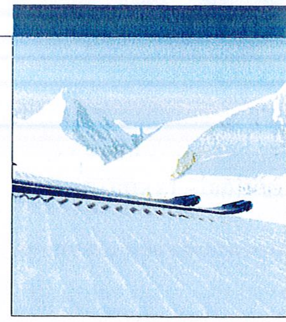

Planning for Charitable Contributions by Estates and Trusts

Differences between the rules for deducting charitable contributions by estates and trusts and by individuals create tax opportunities.

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The income tax charitable deduction for an estate or trust[1] is similar to, but somewhat different from, the income tax charitable deduction for individuals. These differences include: (1) no income-based percentage limitation on the charitable donation of an estate or a trust, but the deduction is limited to contributions of gross income; (2) the ability of an estate or trust to deduct a charitable contribution in the immediately preceding tax year in some circumstances; (3) a requirement that the governing instrument of the estate or trust evidence a charitable intent; and (4) no necessity that the charitable recipient of the gift from an estate or trust be a U.S. (domestic) organization.

Because the parameters for an income tax charitable deduction for trusts (and estates) are not the same as for individuals, it is important to recognize the differences when trusts are created that might, should, or perhaps, should not seek an income tax charitable deduction. Moreover, the income tax charitable deduction for an estate or trust may be more advantageous in some instances than contributions that individuals might make, and as a result, there may be important planning opportunities to consider.

This article explores the income tax charitable deduction requirements under Section 642(c) for estates and trusts, the planning that is required to qualify for the deduction, and some special opportunities that may be available.

Charitable contributions by individuals

As a general rule, individuals are entitled to a deduction under Section 170(a) for the value of contributions (donations) of property (including cash) to or for the use of charitable organizations defined in Section 170(c), but the deduction is limited to qualified domestic (U.S.) charitable entities. In addition, the charitable deduction for individuals is subject to several limitations and special rules. In general, the deduction may never exceed 20%, 30%, or 50% of the

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taxpayer's contribution base.[2] The amount allowable as a deduction also may depend on:

- The type of property contributed (e.g., cash, tangible personal property, intangible property, or real estate).[3]
- The nature of any gain inherent in the asset (e.g., ordinary income, short-term capital gain, or long-term capital gain).[4]
- The use to which the charitable recipient will devote the property (e.g., sell it or use it in furtherance of the recipient's exempt function).[5]
- The type of charitable organization (e.g., private foundation or a public charity).[6]
- Other possible factors.[7]

Additionally, Treasury Regulations appear to distinguish between a contribution made by an individual "to" a charitable organization and one that is "for the use" of the organization, basically limiting the deduction for a contribution for the use of charity to no more than 30% of the taxpayer's contribution base.[8]

Furthermore, if the charitable deduction otherwise allowable to an individual in the tax year exceeds the applicable percentage of his or her contribution base, the excess may be carried forward and deducted in the succeeding five tax years of the taxpayer (again subject to a percentage of contribution base for any such later year).[9]

Individuals taxpayers are subject to the substantiation requirements under Section 170, including those under Section 170(f)(8). These rules provide that no charitable deduction is allowed under Section 170 for gifts of $250 or more unless the taxpayer receives a contemporaneous written receipt from the donee charity.[10] For large, charitable gifts, more complex compliance rules apply.

Estate or trust charitable deduction

Several differences exist between a Section 170 charitable deduction for an individual and a Section 642(c) charitable deduction for an estate or trust. A decedent's estate or a trust is entitled to a charitable deduction under Section 642(c) for its gross income paid (or, for a decedent's estate, paid to or set aside[11]), pursuant to the terms of its governing instrument, for a charitable purpose described in Section 170(c). Unlike an estate or trust, the contribution by an individual need not be paid from gross income.

Flexible timing. While an estate or a trust is entitled to the deduction under Section 642(c) only for a contribution made from its gross income, the deduction may be allowed whether the gross income is from the current year or from a prior year that has not previously been distributed or deducted.[12] Moreover, an estate or trust may elect in the current year to treat a charitable contribution paid from gross income earned in the immediately preceding year as though it had been paid in the prior year, as long as the contribution is made by the time the income tax return for the estate or trust is due to be filed for the immediately preceding year.

The due date of a return may be extended no more than five and one-half months after the normal three and one-half month filing due date following the close of the tax year.[13] For trusts and calendar-year estates,[14] the extended due date to make the election would be September 30 of the year following the year in which the income was included in the gross income of the estate or trust. Thus, the election allows the estate or trust to take the deduction retroactively in the immediate prior year in which the gross income was earned but not paid, or, if the fiduciary does not elect, to take the deduction in the year the gross income is paid.

Individuals cannot take a deduction in a prior year for a contribution made in any later year. On the

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1 For purposes of this article, all trusts are assumed not to be grantor trusts, under Sections 671 through 679.

2 Contribution base is the taxpayer's "adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172)." Section 170(b)(1)(G).

3 See Section 170(e)(1)(B)(i).

4 See Section 170(e)(1)(A).

5 See Section 170(e)(1)(B)(i)(I).

6 See Section 170(e)(1)(B)(ii).

7 See, e.g., Section 170(b)(1)(E).

8 Reg. 1.170A-8(a)(2).

9 Section 170(b)(1)(B).

10 For a more expansive discussion of the substantiation rules of Section 170(f)(8), see the instructions for IRS Forms 1040, 1065, or 1120 and IRS Publication 526.

11 A set-aside deduction is also allowed for certain pre-1970 trusts. See Section 642(c)(2)(A).

12 Section 642(c)(1).

13 For tax years before 2016, an estate or a trust may receive a *five-month* automatic extension of time to file its income tax return by timely filing the appropriate form (IRS Form 7004). Section 6081. Both the Code and Reg. 1.642(c)-1(b)(1) provide that the payment must be made by the end of the year following the year in which the gross income was earned. Reg. 1.642(c)-1(b)(2) states that the "election ... shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year." The Regulation goes on to provide that the election may be revoked within the time prescribed for making it.

14 While a trust is required to use a calendar tax year (see Section 644), an estate has the option of choosing a calendar or non-calendar year.

