

(c) For the CPA certification, submit with the original submission, or within 30 days after the filing date for this form, a Letter or report (not applicable to respondents classified as Class C or Class D prior to January 1, 1984):

(i) Attesting to the conformity, in all material aspects, of the below listed (schedules and) pages with the Commission's applicable Uniform Systems of Accounts (including applicable notes relating thereto and the Chief Accountant's published accounting releases), and

(ii) Signed by independent certified public accountants or an independent Licensed public accountant certified or Licensed by a regulatory authority of a State or other political subdivision of the U.S. (See 18 CFR 41.10–41.12 for specific qualifications.)

Schedules	Reference pages
Comparative Balance Sheet .....	110–113
Statement of Income .....	114–117
Statement of Retained Earnings ..	118–119
Statement of Cash Flows .....	120–121
Notes to Financial Statements .....	122–123

When accompanying this form, insert the Letter or report immediately following the cover sheet. When submitting after the filing date for this form, send the letter or report to the office of the Secretary at the address indicated at III (a).

Use the following format for the Letter or report unless unusual circumstances or conditions, explained in the Letter or report, demand that it be varied. Insert parenthetical phrases only when exceptions are reported.

In connection with our regular examination of the financial statements of for the year ended on which we have reported separately under date of We have also reviewed schedules of FERC Form No. 1 for the year filed with the Federal Energy Regulatory Commission, for conformity in all material respects with the requirements of the Federal Energy Regulatory Commission as set forth in its applicable Uniform System of Accounts and published accounting releases. Our review for this purpose included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Based on our review, in our opinion the accompanying schedules identified in the preceding paragraph (except as noted below) conform in all material respects with the accounting requirements of the Federal Energy Regulatory Commission as set forth in its applicable Uniform System of Accounts and published accounting releases.

State in the letter or report, which, if any, of the pages above do not conform to the Commission's requirements. Describe the discrepancies that exist.

(d) Federal, State and Local Governments and other authorized users may obtain additional blank copies to meet their requirements free of charge from: Public Reference and Files Maintenance Branch, Federal Energy Regulatory Commission, 888 First Street, NE, Room 2A ES–1 Washington, DC 20426, (202) 208–2474.

#### IV. When To Submit

Submit this report form on or before April 30th of the year following the year covered by this report.

#### V. Where to Send Comments on Public Reporting Burden.

The public reporting burden for this collection of information is estimated to average 1,217 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any aspect of this collection of information, including suggestions for reducing this burden, to the Federal Energy Regulatory Commission, 888 First Street N.E., Washington, DC 20426 (Attention: Mr. Michael Miller, CI–1); and to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, DC 20503 (Attention: Desk Officer for the Federal Energy Regulatory Commission). No person shall be subject to any penalty if this collection of information does not display a valid control number. (44 U.S.C. 3512(a).)

I. Prepare this report in conformity with the Uniform System of Accounts (18 CFR 101) (U.S. of A.). Interpret all accounting words and phrases in accordance with the U. S. of A.

II. Enter in whole numbers (dollars or MWH) only, except where otherwise noted. (Enter cents for averages and figures per unit where cents are important. The truncating of cents is allowed except on the four basic financial statements where rounding is required.) The amounts shown on all supporting pages must agree with the amounts entered on the statements that they support. When applying thresholds to determine significance for reporting purposes, use for balance sheet accounts the balances at the end of the current reporting year, and use for statement of income accounts the current year's amounts.

III. Complete each question fully and accurately, even if it has been answered in a previous annual report. Enter the word "None" where it truly and completely states the fact.

IV. For any page(s) that is not applicable to the respondent, omit the page(s) and enter "NA," "NONE," or "Not Applicable" in column (d) on the List of Schedules, pages 2, 3, and 4.

V. Enter the month, day, and year for all dates. Use customary abbreviations. The "Date of Report" included in the header of each page is to be completed only for resubmissions (see VII. below). The date of the resubmission must be reported in the header for all form pages, whether or not they are changed from the previous filing.

VI. Generally, except for certain schedules, all numbers, whether they are expected to be debits or credits, must be reported as positive. Numbers having a sign that is different from the expected sign must be reported by enclosing the numbers in parentheses.

VII. For any resubmissions, submit the electronic filing using the Form 1 Submission Software and an original and six (6)

conformed paper copies of the entire form, as well as the appropriate number of copies of the subscription statement indicated at instruction III (a). Resubmissions must be numbered sequentially on the cover page of the paper copies of the form. In addition, the cover page of each paper copy must indicate that the filing is a resubmission. Send the resubmissions to the address indicated at instruction III (a).

