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Steve Leimberg's Charitable Planning Email Newsletter Archive Message #259

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Subject: Larry Katzenstein on CCA 2016510134: What is the "Governing" Instrument for Section 642(c) Purposes?

"A recent Chief Counsel Advice is further evidence that trusts making distributions to charity continue to be vexed by the governing instrument requirement. The primary question posed in Chief Council Advice 201651013 was this: 'Is a trust which has been modified pursuant to a state court order entitled to a section 642(c)(1) charitable deduction for current payments to charitable organizations which could only be made because of the modification?'"

Now, **Larry Katzenstein** provides members with his analysis of **CCA 201651013**.

Lawrence P. Katzenstein is a nationally known authority on estate planning and planned giving. He practices in St. Louis, Missouri in **Thompson Coburn LLP**'s private client services area and is a frequent speaker around the country to professional groups. He appears annually on several American Law Institute estate planning programs and has spoken at many other national tax institutes, including the Notre Dame Tax Institute, the University of Miami Heckerling Estate Planning Institute and the Southern Federal Tax Institute. Larry has served as an adjunct professor at the Washington University School of Law where he has taught both estate and gift taxation and fiduciary income taxation. A former chair of the American Bar Association Tax Section Fiduciary Income Tax Committee, he is also a fellow of the American College of Trust and Estate Counsel and a member of its Charitable Planning Committee, and has served as a member of the advisory board of the New York University National Center on Philanthropy and the Law. He is listed in The Best Lawyers in America® in the field of Trusts and Estates. Larry was named the St. Louis Non-Profit/Charities Lawyer of the Year in 2011 and 2015 and the St. Louis Trusts and Estates Lawyer

of the Year in 2010 and 2013 by Best Lawyers®. He was nationally ranked in the 2009-2016 editions of Chambers USA for Wealth Management. Larry is also the creator of Tiger Tables actuarial software, which is widely used by tax lawyers and accountants nationwide.

Now, here is Larry's commentary:

EXECUTIVE SUMMARY:

A recent Chief Counsel Advice is further evidence that trusts making distributions to charity continue to be vexed by the governing instrument requirement. The primary question posed in Chief Council Advice 201651013 was this: "Is a trust which has been modified pursuant to a state court order entitled to a section 642(c)(1) charitable deduction for current payments to charitable organizations which could only be made because of the modification?" Section 642(c) allows a charitable income tax deduction to a trust distributing amounts from gross income to charity but only if the distribution is made "pursuant to the terms of the governing instrument." What is the governing instrument?

COMMENT:

In this particular case, a family trust was modified by settlement agreement that divided the trust into two trusts, one for the descendants of each child of the grantor. The settlement was approved by a state court and, in earlier private letter rulings, the Service ruled that the division would not cause the trusts to lose their generation-skipping tax grandfathered status. Later, the trustees of one of the trusts filed an additional petition in state court requesting certain modifications, including modifying testamentary powers of appointment into inter vivos powers. (Both the testamentary and inter vivos powers allowed appointment of income and principal to charity.) The court approved the modification, and distributions were thereafter made to a private foundation.

On its original Form 1041, the trust did not claim a deduction for any of the payments to the foundation, but on an amended return the trust deducted both ordinary income and capital gains paid to the foundation under

§642(c). The CCA was requested in connection with an examination of the return on which the charitable deduction was claimed.

The first question asked was whether the distribution was in fact made pursuant to the terms of the governing instrument or, more specifically, whether the modified instrument was the “governing instrument” for §642(c) purposes. Here the law is cloudy. On the one hand, the Supreme Court in Old Colony Trust Co. v. Commissioner, 57 S. Ct. 813 (1937), held that payments from a discretionary trust to charity qualified for a charitable deduction even though the distribution was not required. More directly on point was the decision in Crown Income Charitable Fund, 8 F.3d 571 (7th Cir. 1993), aff’g 98 T.C. 327 (1992), involving commutation of a charitable lead trust. Both the court of appeals and the Tax Court held that the excess distribution triggered by the commutation were not deductible under §642(c) because they were not made pursuant to the terms of the governing instrument.

A particularly narrow reading is the one found in *Brownstone v. United States*, 465 F. 3d 525 (2nd Cir. 2006), in which a surviving spouse exercised a general power of appointment over a marital deduction trust in favor of charitable organizations. The court held that the distribution to the charities was made pursuant to the wife’s power of appointment and not pursuant to the governing instrument. That seems like a particularly cramped reading and not one that would prevent any perceived tax avoidance abuse. No modifications were made to any instrument by settlement, court order or otherwise, and the power was exercised in full compliance with the governing instrument’s requirements.