15 The term "contribution base" has no meaning for an estate or trust but the equivalent for an individual is adjusted gross income, as specially computed. See *supra* note 4.

16 Reg. 1.170A-13(f)(13).

17 Section 681(a).

18 See discussion in Brownstone, 465 F.3d 525, 98 AFTR2d 2006-6889 (CA-2, 2006).

19 Weir Foundation, 362 F. Supp. 928, 32 AFTR2d 73-5649 (DC N.Y., 1973), *aff'd* 508 F.2d 894, 35 AFTR2d 75-538 (CA-2, 1974); see also Old Colony Trust Co., 301 U.S. 379, 19 AFTR 489 (1937).

20 See, e.g., Green, 144 F. Supp. 3d 1254, 116 AFTR2d 2015-6668 (DC Okla., 2015).

21 8 F.3d 571, 72 AFTR2d 93-6524 (1973).

22 The term "charitable lead trust" refers to a trust described in Section 170(f)(2)(B).

23 710 F.2d 1316, 52 AFTR2d 83-5487 (CA-8, 1983).

other hand, an estate or trust cannot carryover any excess charitable deduction to a subsequent year and take a deduction for a contribution made in an earlier year.

No percentage limitations. Furthermore, an estate or trust may reduce its taxable income to zero through contributions for charitable purposes except to the extent the payment to charity consists of unrelated business income (UBI), as discussed below. In other words, the deduction under Section 642(c) is not limited to a maximum 50% of the contribution base[15] of the estate or trust, as is the case with an individual, except to the extent of its UBI.

In addition, the charitable deduction for estates and trusts is not dependent on the type of charitable organization that receives the contribution, as it is for individuals. Section 642(c) does not distinguish between contributions to public charities (including "publicly supported charities") and private foundations. Furthermore, an estate or trust is entitled to the deduction for a charitable purpose even if it is not made to or for a domestic (U.S.) charitable organization, as is required for individuals.

Simpler substantiation. Finally, it seems relatively certain that estates and trusts are generally not subject to the charitable deduction substantiation rules of Section 170 for individuals, including the contemporaneous written acknowledgment requirement of Section 170(f)(8).[16] The charitable deduction for estates and trusts is authorized by Section 642(c) and is in lieu of a deduction under Section 170. There is one exception, however. To the extent that a trust (but not an estate) has UBI, no deduction is allowed under Section 642(c).[17] Instead, Section 681—which disallows a charitable deduction for UBI—references Section 512, which permits a more limited charitable deduction under Section 170. As a result, the substantiation rules likely apply in that situation, given that the charitable deduction is then permitted only pursuant to Section 170. The UBI limitation is discussed in greater detail later in this article.

Pursuant to governing instrument

To be deducted under Section 642(c), the payment of gross income for a charitable purpose must be made pursuant to the terms of the governing instrument—likely the will or the trust agreement under which the trust was created.[18] The payment need not be mandated by the governing instrument, but courts have held that "the instrument must be shown to possess some positive charitable intent or purpose of the settlor—not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty."[19] Therefore, a discretionary payment to charity will support the deduction if authorized in the governing instrument.[20]

Payments to charity, however, will not be treated as made pursuant to the terms of the governing instrument where found not to be made to in accordance with the terms of the will or trust agreement. For example, in *Rebecca K. Crown Income Charitable Fund*,[21] commutation payments (or prepayments) to the charitable beneficiary of a charitable lead trust[22] that mandated annual payments to charity were not deductible under Section 642(c) where the court found the prepayment of the annuity payments was not authorized under the terms of the instrument that created the trust.

In *John Allan Love Charitable Foundation*,[23] a trustee made distributions to a charitable foundation on the basis that distributions "were agreeable or conformable to the expressed intent of the Trust instrument." The court held that a charitable income tax deduction was not available under Section 642(c) because it was "clear that the trustee was without authority to make these distributions." Thus, where a will or trust makes no provision for a payment to a charitable organization, a charitable income tax deduction will not be allowed to an estate or trust, even though all of the beneficiaries may agree to the contribution. Where the terms of a trust authorize charitable payments only on termination of a trust, payments made prior to termination do not qualify for a charitable income tax deduction under Section 642(c).[24]

In *Riggs National Bank*,[25] a testamentary trust was established under the decedent's will that provided the corpus would be shared by four charities upon the termination of the trust. A charitable income tax deduction was disallowed for income accumulated by the trust because the "will did not direct that the surplus trust income be set aside for, or paid to, the charities," and under local law, such income passed to the decedent's heirs under the laws of intestacy. The court rejected the argument that the trust income was deductible because it was used to repay a loan that was secured by trust property that was to be distributed to charities upon the termination of the trust.

Troubling case. A payment of gross income to charity pursuant to the exercise of a power of appointment granted to a beneficiary may qualify for the deduction under Section 642(c).[26] In *Brownstone*,[27] however, the court held that no deduction would be allowed to a testamentary trust for gross income paid to the estate of the grantor's surviving spouse although the grantor's surviving spouse exercised her general power of appointment over the trust in favor of her estate and her will devised the entire residue to charity.

The court determined that the surviving spouse's will contained the requisite "positive charitable intent or purpose," but the terms of the testamentary trust created by the husband did not express that intent or purpose: His will was the governing instrument and payments had to be made without regard to his wife's exercise of the power of appointment. In other words, the exercise of general power in favor of the spouse's estate, which passed to charity, was insufficient—the governing instrument was the one that created the power and not the document that exercises it.[28]

The result in *Brownstone* may be questioned on several grounds. First, it seems that the result might have been different if the widow had appointed the property directly to charity rather than to her estate, which passed to charity.[29] Arguably, that is a distinction without any meaningful difference as her will essentially mandated that the income be paid to charity.

