policyholder (or certificate holder), the insured, or the insurance company;

(B) A substitution of the insured under an individual contract; or

(C) A change (other than an immaterial change) in the contractual terms, or in the plan under which the contract was issued, relating to eligibility for membership in the group covered under a group contract.

(ii) *Exceptions.* For purposes of this paragraph (b)(4), the following changes are not treated as the issuance of a new contract—

(A) A policyholder's exercise of any right provided under the terms of the contract as in effect on December 31, 1996, or a right required by applicable State law to be provided to the policyholder;

(B) A change in the mode of premium payment (for example, a change from monthly to quarterly premiums);

(C) In the case of a policy that is guaranteed renewable or noncancellable, a classwide increase or decrease in premiums;

(D) A reduction in premiums due to the purchase of a long-term care insurance contract by a family member of the policyholder;

(E) A reduction in coverage (with a corresponding reduction in premiums) made at the request of a policyholder;

(F) A reduction in premiums as a result of extending to an individual policyholder a discount applicable to similar categories of individuals pursuant to a premium rate structure that was in effect on December 31, 1996, for the issuer's pre-1997 long-term care insurance contracts of the same type;

(G) The addition, without an increase in premiums, of alternative forms of benefits that may be selected by the policyholder;

(H) The addition of a rider (including any similarly identifiable amendment) to a pre-1997 long-term care insurance contract in any case in which the rider, if issued as a separate contract of insurance, would itself be a qualified long-term care insurance contract under section 7702B and any regulations issued thereunder (including the consumer protection provisions in section 7702B(g) to the extent applicable to the addition of a rider);

(I) The deletion of a rider or provision of a contract that prohibited coordination of benefits with Medicare (often referred to as an HHS (Health and Human Services) rider);

(J) The effectuation of a continuation or conversion of coverage right that is provided under a pre-1997 group contract and that, in accordance with the terms of the contract as in effect on December 31, 1996, provides for coverage under an individual contract following an individual's ineligibility for continued coverage under the group contract; and

(K) The substitution of one insurer for another insurer in an assumption reinsurance transaction.

(5) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. (i) On December 3, 1996, A, an individual, submits a signed application to an insurance company to purchase a nursing home contract that meets the long-term care insurance requirements of the State in which the contract is sitused. The insurance company decides on December 20, 1996, that it will issue the contract, and assigns December 20, 1996, as the issue date for the contract. Under the terms of the contract, A's insurance coverage becomes effective on January 1, 1997. The company delivers the contract to A on January 3, 1997. A has the right to return the contract within 15 days following delivery for a refund of all premiums paid.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is December 20, 1996. Thus, the contract is a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

Example 2. (i) The facts are the same as in *Example 1,* except that the insurance coverage under the contract does not become effective until March 1, 1997. Under the insurance company's usual business practice, the period between the date of the application and the date the contract becomes effective is 30 days or less.

(ii) Under paragraph (b)(3)(i) of this section, the issue date of the contract is March 1, 1997. Thus, the contract is not a pre-1997 long-term care insurance contract, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder to be a qualified long-term care insurance contract.

Example 3. (i) B, an individual, is the policyholder under a long-term care insurance contract purchased in 1995. On June 15, 2000, the insurance coverage and premiums under the contract are increased by agreement between B and the insurance company.

(ii) Under paragraph (b)(4)(i)(A) of this section, a change in the terms of a contract that alters the amount or timing of an item payable by the policyholder or the insurance company is treated as the issuance of a new contract. Thus, B's coverage is treated as coverage under a contract issued on June 15, 2000, and, accordingly, the contract must meet the requirements of section 7702B(b) and any regulations issued thereunder in order to be a qualified long-term care insurance contract.

Example 4. (i) C, an individual, is the policyholder under a long-term care insurance contract purchased in 1994. At that time and through December 31, 1996, the contract met the long-term care insurance requirements of the State in which the contract was sitused. In 1996, the policy was amended to add a provision requiring the policyholder to be offered the right to increase dollar limits for inflation every three years (without the policyholder being required to pass a physical or satisfy any other underwriting requirements). During 2002, C elects to increase the amount of insurance coverage (with a resulting premium increase) pursuant to the inflation provision.