VIII. Do not make references to reports of previous years or to other reports in lieu of required entries, except as specifically authorized.

IX. Wherever (schedule) pages refer to figures from a previous year, the figures reported must be based upon those shown by the annual report of the previous year, or an appropriate explanation given as to why the different figures were used.

#### Definitions

I. Commission Authorization (Comm. Auth.)—The authorization of the Federal Energy Regulatory Commission, or any other Commission. Name the commission whose authorization was obtained and give date of the authorization.

II. Respondent—The person, corporation, licensee, agency, authority, or other Legal entity or instrumentality in whose behalf the report is made.

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 8849]

RIN 1545–AW57

#### Section 663(c); Separate Share Rules Applicable to Estates

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations concerning separate share rules applicable to estates under section 663(c) of the Internal Revenue Code. These regulations provide that substantively separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing distributable net income and applying the distribution provisions of sections 661 and 662. These regulations also provide that a surviving spouse's statutory elective share of a decedent's estate and a pecuniary formula bequest are separate shares. Further, a revocable trust that elects to be treated as part of a decedent's estate is a separate share.

**DATES:** *Effective Date:* December 28, 1999.

*Applicability Dates:* For dates of applicability of these regulations, see § 1.663(c)–6.

**FOR FURTHER INFORMATION CONTACT:** Laura Howell, (202) 622–3060 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

On January 6, 1999, a notice of proposed rulemaking was published in the **Federal Register** (64 FR 790) relating to the application of the separate share rules to estates under section 663(c). Written comments were received on the proposed regulations, and a public hearing was held on April 22, 1999. After consideration of all the comments, the proposed regulations under section 663(c) are adopted as revised by this Treasury decision.

**Explanation of Provisions**

*General Separate Share Rules*

The proposed regulations define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries (for example, rights to income or gains from specified items of property) are not affected by economic interests accruing to another beneficiary or class of beneficiaries. The proposed regulations conclude that there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has.

Two commentators suggested a narrower definition of a separate share. One commentator suggested that separate shares exist only when the estate is administered as two or more well-defined shares that could be separate estates. Another commentator suggested that separate share treatment should apply only where the existence of separate shares is clear and the funding thereof does not require burdensome adjustments due to disproportionate distributions.

Generally, the final regulations clarify the definition and narrow the application of the separate share rules that are in the proposed regulations. The final regulations generally define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by economic interests accruing to another beneficiary or class of beneficiaries. The final regulations add “nor are affected

by” to clarify the definition of a separate share. Under this revised definition, a separate share generally exists only if it includes both corpus and the income attributable thereto and is independent from any other share. Thus, income earned on assets in one share (first share) and appreciation and depreciation in the value of those assets have no effect on any other share. Similarly, the income and changes in value of any other share have no effect on the first share.

*Effect on Section 663(a)(1)*

The proposed regulations provide that the separate share rules do not change the rules involving bequests of specific sums of money or specific property described in section 663(a)(1).

Commentators asked for clarification concerning whether the separate share rules apply to bequests described in section 663(a)(1). One commentator recommended that separate share treatment should apply to these bequests. Another commentator suggested that while revising § 1.663(c) to apply to estates, the IRS and the Treasury Department should reconsider and amend § 1.663(a)–1(b)(1) to permit principal distributions that are made to fund both pecuniary formula bequests and surviving spouses' elective shares to be recognized as coming within the definition of excluded gifts or bequests described in section 663(a)(1).

The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.

*Surviving Spouse's Elective Share*

The proposed regulations provide that a surviving spouse's statutory elective share constitutes a separate share of an estate. As a result, the surviving spouse may be taxed on the estate's gross income only to the extent of the surviving spouse's share of that income under state law.

One commentator recommended that separate share treatment for a surviving spouse's elective share should be reconsidered. Elective shares should be a matter of further study because they are forced by state law, differ from state to state, and usually are part of an acrimonious conflict. Another commentator requested clarification of whether a surviving spouse's statutory

elective share is included in the subchapter J estate. Further, this commentator recommended that an elective share that is not entitled to income or appreciation should be excluded from the subchapter J estate, but an elective share that is entitled to income and appreciation should be included in the subchapter J estate.

Conversely, other commentators agreed that separate share treatment should apply to a surviving spouse's statutory elective share regardless of whether the surviving spouse is entitled to income and shares in appreciation or depreciation. One commentator suggested that the separate share examples in the proposed regulations be revised to track more closely the Uniform Probate Code model because it will likely be adopted by most states.