Second, it seems that the distribution from the trust to the widow's estate would have been deemed to consist of the trust's distributable net income (DNI),[30] which would have been deductible by the trust (except to the extent consisting of tax-exempt income) under Section 651(a) or 661(a). The amount deducted by the trust would have been included in the gross income of the estate under Sections 652(a) or 662(a) and then would have been set aside for charity pursuant to the terms of the widow's will. This would seem to support a deduction for her estate under Section 642(c).[31]

Third, the court stated that it reached its decision, at least in part, because it viewed deductions, quite apparently including charitable deductions, as a matter of legislative grace. Thus, in cases of doubt, the controlling statute should be construed in favor of the government (to collect tax). This conclusion should be contrasted with the many statements of courts that there should be a liberal construction of the law in favor of charitable deductions. For example, in *Green*,[32] in discussing the deduction allowed under Section 642(c), the court emphasized that charitable deductions are not a matter of legislative grace, but rather expres-

24 Rev. Rul. 55-92, 1955-1 CB 390; W.K. Frank Trust of 1931, 145 F.2d 411, 32 AFTR 1478 (CA-3, 1944).

25 352 F.2d 812, 16 AFTR2d 5881 (Ct. Cl., 1965).

26 See, e.g., Green, *supra* note 20.

27 Note 18, *supra*.

28 In Williams, 158 F. Supp. 227, 52 AFTR 1162 (DC Calif., 1957), *aff'd* 251 F.2d 847, 1 AFTR2d 815 (CA-9, 1958), the United States District Court for the Northern District of California reached an analogous result.

29 GCM 34277 (1970) (not precedent).

30 "DNI" is defined in Section 643(a) as taxable income as specially modified.

31 This conclusion seems supported by GCM 34277 (1970) (not precedent).

32 Note 20, *supra*.

33 The court, referring to other case law, stated: "However, and of particular importance here, *Weingarden* went further to distinguish statutes regarding charitable deductions, stating they are not matters of legislative grace, but rather 'expression[s] of public policy.'" Weingarden [825 F.2d 1027, 60 AFTR2d 87-5448] (CA-6, 1987) (citing Helvering v. Bliss, 293 U.S. 144, 14 AFTR 668 (1934) (further citations omitted, internal quotations omitted)). As such, "[p]rovisions regarding charitable deductions should ... be liberally construed in favor of the taxpayer." *Id.* (citing Hartwick College, 801 F.2d 608, 58 AFTR2d 86-5846 (CA-2, 1986)). Thus, even if the language of the statute were unclear, a liberal construction in favor of the taxpayer" would be appropriate." *Id.* (internal citations reformatted).

34 "Decanting" is the act of "pouring" assets of one trust to another, where permitted under the terms of the governing instrument or state law. See generally Zeydel and Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 J. Tax'n 288 (November 2009) (cited in Morse v. Kraft, 992 N.E.2d 1021 (Mass. 2013)).

35 Reg. 1.671-2(e)(5).

36 1 CB 295. See also CCA 200928029 (not precedent).

37 See, e.g., Section 663(a)(1).

38 Compare the following cases with each other: Old Colony Trust Co., *supra* note 19; Benedict, 592 U.S. 692, 38 AFTR 1208 (1950); Crestar Bank, 47 F. Supp. 2d 670, 83 AFTR2d 99-2555 (1999); Van Buren, 89 TC 1101 (1987); Riggs National Bank, *supra* note 25; W.K. Frank Trust of 1931, *supra* note 24; Freund's Estate, 303 F.2d 30, 9 AFTR2d 1479 (CA-2, 1962); Sid W. Richardson Foundation, 430 F.2d 710, 26 AFTR2d 70-5144 (CA-5, 1970); and Esposito, 40 TC 459 (1963), *acq.* 1964-1 CB (pt. 1) 4.

39 Riggs Nat'l Bank, *supra* note 25. The tracing in the context of Section 642(c) forms the basis for the limited exception to the general removal of the tracing requirement accomplished by Subchapter J. Van Buren, *supra* note 38. This concept was specifically recognized in Mott, 462 F.2d 512, 30 AFTR2d 72-5193 (Ct. Cl., 1972) (en banc), where the court stated that "tracing of charitable distributions is still required under Section 642(c) and to the extent that a charitable deduction is not paid out of gross income in accordance with the requirements of Section 642(c), then we think that Congress intended that no deduction is allowable."

40 Note 38, *supra*.

sions of public policy that should be liberally construed.[33]

Use of decanting. A question of deductibility under Section 642(c) may arise when a trust that does not have the requisite "positive charitable intent or purpose of the settlor" is decanted or otherwise reformed by transferring trust assets to a new trust that has the requisite intent or purpose.[34] For example, a father creates a trust exclusively for the benefit of his descendants and does not grant any of them a power of appointment. Independently, the mother creates a separate trust for them and grants the oldest child a power to appoint all or a portion of the trust's gross income to charity. It appears relatively certain that a deduction will be allowed under Section 642(c), to the extent the child exercises the power over the mother's trust. Thereafter, the trustee of the trust created by the father decants (contributes) the trust assets to the trust created by the mother.

The Section 642(c) question is whether a deduction is allowed to the extent the eldest child directs that the gross income earned by the assets formerly contained in the trust created by the father be paid to charity. The identity of the grantor of a trust for income tax purposes does not change when assets of one trust are contributed to another;[35] it is as though the income earned on the assets in the trust the father created has effectively been distributed to the trust the mother created, which contains the requisite positive charitable intent or purpose of its settlor.

Thus, the ultimate question is whether decanting can add the requisite charitable intent for income attributable to the assets previously held in the father's trust or whether the father's lack of a stated charitable purpose carries over to the trust created by the mother. If the latter, the income produced by the assets from the trust the father created are not being distributed pursuant to the terms of the governing instrument. The alternative analysis of *Brownstone* above suggests that the charitable intent of the mother's trust should be sufficient if the income attributable to the father's trust "moves" to the mother's trust and then is being distributed pursuant to her express charitable intent.

The uncertainty of decanting suggests that trustees seek a more viable alternative. One potential way to work around the prerequisite of positive charitable intent or purpose of the settlor is to have the trust invest in a partnership that may make contributions to charity from gross income of the partnership. Under Section 702(a)(4), charitable contributions made by a partnership pass through to the partners. A trust that is a partner must take into account its distributive share of the partnership's income, gain, loss, and deductions (including charitable contributions).