(ii) Under paragraph (b)(4)(ii)(A) of this section, an increase in the amount of insurance coverage at the election of the policyholder (without the insurance company's consent and without underwriting or other limitations on the policyholder's rights) pursuant to a pre-1997 inflation provision is not treated as the issuance of a new contract. Thus, C's contract continues to be a pre-1997 long-term care insurance contract that is treated as a qualified long-term care insurance contract.

(c) *Effective date.* This section is applicable January 1, 1999.

David A. Mader,

Acting Deputy Commissioner of Internal Revenue.

Approved: November 24, 1998.

Donald C. Lubick,

Assistant Secretary of the Treasury.

[FR Doc. 98-32759 Filed 12-9-98; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 25, and 602

[TD 8791]

RIN 1545-AU25 REG-209[illegible]

Guidance Regarding Charitable Remainder Trusts and Special Valuation Rules for Transfers of Interests in Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to charitable remainder trusts and to special valuation rules for transfers of interests in trusts. The final regulations provide additional guidance regarding charitable remainder trusts. The final regulations affect charitable remainder trusts and their beneficiaries.

DATES: *Effective date:* These regulations are effective December 10, 1998.

Applicability dates: For dates of applicability of these regulations, see the explanations under **SUPPLEMENTARY INFORMATION.**

FOR FURTHER INFORMATION CONTACT: Mary Beth Collins or Jeff Erickson, (202) 622-3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1536. Responses to this collection of information are required to allow taxpayers alternative means of valuing a charitable remainder trust's unmarketable assets.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .25 to .75 hours, depending on individual circumstances, with an estimated average of .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On April 18, 1997, the IRS published in the **Federal Register** (62 FR 19072) a notice of proposed rulemaking (REG–209823–96) regarding sections 664 and 2702. Comments responding to the proposed regulations were received, and a public hearing was held on November 18, 1997. After considering the comments received and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

This document amends 26 CFR parts 1 and 25 to provide additional rules under sections 664 and 2702. Section 664 contains the rules for charitable remainder trusts (CRTs). In general, a CRT provides for a specified periodic distribution to one or more beneficiaries (at least one of whom is a noncharitable beneficiary) for life or for a term of years with an irrevocable remainder interest held for the benefit of charity.

There are two types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). A CRAT pays a sum certain at least annually to the beneficiaries (the annuity amount). A CRUT pays a unitrust amount at least annually to the beneficiaries. Generally, the unitrust amount is a fixed percentage of the net fair market value of the CRUT's assets valued annually (fixed percentage CRUT). The unitrust amount can instead be calculated under one of two income exception methods (income exception CRUT). Under the first method, the unitrust amount is the lesser of the fixed percentage amount or the trust's annual net income (net income method). Under the second method, the unitrust amount is determined under the net income method plus any amount of income that exceeds the current year's fixed percentage amount to make up for any shortfall in payments from prior years when the trust income was less than the fixed percentage amount (NIMCRUT method). The shortfall in payments from prior years is commonly referred to as the "make-up amount."

The revisions to the proposed regulations are discussed below.

I. Flip Unitrusts

A. Triggering Events

The proposed regulations provide specific rules for when a trust may convert from one of the income exception methods of computing the unitrust amount to the fixed percentage method (flip unitrust). The proposed rule was designed for taxpayers who ultimately wanted the unitrust amount to be computed on the fixed percentage method but funded the trust with unmarketable assets that generate little annual income. A number of commentators agreed with the policy underlying the proposed rule. Some commentators requested that we permit flip unitrusts for all income exception CRUTs regardless of the marketability of the trust assets. Other commentators suggested that the final regulations clarify whether the proposed rule was a safe harbor or the exclusive circumstance for which a flip unitrust would be permitted.