These final regulations do not change the result of the proposed regulations. However, under these final regulations, a surviving spouse's elective share that under local law is entitled to income and to share in appreciation or depreciation constitutes a separate share under the general definition. Further, under a special rule in the final regulations, a surviving spouse's elective share that is not entitled to income or does not share in appreciation or depreciation is also a separate share.

*Revocable Trust as a Part of Estate*

The proposed regulations provide that a qualified revocable trust that elects under section 645 to be treated as part of the decedent's estate for income tax purposes constitutes a separate share. In response to comments, these final regulations include a reference that the electing revocable trust itself may have two or more separate shares. These final regulations further provide that qualified revocable trusts within the definition of section 645(b)(1) are subject to the separate share rules applicable to estates rather than trusts whether or not an election is made to be part of the estate.

*Pecuniary Formula Bequests*

The preamble to the proposed regulations requests comments concerning the treatment of pecuniary formula bequests as separate shares. Several commentators, noting that pecuniary formula bequests are similar to a surviving spouse's statutory elective share, suggested that such bequests be treated as separate shares. Commentators disagreed, however, on whether pecuniary formula bequests not entitled to income should be separate shares.

Under these final regulations, any pecuniary formula bequest that is entitled to income and to share in appreciation or depreciation under the governing instrument or local law constitutes a separate share under the general definition. Further, under a special rule, a pecuniary formula bequest that is not entitled to income or to share in appreciation or depreciation is also a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments. This provision regarding three or fewer installments parallels the specific bequest requirements in section 663(a)(1).

#### *Administrative Rules*

Commentators requested guidance concerning several administrative matters. Commentators asked for guidance concerning when separate shares come into existence. The final regulations provide that separate shares come into existence at the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate share exists.

Two commentators expressed concern about the need to readjust the separate shares as a result of an IRS examination. One commentator suggested that separate share treatment should apply to pecuniary formula bequests only if no amended returns and no adjustments to any tax periods would be required when the tax returns were filed in good faith. Another commentator recommended that separate share treatment should not apply to residuary bequests unless or until the regulations provide simple and practical methods of compliance for possible adjustments made during IRS examinations.

These final regulations do not adopt either suggestion. The regulations provide that the fiduciary must use a reasonable and equitable method to determine the value of each separate share and the allocation of taxable income to each share. This approach gives the fiduciary flexibility, within limits, in applying the separate share rules. However, redeterminations in value of those separate shares must be taken into account.

Commentators asked for a clarification of whether gross income of an estate must be allocated to a separate share based upon the amount of income each share is entitled to under the terms of the governing instrument or applicable local law. These final regulations clarify that, in computing the distributable net income for each separate share, the portion of gross income that is income within the meaning of section 643(b) must be

allocated to each share based upon the amount of income each share is entitled to under the terms of the governing instrument or applicable local law. A similar allocation rule is provided for the amount of gross income that is not attributable to cash received by a trust or estate, such as a distributive share of a partnership's tax items, or the pro rata share of an S corporation's tax items.

Commentators asked whether the general rule for allocating gross income is applicable for income in respect of a decedent under section 691(a). These final regulations clarify that such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether a share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount allocated to each share is based upon the relative value of each of those shares that could potentially be funded with such amounts.

One commentator requested clarification concerning the allocation of expenses to a separate share. These final regulations do not change the long standing rule under § 1.663(c)-2 of the Income Tax Regulations that any expense which is applicable solely to one separate share of a trust is not available as a deduction to any other share of the same trust. The IRS and the Treasury Department are not aware of any issues that have arisen in applying this rule.

#### *Interest on Pecuniary Bequests or Delayed Estate Distributions*

Commentators questioned why the proposed regulations take the position that interest, imposed by state law, on a pecuniary bequest or a delayed estate distribution is a payment of interest by the estate and not a distribution for purposes of sections 661 and 662. These same commentators indicated that alternatively such interest payments should be deductible administrative expenses if the interest was required to be paid by state law as part of the distribution and settlement of the estate. The final regulations retain the position taken in the proposed regulations because the IRS and the Treasury Department view this result as compelled by section 163(h) which disallows a deduction for personal interest as described in section 163(h)(2).

#### *Requests Concerning Applicable Dates*

One commentator suggested that either the applicable date of these final regulations should be retroactive to the date that section 1307 of the Tax Reform Act of 1997 became applicable, or the

regulations should provide that during the interim period before final regulations are published, the IRS will accept any reasonable interpretation of the separate share rules, including those rules provided in the proposed regulations.

Another commentator requested that the final regulations, to the extent applicable to trusts, apply prospectively and apply either only to trusts that become irrevocable after the date the regulations are finalized or only to taxable years of trusts beginning after the date the regulations are finalized.