In Rev. Rul. 2004-5,[36] the Service ruled that a trust was allowed a deduction under Section 642(c) for the trust's distributive share of a charitable contribution made by the partnership from the partnership's gross income, even though the governing instrument of the trust neither authorized nor directed the trustee to make distributions to charity. Note that when a partnership makes a charitable contribution from gross income, that income is never available to the trust. In the ruling, it seemed important that the partnership made the charitable contribution from its own gross income.

Paid from gross income: tracing the income

Unlike the deduction for distributions to beneficiaries, which are deemed to consist of DNI, even if the distributions consist of corpus (with certain exceptions[37]), some type of tracing of the charitable contribution to gross income received by the trust or estate is required to support a deduction under Section 642(c).[38] Tracing is required because the statute specifically requires that the source of the contribution be gross income.[39]

For example, in *Sid W. Richardson Foundation*,[40] the decedent left his estate to charity. The estate included stock in an S corporation, and as a result the income from the S corporation was attributed to the estate under Section 1366, although there were no distributions from the S corporation. The decedent's estate took a set aside deduction under Section 642(c) for the S corporation income, as all of the S stock apparently was distributed eventually to the charitable residuary beneficiary, even if the income was kept in the corporation. However, the court held that no set aside deduction would be allowed because the income, although imputed to the estate, was never actually received by it and, therefore, could not have been set aside for charity.

Distributions in kind. In *W.K. Frank Trust of 1931*,[41] a distribution of appreciated stock was not deductible because the shares were corpus rather than items of gross income, even if under the instrument the distribution was chargeable to trust-accounting income. However, in CCA 201042023 (not precedent), the IRS ruled that property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income, although the charitable deduction was limited to the trust's adjusted basis in the property.

Nevertheless, the federal district court in *Green*, discussed above, in a case of apparent first impression, disagreed on the limitation of the deduction to basis. The district court held that a trust that was authorized to distribute any amount of its gross income to charity was entitled to an income tax deduction under Section 642(c) for the full fair market value of property that was purchased with gross income the trust had received in prior years and was not limited to the trust's adjusted basis in the property. In *Green*, property purchased by the trust and subsequently contributed to charity was specifically traceable to gross income the trust received in an earlier year.

Estates and trusts that seek to make in-kind contributions of property may follow the *Green* pattern; that is, acquire property with gross income, and when it has appreciated, contribute it to charity. An alternative plan for an estate or trust that already owns property (not traceable to gross income) it would like to contribute to charity might be structured with a two-trust arrangement: property is transferred from the old trust (which permits gifts to charity) to a second trust (which permits gifts to charity) in a manner that the distribution from the first trust to the second trust is deemed to be gross income under the DNI rules of Sections 662.[42] Therefore, when received by the second trust, it will be deemed to consist of gross income to the extent of DNI. Moreover, the property could be (or at least might be) fiduciary accounting income under UPIA section 402, if the trustee of Trust 1 so designates the distribution.[43]

As a result, the property represents both gross income in a tax sense and accounting income when contributed to charity by the second trust. Therefore, the only real issue is the amount of the charitable deduction because Section 643(e) will limit the amount of gross income received by the second trust to the basis of the property distributed, unless the transferor trust elects to recognize gain. Note at that point, *Green* held that a fair market deduction is appropriate.

Example. Alice created and funded Trust 1 for the benefit of her issue. The trustee has discretion to distribute trust income and principal to or for the benefit of Alice's issue and charity. Trust 1 has assets valued at $10 million and, for the current year, has $200,000 of gross income. Assume that Trust 1's DNI is $200,000 and its fiduciary accounting income is $200,000. Among its assets is Stock X with a fair market value of $100,000 and an income tax basis of $40,000. The trustee would like to distribute Stock X to charity. Because Stock X is fiduciary accounting principal, a transfer of the stock to charity likely would not entitle Trust 1 to an income tax charitable deduction.

However, if Alice creates a second discretionary trust (Trust 2) for her issue and charity, it is possible that the trustee of Trust 1 could distribute Stock X to Trust 2. Under the rules of Section 643(e), the distribution will limit the DNI attributable to the distribution to $40,000, and Trust 2 will have gross income of $40,000 under Section 662. Trust 1 will receive a distribution deduction of $40,000 under Section 661.

Assuming that the trustee of Trust 1 charges the entire distribution of Stock X to its fiduciary accounting income, the receipt of Stock X by Trust 2 will be both gross income, at least to the extent of $40,000, and fiduciary accounting income. Therefore, in the hands of the trustee of Trust 2, Stock X is both gross income and fiduciary accounting income and therefore should support a Section 642(c) deduction for Trust 2. The only question is the amount of the deduction. Is it limited to the trust's basis of $40,000 or is it $100,000? *Green* would support the higher amount.

Imputed income. The apparent tracing requirement may present a problem for trusts and estates that own entities, such as partnerships and S corporations, where the entity's income is imputed to the partners without an equivalent amount of cash necessarily being distributed to and received by them. A sig-

41 Note 24, *supra*.

42 A distribution from a simple trust will likely generate income if the property is appreciated as under Kenan, 114 F.2d 217, 25 AFTR 607 (CA-2, 1940), and the amount required to be distributed is being satisfied with appreciated property.

43 Unif. Principal & Income Act § 402 (1997), 7B U.L.A. 163 (2000).

nificant number of investments available in the market are, or use, pass-through vehicles (typically, partnerships or limited liability companies treated as partnerships for federal income tax purposes), including hedge funds, private equity investments, and others. Virtually none of these pass-through entities distributes the income imputed to its partners or owners during the year in which the income is earned and imputed.

Although it would seem the trust or estate could make the election, as discussed above, to treat income paid to charity in the year following the year the gross income is attributed by the investment to the estate or trust, many of these investments do not distribute much cash even in the year following the year in which the income was earned and imputed to the investors. Indeed, when the cash earned in a pass-through entity is distributed, it is not treated as a distribution of the entity's gross income for income tax purposes, but essentially is treated as a redemption of the investment because the income has already been imputed to the partners or S corporation shareholders.