In response, the final regulations expand the availability of the flip unitrust to certain other situations that the IRS and Treasury believe are consistent with the legislative history indicating that a trustee should not have discretion to change the method used to calculate the unitrust amount. H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 296 (1969), 1969–3 C.B. 644, 655.

The final regulations allow the governing instrument of a CRUT to provide that the CRUT will convert once from one of the income exception methods to the fixed percentage method for calculating the unitrust amount if the date or event triggering the conversion is outside the control of the trustees or any other persons. The final regulations include examples of permissible and impermissible triggering events. For example, permissible triggering events with respect to any individual include marriage, divorce, death, or birth of a child. Also, the sale of an unmarketable asset such as real estate is a permissible triggering event. Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient's financial advisor that the trust convert to the fixed percentage method.

The final regulations also provide that the conversion to the fixed percentage method occurs at the beginning of the taxable year that immediately follows the taxable year in which the triggering date or event occurs. Any make-up amount described in section 664(d)(3)(B) is forfeited when the trust converts to the fixed percentage method.

The proposed regulations define unmarketable assets as assets other than cash, cash equivalents, or marketable securities (within the meaning of section 731(c)). Commentators asked for clarification of the term *unmarketable assets* and recommended changing the scope of this class of assets. In response, the final regulations define unmarketable assets as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale.

Commentators requested that the final regulations permit conversions from the fixed percentage method to one of the income exception methods and conversions from a CRAT to a CRUT. The flip unitrust allowed in the final regulations is the only type of permissible conversion. Thus, a CRAT cannot convert to a CRUT without losing its status as a CRT. Similarly, a CRUT using the fixed percentage method cannot convert to an income exception method without losing its status as a CRT.

B. Effective Date and Transitional Rules

The rules for flip unitrusts are effective for CRUTs created on or after December 10, 1998. The proposed regulations allowed reformations in limited circumstances. In response to comments, the final regulations expand the circumstances in which reformation is available. The final regulations allow income exception CRUTs to be reformed to add provisions allowing a conversion to the fixed percentage method provided the triggering event does not occur in a year prior to the year in which the court issues the order reforming the trust. Adding the conversion provisions will not cause the CRUT to fail to function exclusively as a CRT and will not be an act of self-dealing under section 4941 if the trustee initiates legal proceedings to reform the trust by June 8, 1999.

II. Time for Paying the Annuity Amount or the Unitrust Amount

The proposed regulations provide that the payment of the annuity amount or the unitrust amount determined under the fixed percentage method must be made by the close of the taxable year in which it is due. The rules were proposed in response to abuses associated with the use of accelerated CRTs described in Notice 94-78 (1994-2 C.B. 555). After receiving a significant number of comments on the proposed rules, the IRS issued Notice 97-68 (1997-48 I.R.B. 11), which provided guidance on complying with the proposed rules for the 1997 taxable year.

One commentator recommended applying the proposed rules only to trusts created after the date the final regulations are published. Another commentator suggested adopting the rules in Notice 97-68 for all trusts created after a certain date. Although recent legislative changes have reduced the potential tax benefits of accelerated CRTs, the IRS and Treasury continue to be concerned about the potential abuse of the post-year-end grace period to produce a tax-free return of appreciation in the assets contributed to a CRAT or a fixed percentage CRUT. Therefore, the final regulations adopt rules similar to those in Notice 97-68 with certain modifications. The rules are effective for taxable years ending after April 18, 1997.

For CRATs and fixed percentage CRUTs, the annuity or unitrust amount may be paid within a reasonable time after the close of the year for which it is due if (a) the character of the annuity or unitrust amount in the recipient's hands is income under section 664(b)(1), (2), or (3); and/or (b) the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects on Form 5227, "Split-Interest Trust Information Return," to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. In addition, for CRATs and fixed percentage CRUTs that were created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the annuity or unitrust amount is 15 percent or less.

III. Appraising Unmarketable Assets

Under section 664(d)(2)(A), a CRUT must value its assets annually. The proposed regulations provide that, if a CRT holds unmarketable assets and the only trustee is the grantor, a noncharitable beneficiary, or a related or subordinate party to the grantor or the noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations, the trustee must value those assets using a *current qualified appraisal*, as defined in § 1.170A-13(c)(3), from a *qualified appraiser*, as defined in § 1.170A-13(c)(5).

