with the applicable provisions of § 1.664-1 and meets all of the following requirements:

(1) *Required payment of annuity amount—(i) Payment of sum certain at least annually.* The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section.

(a) *General rule applicable to all trusts.* A trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664-1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire annuity amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(I) The trust pays the annuity amount by distributing property (other