Notwithstanding the lack of cash distributed by the investment vehicle to the estate or trust, there seems to be a workaround, although it is somewhat complicated. The estate or trust creates and owns virtually all, but not all, of the equity in a partnership that is not a disregarded entity.[44] That partnership would make investments in pass-through entities (such as other partnerships) that the estate or trust might otherwise make. The income from the pass-through investments will be imputed to the partnership that the estate or trust "owns," and it is *that* partnership's income, not the income of the pass-through investments, that will be imputed to the estate or trust that is the partner. The partnership that is "owned" directly by the trust may distribute to the trust an amount of cash equal to the amount of its gross income, which of course, would include the gross income attributed to it from the pass-through investments. Thereafter, the trust may contribute to charity the cash it received from the partnership. As a consequence, the amount contributed to charity (or the amount set aside, in the case of an estate) should qualify for the Section 642(c) deduction.

As a practical matter, the determination of the gross income imputed from the partnership to the estate or trust and, therefore, the amount of cash to be distributed as gross income, will not be determined until the year after the income is imputed to the estate or trust. Hence, the estate or trust would need to make the distribution by the time its income tax return for the year the income is imputed is due, and make the election discussed above, to treat the distribution as having been made in the year in which the income was so imputed.[45]

Example. Trust A owns a 25% interest in an investment partnership (Partnership 1) valued at $5 million, together with cash equal to the anticipated earnings that will be imputed from the 25% interest over the next several years. Trust A contributes its interest in Partnership 1 and the cash to a new Partnership 2 in exchange for a 99% limited partnership interest in Partnership 2. As a result, Partnership 2 is a 25% partner of Partnership 1 and Trust A is the 99% partner of Partnership 2. In Year 1, Partnership 1 earns $200,000, of which the Partnership 2's share is $50,000. As a 99% partner in Partnership 2, Trust A has $49,500 of that income, but Partnership 1 makes no distribution of the earnings to its partners, including Partnership 2.

Trust A would like to distribute all of the income from Partnership 2 (totaling $49,500) to charity and receive a deduction under Section 642(c). For Trust A to receive that deduction, Partnership 2 distributes $49,500 in cash to Trust A and then Trust A contributes $49,500 to Charity C. Partnership 2 advises Trust A that the $49,500 distribution is of Partnership 2's income for Year 1. Even if Trust A does not receive the cash until Year 2, it can distribute it to charity by the time it must file its income tax return for Year 1 (not later than October 15 of Year 2), if it receives the cash from Partnership 2 by then, and can elect to treat the distribution as though made in Year 1.

Limit where UBI is distributed by a trust

Although an estate or a non-grantor trust is entitled to a charitable deduction without limitation, no Section 642(c) charitable deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's UBI within the meaning of Section 681.[46] To the extent the

44 Under Reg. 301.7701-3, certain entities are disregarded for federal tax purposes. If the trust or estate "owns" such an entity, income imputed from pass-through entities (such as a hedge fund) to that disregarded entity might be treated as received by the trust or estate.

45 *Cf.* Ltr. Rul. 201246003 (not precedent).

46 UBI, for purposes of a non-grantor trust, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in Section 512(b). These modifications include a deduction for charitable contributions allowed by Section 170, subject to the percentage limitations applicable to individuals. UBI, within the meaning of Section 681 for trust purposes, is essentially the same as unrelated business taxable income (UBTI) defined in Section 512 and includes income attributable to acquisition indebtedness. Acquisition indebtedness is defined in Section 514(c)(7). Capital gain recognized on the sale of an asset is not normally UBTI if there is no debt against the property. Section 512(b)(5).

trust has UBI that is paid to charity, the deduction limitations are the same as those for an individual.[47] Section 681 does not apply to an estate; by its terms, the rule applies only to trusts.

Use of a partnership arrangement. As noted above, an estate or trust that is a partner in a partnership is entitled to a deduction under Section 642(c) for charitable contributions made by the partnership, even if the governing instrument of the estate or trust does not provide the requisite charitable intent that would be required to support the deduction if made directly by the estate or trust. Rev. Rul. 2004-5 states explicitly that the charitable contribution by a partnership is from its gross income, although the conclusion (that the trust, as a partner, is entitled to take a deduction under Section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from the partnership's gross income. Nonetheless, it appears to be the position of the IRS that for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income.[48]

Also, it seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset so acquired with the trust's gross income should be treated as a contribution of gross income for purposes of Section 642(c).[49] In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income, at least as long as the asset can be traced to gross income.[50]

UBI ramifications. Rev. Rul. 2004-5 indicates that Section 681 would apply if the partnership makes the charitable contribution from gross income that would have been UBI if received directly by the trust.[51] Although the concept of UBI does not apply to a partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes.[52]

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to Section 642(c) or otherwise, the gross income should not be treated as UBI in the hands of the charity, even if it would have been UBI if received directly by the charity. This conclusion is based on:

1. The absence of a provision that would cause the distribution to be treated as UBI in the hands of the charitable recipient.
2. The several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust.
3. The fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBTI if it would have been UBTI if earned directly by the charity.

For example, in the case of a partnership, UBI carries out to any partner that is a charity, as provided in Section 512(c) and as UBTI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBTI to the Section 170 limitations to individuals. However, payments to charity from an estate or trust, even if consisting of UBTI, should not

47 See Reg. 1.681(a)-2(a) (second to last sentence); Section 512(b)(11).

48 See FSA 200140080 (not precedent).

49 See, e.g., Green, *supra* note 20. See also Old Colony Trust Co., *supra* note 19 (dealing with the predecessor to current Section 642(c), in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal); CCA 201042023 (ruling that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income, however, the charitable deduction was limited to the trust's adjusted basis in the property) (not precedent). *Cf.* Crestar Bank, *supra* note 38; Freund's Estate, *supra* note 38; Sid W. Richardson Foundation, *supra* note 38; W.K. Frank Trust of 1931, *supra* note 24; Esposito, *supra* note 33.