The final regulations follow the proposed regulations and provide that the trust's unmarketable assets must be valued by an independent trustee, or by a qualified appraisal from a qualified appraiser. The proposed regulations define an independent trustee as a person who is not the grantor, a noncharitable beneficiary or a related or subordinate party to the grantor, or the noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations. The final regulations add the grantor's spouse to the list of persons to whom an independent trustee cannot be related or subordinate. A co-trustee who is an independent trustee may value the trust's unmarketable assets.

Finally, in response to comments, the final regulations define unmarketable assets as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale.

The rules for valuing unmarketable assets are effective for trusts created on or after December 10, 1998.

IV. Application of Section 2702 to Certain CRUTs

Under the proposed regulations, unitrust interests in an income exception CRUT that are retained by the donor or any applicable family member will be valued at zero when a noncharitable beneficiary of the trust is someone other than (1) the donor, (2) the donor's U.S. citizen spouse, or (3) both the donor and the donor's U.S. citizen spouse. Commentators stated that income exception CRUTs without a make-up provision should be exempt from section 2702. The IRS and Treasury believe that, in addition to the NIMCRUT method, the net income method can be used to circumvent the intent of section 2702. Therefore, the final regulations do not exempt from section 2702 CRUTs that use only the net income method.

Commentators also stated that the proposed rule encompassed other transfers that section 2702 was not intended to include. A commentator noted that the proposed rule would value a transferor's interest at zero even though the transferor merely retained a secondary life estate. The final regulations clarify that section 2702 will not apply when there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests.

Commentators also asked whether section 2702 may apply to flip unitrusts. The potential abuse associated with income exception CRUTs also exists with flip unitrusts. Therefore, under the final regulations, section 2702 applies to a flip unitrust if the CRUT does not fall within one of the exemptions.

V. Prohibition on Allocating Precontribution Gain to Trust Income and Make-up Amount as a Liability

The proposed regulations clarify that the proceeds from the sale of an income exception CRUT's assets, at least to the extent of the fair market value of the assets when contributed to the trust, must be allocated to trust principal. Some commentators stated that the rule is inconsistent with the rule concerning income under section 643(b). Other commentators questioned whether the make-up amount under the NIMCRUT method should be treated as a liability when valuing the trust's assets.

The final regulations maintain the prohibition on allocating precontribution gain to trust income for an income exception CRUT. However, the governing instrument, if permitted under applicable local law, may allow the allocation of post-contribution capital gains to trust income. Taxpayers do not have to treat the make-up amount as a liability when valuing the assets of a NIMCRUT.

VI. Example Illustrating Rule for Characterizing Distributions From CRUTs

The proposed regulations contain an example of how the ordering rule under section 664(b) operates when the unitrust amount is computed under an income exception method. No comments were received on this example. Thus, the final regulations adopt the example without any changes.

Effect on Other Documents

Notice 97-68 (1997-48 I.R.B. 11) is obsolete as of December 10, 1998.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 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 the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), 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 authors of these regulations are Mary Beth Collins and Jeff Erickson, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from offices of the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, CFR parts 1, 25, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. In § 1.664-1, paragraphs (a)(7) and (d)(1)(iii) are added and paragraph (f)(4) is added following the concluding text of paragraph (f)(3) to read as follows:

§ 1.664-1 Charitable remainder trusts.

(a) * * *

(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).