The final regulations have taken these comments into account as noted below.

#### **Effective Dates**

These final regulations are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die 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)). For trusts other than qualified revocable trusts, § 1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.

#### **Effect on Other Documents**

The following publications are obsolete as of December 28, 1999: Rev. Rul. 64-101 (1964-1 C.B. 77). Rev. Rul. 71-167 (1971-1 C.B. 163).

#### **Special Analyses**

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these final regulations do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information. The principal author of these regulations is Laura Howell of the Office of Assistant Chief Counsel (Passthroughs and Special

Industries). However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and Recordkeeping requirements.

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Sections 1.663(c)–1, 1.663(c)–2, 1.663(c)–3, 1.663(c)–4, 1.663(c)–5, and 1.663(c)–6 also issued under 26 U.S.C. 663(c). \* \* \*

**Par. 2.** In § 1.663(a)–1, paragraph (b)(3) is amended by revising *Example 1*, *Example 2*, and *Example 3* to read as follows:

#### § 1.663(a)–1 Special rules applicable to sections 661 and 662; exclusion; gifts, bequests, etc.

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

*Example 1.* Under the terms of a will, a legacy of \$5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of \$25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of \$5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under section 663(a)(1).

*Example 2.* Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of \$50,000 for the taxable year. The estate distributed to A stock with a basis of \$40,000 and with a fair market value of \$40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property (\$40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see § 1.661(a)–2(c)).

*Example 3.* Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During

the eleventh year, the trustee is to distribute \$10,000 to B, payable from income or corpus, and \$10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

\* \* \* \* \*

**Par. 3.** Section 1.663(c)–1 is amended as follows:

1. The section heading is revised.

2. Paragraph (a) is amended by revising the words “trust” and “trusts” to read “trust (or estate)” and “trusts (or estates)”, respectively, in the first through fourth sentences.

3. Paragraph (b)(2) is removed and paragraphs (b)(3) and (b)(4) are redesignated as paragraphs (b)(2) and (b)(3), respectively.

4. Paragraphs (b) through (d) are amended by revising the words “trust” and “trusts” to read “trust (or estate)” and “trusts (or estates)”, respectively.

The revision reads as follows:

#### § 1.663(c)–1 Separate shares treated as separate trusts or as separate estates; in general.

\* \* \* \* \*

**Par. 4.** Section 1.663(c)–2, is revised to read as follows:

#### § 1.663(c)–2 Rules of administration.

(a) *When separate shares come into existence.* A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

(b) *Computation of distributable net income for each separate share—(1) General rule.* The amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

(2) *Section 643(b) income.* This paragraph (b)(2) governs the allocation of the portion of gross income includible in distributable net income that is income within the meaning of section 643(b). Such gross income is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

(3) *Income in respect of a decedent.* This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent

within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

(4) *Gross income not attributable to cash.* This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as section 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.

(5) *Deductions and losses.* Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate.

(c) *Computations and valuations.* For purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section.

**Par. 5.** Section 1.663(c)–3 is amended by revising the section heading and the first sentence of paragraph (a), and removing paragraph (f) to read as follows:

#### § 1.663(c)–3 Applicability of separate share rule to certain trusts.

(a) The applicability of the separate share rule provided by section 663(c) to trusts other than qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created.

\* \* \* \* \*

#### § 1.663(c)–4 [Redesignated as § 1.663(c)–5]

**Par. 6.** Section 1.663(c)–4 is redesignated as § 1.663(c)–5.

**Par. 7.** A new § 1.663(c)–4 is added to read as follows:

**§ 1.663(c)-4 Applicability of separate share rule to estates and qualified revocable trusts.**

(a) *General rule.* The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

(b) *Special rule for certain types of beneficial interests.* Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

(c) *Shares with multiple beneficiaries and beneficiaries of multiple shares.* A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.

**Par. 8.** Newly designated § 1.663(c)-5 is amended by:

1. Revising the section heading and introductory text.

2. Redesignating the *Example* as *Example 1* and, in newly designated *Example 1*, redesignating paragraphs (a) through (e) as paragraphs (i) through (v), respectively.

3. Adding *Example 2, Example 3, Example 4, Example 5, Example 6, Example 7, Example 8, Example 9, Example 10, and Example 11.*

The revisions and additions read as follows:

**§ 1.663(c)-5 Examples.**

Section 663(c) may be illustrated by the following examples:

*Example 1. \* \* \**

*Example 2 (i) Facts.* Testator, who dies in 2000, is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the executor makes a partial proportionate distribution of \$1,000,000, (\$600,000 to the surviving spouse and \$400,000 to the children's trust) and makes no other distributions. The estate receives dividend income of \$20,000, and pays expenses of \$8,000 that are deductible on the estate's federal income tax return.