50 See sources cited *supra* note 49.

51 The ruling states, in part, "[b]ecause none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. In FSA 200140080 (not precedent), which dealt with a trust's distributive share of a partnership's charitable contributions, the IRS stated that although the courts in Estate of Lowenstein, 12 TC 694 (1949), *aff'd* 183 F.2d 172, 39 AFTR 643 (sub nom First National Bank of Mobile v. Commissioner) (CA-5, 1950)) and Estate of Bluestein, 15 TC 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the *Bluestein* and *Lowenstein* cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions. However, all of the other requirements of [IRC] § 642(c)(1) must be met, and the limitations of [IRC] § 681(a) must be taken into account."

52 Section 513(b).

53 See Section 663(a)(2) (denying this treatment for amounts paid to charity that are deducted under Section 642(c) (and determined without regard to Section 681) by an estate or trust).

54 See Notice 2004-35, 2004-19 IRB 889. So, UBI should not be treated as "carried out" from an estate or trust to a charity and treated as UBTI in its hands.

55 See also Section 642(c)(4) (providing that, in the case of a trust (but not an estate), the deduction allowed by Section 642(c) is subject to Section 681 (related to UBI)). *Cf.* also discussion in Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26th Annual Heckerling Institute on Estate Planning (1992).

56 Note that Section 68(a), which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. Section 68(e). The 2% "floor" rule of Section 67(a) does not apply to Section 642(c) deductions. Section 67(b)(4).

57 See Reg. 1.642(c)-3(b)(2).

be treated as UBTI in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under Section 651(a) or 661(a) and do not consist of the distributable net income (DNI) of the estate or trust under Section 652(a) or 662(a), whose tax character is also passed out to the non-charitable recipient of the DNI.[53]

This seems consistent with the private foundation rules, where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of Section 4940.[54] But, as previously mentioned, Section 681(a) provides that in computing the deduction allowable under Section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under Section 642(c) shall be allowed as a deduction with respect to income of the tax year that is allocable to "unrelated business income."[55]

Nevertheless, with the uncertainty, the safer course to allow a non-grantor trust partner to be entitled to the charitable deduction without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI.[56]

Tracing contribution's source. Although not addressed, Rev. Rul. 2004-5 suggests that tracing of the source of the contribution by the partnership may be permitted—that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, it seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, a 2012 amendment to the Section 642(c) regulations provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of "shifting" income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has independent economic effect.[57]

This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a trust and an estate under the prior regulation could specify the character of the income being distributed to charity, and because the amended regulation does not by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid, which would be respected for purposes of Section 681.

In any event, under Rev. Rul. 2004-5, if a trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to Section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") applicable to an individual taxpayer.

Trust as S corporation shareholder. There is developed law on whether a non-grantor trust that is a shareholder of an S corporation can take a deduction for charitable

contributions made by the S corporation.[58] The Treasury Regulations dealing with Electing Small Business Trusts (ESBTs), defined in Section 1361(e)(1), provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion."[59]

If the shareholder of an S corporation is a grantor trust for income tax purposes,[60] the charitable deduction would pass through to the individual who is the income tax owner of the trust.

In circumstances where the decedent's estate is the shareholder, or treated as the shareholder of the S corporation, the principles of Rev. Rul. 2004-5 should apply. Thus, the estate will obtain a Section 642(c) deduction for contributions by the S corporation (and not be limited by Section 681, as that section does not apply to a decedent's estate).

Trust with UBI. The limit on a charitable deduction for UBI of a trust does offer one possible advantage.[61] Section 681 disallows the charitable deduction under Section 642(c). However, the Regulations under Section 681 permit a partial deduction by applying Section 512(b)(11), which imposes the percentage limitations applicable to individuals.[62] The Regulations provide in part: "While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to 'unrelated business income,' a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11)."[63] Then Section 511(b)(11) provides:

> In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Therefore, a trust with UBI is potentially entitled to a charitable deduction under Section 170. As a result, the special rules of Section 642(c) are not applicable, particularly the requirement that the contribution come from gross income and, possibly, traceable to gross income. In addition, the requirement that the contribution be authorized by the terms of the governing instrument may not be applicable, although, for their own fiduciary protection, trustees should otherwise ensure the permissibility of distributions to charity. Without the Section 642(c) limits applying, it may be possible for a trust to make charitable gifts in kind and deduct the fair market value of the donated property, subject to the limits applicable to individuals and the amount of UBI for the tax year. Moreover, the charitable deduction carryover may in fact be applicable. However, the

58 Although Section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, Section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and any basis in any debt the corporation owes to the shareholder. For years 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

59 Reg. 1.641(c)-1(d)(2). The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. See generally Blattmachr and Boyle, *Blattmahr on the Income Taxation of Estates and Trusts* (PLI, 2015).

60 Note that the beneficiary of a qualified Subchapter S trust makes an election pursuant to Section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to Section 678. See Blattmachr and Boyle, *supra* note 59.

61 Section 681(a).

62 Reg. 1.681(a)-2.

63 *Id.*

64 Note that both the gift tax and income tax charitable contribution provisions contain similar partial interest rules. Both, in general, disallow any deduction for a contribution of a partial interest in property, although both permit a deduction if the only interest the taxpayer holds is the partial interest. Sections 170(f)(3) and 2522(c). However, for income tax purposes, the rule disallowing a deduction for the partial interest applies even if that is the only interest the taxpayer held in the property if it was divided to avoid the partial interest disallowance rule even if the division occurs by a sale for full and adequate consideration. Reg. 1.170A-7(a)(2)(i) (third sentence). Nonetheless, for gift tax purposes, the disallowance applies regardless of the reason for the division if the interest not contributed to charity is retained by the donor or has been transferred to anyone for less than an adequate and full consideration in money or money's worth.

65 Section 170(f)(2)(A).

66 Emphasis added.

67 Similarly, other parts of Section 170(f) will not apply to contributions by an estate or trust that qualify under Section 642(c), such as the substantiation requirement under Section 170(f)(8), which begins "No deduction shall be allowed under subsection (a)...." There is no substantiation requirement in Section 642(c).