* * * * *

(d) * * * (1) * * *

(iii) *Example.* The following example illustrates the application of this paragraph (d)(1):

Example. (i) *X* is a charitable remainder unitrust described in section 664(d)(2) and (3). The annual unitrust amount is the lesser of the amount of trust income, as defined in § 1.664-3(a)(1)(i)(*b*), or six percent of the net fair market value of the trust assets valued annually. The net fair market value of the trust assets on the valuation date in 1996 is $150,000. During 1996, *X* has $7,500 of income after allocating all expenses. All of *X*'s income for 1996 is tax-exempt income. At the end of 1996, *X*'s ordinary income for the current taxable year and undistributed ordinary income for prior years are both zero; *X*'s capital gain for the current taxable year is zero and undistributed capital gain for prior years is $30,000; and *X*'s tax-exempt income for the current year is $7,500 and undistributed tax-exempt income for prior years is $2,500.

(ii) Because the trust income of $7,500 is less than the fixed percentage amount of $9,000, the unitrust amount for 1996 is $7,500. The character of that amount in the hands of the recipient of the unitrust amount is determined under section 664(b). Because the unitrust amount is less than *X*'s undistributed capital gain income, the recipient of the unitrust amount treats the distribution of $7,500 as capital gain. At the beginning of 1997, *X*'s undistributed capital gain for prior years is reduced to $22,500, and *X*'s undistributed tax-exempt income is increased to $10,000.

* * * * *

(f) * * *

(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.

* * * * *

Par. 3. In § 1.664-2, paragraph (a)(1)(i) is revised to read as follows:

§ 1.664-2 Charitable remainder annuity trust.

(a) * * *

(1) * * * (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—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the annuity amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due.

(*b*) *Special rule for trusts created before* December 10, 1998. In addition to the circumstances described in paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998 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 sum certain to be paid each year as the annuity amount is 15 percent or less of the initial net fair market value of the property irrevocably passing in trust as determined for federal tax purposes.

(*c*) *Reasonable time.* For this paragraph (a)(1)(i), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, "Split-Interest Trust Information Return," (including extensions) for the taxable year.

(*d*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(*a*) of this section:

Example. X is a charitable remainder annuity trust described in section 664(d)(1) that was created after December 10, 1998. The prorated annuity amount payable from *X* for Year 1 is $100. The trustee does not pay the annuity amount to the recipient by the close of Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the recipient of the annuity a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 annuity amount due for Year 1. The trust owned the asset at the end of Year 1. Under § 1.664-1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under § 1.664-1(d)(1), the character of the annuity amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(a) of this section.

(*e*) *Effective date.* This paragraph (a)(1)(i) is applicable for taxable years ending after April 18, 1997.

* * * * *

Par. 4. Section 1.664-3 is amended as follows:

1. Paragraphs (a)(1)(i)(*a*), (a)(1)(i)(*b*)(*1*), and (a)(1)(i)(*b*)(*2*) are revised.

2. Paragraphs (a)(1)(i)(*b*)(*3*), (a)(1)(i)(*b*)(*4*), (a)(1)(i)(*b*)(*5*), and (a)(1)(i)(*c*) through (a)(1)(i)(*f*) are added.

3. The third sentence of paragraph (a)(1)(iv) is revised.

The added and revised provisions read as follows:

§ 1.664-3 Charitable remainder unitrust.

(a) * * *

(1) * * * (i) * * * (*a*) *General rule.* The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined 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. This paragraph (a)(1)(i)(*a*) is applicable for taxable years ending after April 18, 1997.

(*b*) * * *

(*1*) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section.

(*2*) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(*b*)(*1*) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(*3*) For this paragraph (a)(1)(i)(*b*), trust income means income as defined under section 643(b) and the applicable regulations.

(*4*) For this paragraph (a)(1)(i)(*b*), proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution.

(*5*) The rules in paragraphs (a)(1)(i)(*b*)(*1*), (*2*), and (*3*) of this section are applicable for taxable years ending after April 18, 1997, and the rule in paragraph (a)(1)(i)(*b*)(*4*) is applicable for sales or exchanges that occur after April 18, 1997.