(ii) *Conclusion.* The fractional formula bequests to the surviving spouse and to the children's trust are separate shares. Because Testator's will provides for fractional formula residuary bequests, the income and any appreciation in the value of the estate assets are proportionately allocated between the marital share and the trust's share. Therefore, in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share. The distributable net income is \$7,200 (60% of income less 60% of expenses) for the marital share and \$4,800 (40% of income less 40% of expenses) for the trust's share. Because the amount distributed in partial satisfaction of each bequest exceeds the distributable net income of each share, the estate's distribution deduction under section 661 is limited to the sum of the distributable net income for both shares. The estate is allowed a distribution deduction of \$12,000 (\$7,200 for the marital share and \$4,800 for the trust's share). As a result, the estate has zero taxable income (\$20,000 income less \$8,000 expenses and \$12,000 distribution deduction). Under section 662, the surviving spouse and the trust must include in gross income \$7,200 and \$4,800, respectively.

*Example 3.* The facts are the same as in *Example 2*, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no

longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

*Example 4 (i) Facts.* Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child in the amount needed to reduce the estate taxes to zero and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of \$200,000 and pays expenses of \$15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of \$350,000 and a fair market value of \$380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of \$30,000.

(ii) *Conclusion.* The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the \$380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is \$214,400 (\$200,000 (dividend income) plus \$30,000 (capital gain) minus \$15,000 (expenses) and minus \$600 (personal exemption)).

*Example 5.* The facts are the same as in *Example 4*, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the \$380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

*Example 6.* The facts are the same as in *Example 4*, except that during 2000 the estate receives a distribution of \$900,000 from the

decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire \$900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the \$900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the \$900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

**Example 7 (i) Facts.** Testator, who dies in 2000, is survived by a spouse and three adult children. Testator's will divides the residue of the estate equally among the three children. The surviving spouse files an election under the applicable state's elective share statute. Under this statute, a surviving spouse is entitled to one-third of the decedent's estate after the payment of debts and expenses. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. However, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the payment until the executor actually makes payment. During the estate's 2001 taxable year, the estate distributes to the surviving spouse \$5,000,000 in partial satisfaction of the elective share and pays \$200,000 of interest on the delayed payment of the elective share. During that year, the estate receives dividend income of \$3,000,000 and pays expenses of \$60,000 that are deductible on the estate's federal income tax return.

**(ii) Conclusion.** The estate has four separate shares consisting of the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state law, none of the estate's gross income is allocated to the spouse's separate share for purposes of determining that share's distributable net income. Therefore, with respect to the \$5,000,000 distribution, the estate is allowed no deduction under section 661, and no amount is included in the spouse's gross income under section 662. The \$200,000 of interest paid to the spouse must be included in the spouse's gross income under section 61. Because no distributions were made to any other beneficiaries during the year, there is no need to compute the distributable net income of the other three separate shares. Thus, the taxable income of the estate for the 2000 taxable year is \$2,939,400 (\$3,000,000 (dividend income) minus \$60,000 (expenses) and \$600 (personal exemption)). The estate's \$200,000 interest payment is a nondeductible personal interest expense described in section 163(h).

**Example 8.** The will of Testator, who dies in 2000, directs the executor to distribute the

X stock and all dividends therefrom to child A and the residue of the estate to child B. The estate has two separate shares consisting of the income on the X stock bequeathed to A and the residue of the estate bequeathed to B. The bequest of the X stock meets the definition of section 663(a)(1) and therefore is not a separate share. If any distributions, other than shares of the X stock, are made during the year to either A or B, then for purposes of determining the distributable net income for the separate shares, gross income attributable to dividends on the X stock must be allocated to A's separate share and any other income must be allocated to B's separate share.

**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 income 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.

**Par. 9.** Section 1.663(c)–6 is added to read as follows:

**§ 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 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.

**Robert E. Wenzel,**

*Deputy Commissioner of Internal Revenue.*

Approved: December 13, 1999.

**Jonathan Talisman,**

*Acting Assistant Secretary for the Treasury.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Parts 1 and 602

[TD 8850]

RIN 1545–AV69

#### Information Reporting With Respect to Certain Foreign Partnerships and Certain Foreign Corporations

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations under section 6038 of the Internal Revenue Code relating to information reporting requirements for United States persons owning interests in controlled foreign partnerships (CFPs). This document also contains