68 Note that somewhat different partial interest rules are contained in Sections 2055 and 2522 for estate and gift tax purposes, but there is none under Section 642(c) and the deduction under that section is "in lieu of the deduction allowed by section 170(a)." To begin, under Section 641(b), the taxable income of a decedent's estate and a non-grantor trust is determined in the same manner as that of an individual with certain differences provided in the Code. Perhaps, the most important difference in computing the taxable income of an estate or trust compared to that of an individual is the allowance of a deduction under Section 651(a) or 661(a) for its DNI distributed or required to be distributed to one or more of its beneficiaries. The DNI deducted by the estate or trust is included under Section 652(a) or 662(a) in the gross income of the beneficiary or beneficiaries who are treated as receiving it.

69 Under Section 170(b)(1), charitable contributions include those to certain charitable educational organizations that "normally maintain[] a regular faculty and curriculum and normally ha[ve] a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

70 495 U.S. 472, 65 AFTR2d 90-1051 (1990).

71 N.Y. Tax Law § 615(c).

substantiation requirements of Section 170, including those under Section 170(f)(8), will apply as the charitable deduction is now authorized by Section 170 instead of Section 642(c).

Contributions of partial interests

As a general rule, an individual is not entitled to a charitable deduction for a gift of a partial interest in property unless it is the only interest the taxpayer owns[64] or is the remainder in a charitable remainder trust described in Section 664.[65] It seems that these partial interest rules do not apply to contributions by an estate or trust that qualify for deduction under Section 642(c) as the partial interest rules are contained in Section 170(f)(1) *et seq.*, which states that "[n]o deduction shall be allowed *under this section....*"[66] The word "section," obviously, means Section 170.[67] But there is no comparable condition in Section 642(c).[68] Thus, it seems that an estate or trust could create a charitable remainder trust with its gross income, if permitted under the terms of the governing instrument, without complying with the statutory rules under Section 664.

Alternatively, a trust might contribute gross income to a charitable lead trust, but again, not necessarily in the form described in Section 170(f)(2)(B). This might be advantageous where it is desirable to pay the noncharitable recipient the fiduciary accounting income or some other payment not consisting of an annuity or unitrust amount, as required by Sections 664 and 170(f)(2)(B).

Charitable purpose

For an individual, a charitable contribution must be to, or for, an organization described in Section 170(c). For an estate or trust, the deduction is allowed under Section 642(c) if made for a charitable purpose, and in particular, it is not limited to domestic (U.S.) charities. The scope of "charitable purpose" is uncertain. Neither the Code nor any Regulation seems to provide a definition. Perhaps, it would permit the estate or trust to directly apply its gross income for a charitable purpose, such as "to foster national ... sports competition" or provide education, but not paid to an educational organization within the meaning of Section 170(c)(2).[69] Alternatively, the trust might provide a direct benefit, such as providing food directly to the hungry or making gifts to families of police officers or soldiers killed in the line of duty. It is possible this difference might permit a charitable deduction when applied to the facts in the U.S. Supreme Court's decision in *Davis*,[70] in which a charitable deduction was denied for members of the Church of Jesus Christ of Latter-day Saints who provided direct support to their adult children who were serving as missionaries for the Church. While an interesting thought, likely it may be more prudent to find an organization described in Section 170(b) or (c) to carry out the program or make the benevolent transfers.

State income tax limitations on charitable deductions

Some states (or their political subdivisions) limit an individual's charitable deduction for state (or local) income tax deductions to an even greater extent than the Internal Revenue Code. For example, certain deductions allowed for federal income tax purposes are not allowed for New York income tax purposes,[71] and all itemized deductions for New York income tax purposes, including charitable contributions made by an individual, are reduced in many situations, especially for "high" income taxpayers.[72] One potential way to avoid these state limitations is for the individual taxpayer to create a trust that is not treated as a grantor trust and, perhaps, transfers to the trust are not complete for federal gift tax purposes.[73] Because the trust is not a grantor trust, it would be entitled to a charitable deduction for its gross income paid pursuant to its terms for a charitable purpose without the limitation under Section 642(c), except to the extent that gross income consists of UBI.[74] As a result, this arrangement may avoid the state limitations on the charitable deduction.

Structuring non-grantor trusts in light of Section 642(c)

It is at least arguable that all trusts should permit distributions of gross income to charity, other than ones where a tax benefit might be lost, such as a trust that qualifies for the federal estate tax marital deduction.[75] This discretionary power could be held by the trustee or a beneficiary.

Perhaps, it would be appropriate to require the trustee to obtain the consent of one or more of the beneficiaries of the trust to avoid the appearance that the trustee is trying to garner favor with one or more charities at the "expense" of the beneficiaries. Alternatively, one or more beneficiaries could be given the power to make charitable gifts to charities conditioned on obtaining the consent of another beneficiary and/or the trustees, which avoids any concern that the charity has unfairly influenced the beneficiary or that a beneficiary is trying to "punish" another beneficiary by giving away trust income to a particular charity.

It might be contended that a beneficiary who exercises the power to distribute gross income to charity has made a gift[76] by diverting gross income from himself or herself to charity, but the amount so distributed should qualify for the gift tax charitable deduction.[77] On the other hand, it might be preferable in some cases for the beneficiary to make the donation to charity. When a better choice, the trust could allow discretionary distributions to the beneficiary so he or she could make the charitable contributions with the distributions from the trust.

If gifts of income to charity are anticipated when a trust is created, it may be preferable to merely authorize general distributions to the noncharitable beneficiaries, rather than mandate them. This may be advantageous because "DNI" is defined as the trust's taxable income (with the adjustments provided under Section 643(a)), but the charitable deduction under Section 642(c) is not allowed when computing the amount of DNI for mandatory distributions of accounting income.[78] However, DNI computed for discretionary deductions is calculated after the charitable deduction is allowed. This difference in how DNI is computed and how a beneficiary's reportable income is determined is part of the unique tier system that is a cornerstone of Subchapter J of Chapter 1 of Subtitle A of the Code.

Under what are known as the "tier" rules, all amounts treated as distributed or distributable income fall into one of two categories:

1. The amount of income, for trust-accounting purposes, required to be distributed currently, including the amount of an annuity (or other item payable out of income or corpus) that is actually paid out of such income for the year (and known as "tier 1 or first-tier distributions").
2. All other amounts of income or corpus either required to be distributed or properly paid or credited (and known as "tier 2 or second-tier distributions").[79]

The total amount taxable to the beneficiaries is limited to distributable net income, however, and then only to the taxable portion of DNI.[80]

Amounts in the first category, or first-tier, are included in gross income in full, to the extent DNI is not exceeded, before amounts in the second tier are included in gross

72 *Id.* § 615(g).