(*c*) *Combination of methods.* Instead of the amount described in paragraph (a)(1)(i)(*a*) or (*b*) of this section, the governing instrument may provide that the trust will pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust only if the governing instrument provides that—

(*1*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) to the method prescribed in paragraph (a)(1)(i)(*a*) is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons;

(*2*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section occurs at the beginning of the taxable year that immediately follows the taxable year during which the date or event specified under paragraph (a)(1)(i)(*c*)(*1*) of this section occurs; and

(*3*) Following the trust's conversion to the method described in paragraph (a)(1)(i)(*a*) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(*a*) of this section and not any amount described in paragraph (a)(1)(i)(*b*) of this section.

(*d*) *Triggering event.* For purposes of paragraph (a)(1)(i)(*c*)(*1*) of this section, a triggering event based on the sale of unmarketable assets as defined in § 1.664-1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.

(*e*) *Examples.* The following examples illustrate the rules in paragraph (a)(1)(i)(*c*) of this section. For each example, assume that the governing instrument of charitable remainder unitrust *Y* provides that *Y* will initially pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust and that the requirements of paragraphs (a)(1)(i)(*c*)(*2*) and (*3*) of this section are satisfied. The examples are as follows:

Example 1. Y is funded with the donor's former personal residence. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the trust sells the residence. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 2. Y is funded with cash and an unregistered security for which there is no available exemption permitting public sale under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered on the earlier of the date when the stock is sold or at the time the restrictions on its public sale lapse or are otherwise lifted. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 3. Y is funded with cash and with a security that may be publicly traded under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered when the stock is sold. *Y* does not provide for a combination of methods that satisfies the requirements of paragraph (a)(1)(i)(*c*) of this section because the sale of the publicly-traded stock is within the discretion of the trustee.

Example 4. S establishes *Y* for her granddaughter, *G*, when *G* is 10 years old. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which *G* turns 18 years old. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 5. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the donor is married. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 6. The governing instrument of *Y* provides that if the donor divorces, the change in method for computing the annual unitrust amount will occur as of the first day of the year following the year of the divorce. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 7. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's first child is born. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 8. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's father dies. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 9. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's financial advisor determines that the beneficiary should begin receiving payments under the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 10. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary submits a request to the trustee that the trust convert to the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

(*f*) *Effective date*—(*1*) *General rule.* Paragraphs (a)(1)(i)(*c*), (*d*), and (*e*) of this section are applicable for charitable remainder trusts created on or after December 10, 1998.

(*2*) *General rule regarding reformations of combination of method unitrusts.* If a trust is created on or after December 10, 1998 and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust will qualify as a charitable remainder unitrust only if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust, or is reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. If a trust was created before December 10, 1998 and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust may be reformed to use the initial method for computing the unitrust amount throughout the term of the trust without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664-1(a)(4), or may be reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. Except as provided in paragraph (a)(1)(i)(*f*)(*3*) of this section, a qualified charitable remainder unitrust will not continue to qualify as a charitable remainder unitrust if it is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(*3*) *Special rule for reformations of trusts that begin by June 8, 1999.* Notwithstanding paragraph (a)(1)(i)(*f*)(*2*) of this section, if a trust either provides for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section, or provides for payment of the unitrust amount under only the method prescribed in paragraph (a)(1)(i)(*b*) of this section, then the trust may be reformed to allow for a combination of methods permitted under paragraph (a)(1)(i)(*c*) of this section without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664-1(a)(4) or to engage in an act of self-dealing under section 4941 if the trustee begins legal proceedings to reform by June 8, 1999. The triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust, except for situations in which the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section and the triggering event occurred prior to the reformation.

(*g*) *Payment under general rule for fixed percentage trusts.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, 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 unitrust 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 unitrust 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—

(*1*) The trust distributes property (other than cash) that it owned at the close of the taxable year to pay the unitrust amount; and

(*2*) The trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the unitrust amount is due.

(*h*) *Special rule for fixed percentage trusts created before December 10, 1998.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998 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 unitrust 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 fixed percentage to be paid each year as the unitrust amount is 15 percent or less of the net fair market value of the trust assets as determined under paragraph (a)(1)(iv) of this section.