73 See generally Blattmachr and Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust," 26 Probate Practice Reporter (April 2014).

74 Note that New York has enacted legislation that causes such a trust created by an individual that is not a grantor trust for federal income tax purposes and transfers to which are not complete for gift tax purposes to be treated as a grantor trust for New York income tax purposes. N.Y. Tax Law § 612(b)(41).

75 Only the surviving spouse may be the beneficiary during his or her lifetime of a trust that is intended to qualify for the gift or estate tax marital deduction. See Sections 2523 and 2056. Although certain marital deduction trusts, see, e.g., Section 2056(b)(5), may permit the spouse who is the beneficiary to exercise a general power of appointment, any exercise in favor of charity likely would be treated as being made by the spouse and not the trust.

76 See Regester, 83 TC 1 (1984).

77 The meaning of "charitable" varies slightly for income and gift tax purposes. To avoid any issue, transfers, at least above the gift tax annual exclusion under Section 2503, should be made only to charitable organizations that qualify for the gift tax deduction under Section 2522(a).

78 The last sentence of Section 662(b), which determines the character of amounts distributed from a trust (or estate) to a beneficiary, provides that with respect to amounts of fiduciary accounting income required to be distributed currently: "[D]istributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year." It may be noted that no Section 642(c) deduction is allowable with respect to trust distributions that are governed by Sections 651 and 652. See, e.g., TAM 8738007 (not precedent).

79 Section 662(a).

80 Distributable net income (DNI) is described in detail in section 3:3.2 of Blattmachr and Boyle, *supra* note 59. However, in the very limited circumstances when the "throwback rules" apply, distributions of accumulated (prior years') income may also become taxable to the beneficiary.

income at all. If the first-tier amounts exceed DNI, each recipient of first-tier distributions includes in gross income a proportionate part of the DNI.[81]

If first-tier distributions alone do not exceed DNI, the second-tier distributions are included in the gross income of the recipient-beneficiaries to the extent of the balance of DNI. When the total of first-tier and second-tier distributions exceed DNI, each recipient of second-tier distributions includes in income a proportionate part of the amount that remains after DNI is reduced by the first-tier distributions.[82] For purposes of the DNI limit on taxing first-tier distributions to beneficiaries, the trust's income tax charitable deduction is not allowed when computing distributable net income.[83]

Example. A trust has $65,000 of taxable dividend income. Annually, the trust is required to distribute the first $10,000 of income to a qualified charity, C, and the balance of its accounting income to an individual, Alan. In addition, the trustee is authorized to invade principal for the benefit of a second individual, Barbara, and distributes $10,000 to her. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000, one-half of the trustee's fee). Thus, the amount distributable to Alan is $50,000 ($60,000 less $10,000 due the charity). The trust's taxable income, before any deduction for the distribution of DNI, is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to Alan and Barbara exceed DNI, the trust's distribution deduction is limited to $45,000.

When the amount of income Alan must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose, and Alan has $50,000 of taxable income under Section 662. The income he must report is less than the recomputed DNI by $5,000, because Alan has received only $50,000.

Nevertheless, Barbara has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000, and that amount is not in excess of the tier 1 distribution to Alan.

Therefore, a discretionary distribution, as well as a mandatory one, shifts the trust's DNI from the trust to a beneficiary but there is potentially less gross income for a discretionary noncharitable beneficiary for the same amount of a distribution. Consequently, for trusts that will make distributions to charities and individuals, only discretionary beneficiaries will indirectly receive the benefit of the charitable deduction. By providing for discretionary distributions rather than mandatory ones, a decedent can plan for that potential benefit.

Income tax advantages of a trust's charitable deduction

Another potential advantage of using a trust to make charitable gifts, rather than gifts by an individual, is that neither a trust nor an estate is subject to the 3% "cutback" rule of Section 68.[84]

Also, the net investment income (NII) rules of Section 1411 apply differently to estates and trusts than to individuals and, as a result, there may be less NII tax payable if charitable gifts are made by an estate or trust. Under the Regulations, income distributed for charitable purposes that entitles the estate or trust to a deduction under Section 642(c) is not subject to NIIT in the hands of the trust or estate or, presumably, not in the hands of any tax-exempt recipient.[85]

The fact that an estate or trust can shift its NII to a charity may provide it with an advantage when compared to an individual taxpayer. An individual pays the NIIT on the lesser of NII or adjusted gross income (over the threshold). Charitable contributions do not reduce NII of an individual because the charitable deduction is an itemized deduction for an individual. However, the charitable contributions do reduce NII for an estate or trust.[86]

Conclusion

One of the most important differences in computing the taxable income of an individual on the one hand, and an estate or trust on the other, relates to the deduction for charitable contributions, except where the contribution by an estate or trust consists of UBI. This difference may result in preferable outcomes for taxpayers by arranging for contributions to be made by an estate or trust rather than by its beneficiaries. Building in the opportunity for the trust or estate to make discretionary distributions to charity, where doing that will not cause adverse effects, may be beneficial. ■

81 An exception exists if certain classes of income are distributable to only certain beneficiaries. Reg. 1.662(b)-1.

82 Section 662(a)(2).

83 Section 662(a)(1).

84 See Section 68(e).

85 The deduction under Section 642(c) is permitted when the distribution is for a charitable purpose, which might not include an income tax exempt charity. See section 3:2.1[J] of Blattmachr and Boyle, *supra* note 59, for a detailed discussion. In any case, it seems that no part of a distribution of NII could be considered unrelated business taxable income within the meaning of Section 512(a). See generally Blattmachr, *supra* note 55.

86 However, it may not reduce the NII allocated to a noncharitable beneficiary of an estate or trust to the extent the beneficiary is entitled to a current distribution of fiduciary accounting income. See *supra* note 78 on how to challenge and defeat or avoid will contests and accompanying text.