(*i*) *Example*. The following example illustrates the rules in paragraph (a)(1)(i)(*g*) of this section:

Example. *X* is a charitable remainder unitrust that calculates the unitrust amount under paragraph (a)(1)(i)(*a*) of this section. *X* was created after December 10, 1998. The prorated unitrust amount payable from *X* for Year 1 is $100. The trustee does not pay the unitrust amount to the recipient by the end of the Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b) (2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the unitrust recipient a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 unitrust amount due for Year 1. The trust owned the asset at the end of Year 1. Under § 1.664-1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under § 1.664-1(d)(1), the character of the unitrust amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*g*) of this section.

(*j*) *Payment under income exception*. When the unitrust amount is computed under paragraph (a)(1)(i)(*b*) of this section, 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 payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year.

(*k*) *Reasonable time*. For paragraphs (a)(1)(i) (*g*), (*h*), and (*j*) of this section, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, "Split-Interest Trust Information Return," (including extensions) for the taxable year.

(*l*) *Effective date*. Paragraphs (a)(1)(i) (*g*), (*h*), (*i*), (*j*), and (*k*) of this section are applicable for taxable years ending after April 18, 1997.

* * * * *

(iv) * * * If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, "Split-Interest Trust Information Return," that the trust must file. * * *

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PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority citation for part 25 continues to read in part as follows:

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

Par. 6. In § 25.2702-1, paragraph (c)(3) is revised to read as follows:

§ 25.2702-1 Special valuation rules in the case of transfers of interests in trust.

* * * * *

(c) * * *

(3) *Charitable remainder trust*. (i) For transfers made on or after May 19, 1997, a transfer to a pooled income fund described in section 642(c)(5); a transfer to a charitable remainder annuity trust described in section 664(d)(1); a transfer to a charitable remainder unitrust described in section 664(d)(2) if under the terms of the governing instrument the unitrust amount can be computed only under section 664(d)(2)(A); and a transfer to a charitable remainder unitrust if under the terms of the governing instrument the unitrust amount can be computed under section 664(d)(2) and (3) and either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor, the transferor's U.S. citizen spouse, or both the transferor and the transferor's U.S. citizen spouse.

(ii) For transfers made before May 19, 1997, a transfer in trust if the remainder interest in the trust qualifies for a deduction under section 2522.

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PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In § 602.101, paragraph (c) is amended by adding a new entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * *	* *
1.664-1(a)(7)	1545-1536
* * *	* *

Approved: December 1, 1998.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Donald C. Lubick,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 98-32559 Filed 12-9-98; 8:45 am]

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DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 270

RIN 0790-AG67

Compensation of Certain Former Operatives Incarcerated by the Democratic Republic of Vietnam

AGENCY: Office of Under Secretary of Defense for Personnel and Readiness, DoD.

ACTION: Interim final rule.

SUMMARY: This rule amends part 270 to reflect changes necessary as a result of new language in Section 658 of the FY99 National Defense Authorization Act. Section 658 expands the field of beneficiaries of the Vietnamese Commandos Compensation Commission to parents and siblings of deceased Commandos. It also adds words "notwithstanding any agreement (including a power of attorney) to the contrary, the actual disbursement" must be made directly to the person who is eligible for the payment. This rule also amends part 270 to reflect necessary technical changes to accommodate the new language.

EFFECTIVE DATE: This rule is effective October 17, 1998. Comments are requested by February 8, 1999.

ADDRESSES: Forward comments to Commission on Compensation, Office of the Secretary of Defense, 4000 Defense Pentagon, Washington, DC 20301-4000.

FOR FURTHER INFORMATION CONTACT: Mr. Chuck Witschonke, (703) 693-1059 or LTC Frank Hudson, (703) 588-6570.

SUPPLEMENTARY INFORMATION:

Executive Order 12866, "Regulatory Planning and Review"

It has been determined that this is not a significant rule as defined under section 3(f)(1) through 3(f)(4) of Executive Order 12866.

Public Law 96-354, "Regulatory Flexibility Act" (5 U.S.C. 601)

It has been determined that this rule will not have a significant economic impact on a substantial number of small entities because it affects only a limited