So, based on this background, the CCA advised that the purpose of the court order in the instant case was not to resolve a conflict (settlement of a legitimate dispute might be a different case) but to obtain economic and tax benefits and that, based on *Crown* and *Brownstone*, the governing instrument requirement was not met.

The CCA then considered whether the amounts could be deducted as a regular distribution deduction under §661. Section 663(a)(2) provides that amounts paid or permanently set aside or otherwise qualifying for the §642(c) deduction cannot be deducted under §661. The purpose of §663(a)(2) seems to be to prevent a double deduction: you can’t deduct the distribution under both sections. However, the regulations under §663 go further and have long provided that amounts paid to charity by

a trust or estate are deductible *only* under §642(c). If the distribution does not qualify under that section it cannot then be deducted under §661.

The CCA delved into the 1954 legislative history of §663(a)(2) and concluded that the legislative history was unclear as to the purpose and scope of that section. But by now a number of cases have upheld the §663 regulation reading. The most celebrated and discussed were the cases of *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972), cert. denied, 409 U.S. 1108 (1973), and *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977), which upheld the Service's position that distributions to charity are deductible *only* under §642(c) and that, if they do not qualify under that section, the distributions are not deductible at all. The distributions in those cases were distribution of corpus, not income, and so did not qualify under §642(c).

The CCA then looked to commentators and found that opinions were divided. After looking at the supporting commentators, the CCA then looked at those who disagreed, The CCA is worth quoting at length:

> However, at least as many secondary sources in this area disagree with the disallowance under §661(a), at least under some facts. Another standard treatise, Ferguson, M. Carr, et al, Federal Income Taxation of Estates, Trusts, & Beneficiaries (current through 2016), states at §6.10: "The analysis [explaining why a single payment should not allow double deduction under §§642(c) and 661(a)] does not, however, answer the question whether amounts that pass to charity in such a way as not to qualify for the deduction under §642(c), such as amounts that pass to nonqualified quasi-charitable organizations or are used for purposes that are not exclusively charitable, escape the proscription of §663(a)(2). Obviously, such amounts do not qualify "for the deduction provided in §642(c)." Are they therefore deductible as distributions under §661? A literal reading of the statute strongly suggests that many such amounts should be. Even an undisputedly charitable beneficiary would be treated the same as any other beneficiary under the distribution rules, if it were not for §§642(c) and 663(a)(2). When no deduction is available under §642(c), §663(a)(2) seems to plainly not apply.
>
> Ferguson then acknowledges that the *Mott* analysis is attractive under its facts because allowing the §661 deduction would allow the shifting

of almost all of the estate's DNI to the charity, thus causing those amounts to escape taxation altogether, with the estate and the taxable beneficiaries paying little or no tax on the amounts ultimately received by those beneficiaries. “It is hardly surprising that a court would try to avoid this sort of awkwardness. What is surprising is that the same court that during the same year resorted to an extremely literalistic interpretation of the same statutory structure in deciding *Harkness v. U.S*, [199 Ct. Cl. 721 (1973), cert. denied 94 S. Ct. 115 (1973)], in which the taxpayer was unquestionably over-taxed, would have so openly defied the statute in *Mott*.” In *Harkness*, a decedent's will divided the residual estate into equal parts, one for the benefit of his wife, and the other to be further divided into four trusts for his children, with all estate and inheritance taxes to be paid out of the children's share. In a year prior to final distribution of the residue, the executors paid a series of distributions totaling approximately $27.5 million to the widow, $8.4 million to the children's trusts, and $18.9 million in state and federal estate taxes. In other words, the total payments out of each half share were very nearly equal, with the taxes and children's payments together equivalent to the widow's payments. This was intentional on behalf of the executors, who would make an equalizing distribution to one side whenever a distribution or tax payment was made on the other, with the goal of keeping the corpus balance in the remaining residue equal, so that the income tax liability would also be equal, not requiring any calculations based on one side having more or less than a half interest. This was apparently an accepted practice under state law. The Court did not accept this tracing of additional payments to corpus, but applied the general rule of §662(a)(2) and divided the DNI proportionally to the beneficiaries based on their relative distributions, 76% to the widow rather than the claimed 50%. The *Harkness* dissenter actually criticizes the §662 anti-tracing rule on Constitutional grounds as creating an impermissible unapportioned direct tax on principal. The dissent also notes that *Mott* allowed tracing to defeat the taxpayer while the majority was disallowing it to the same end in the present case.

Ferguson continues: “Much water has passed under the bridge since the decisions in *Mott* and *Harkness*. To be sure, *Mott* now has a substantial judicial following. On the other hand, in extending the separate share rule to estates, as well as to trusts, Congress has not only overruled *Harkness*; it eliminated the over-taxation that

> accompanied its literalistic interpretation of the statute. In extending the separate share rule to estates, Congress also eliminated the need to depart from the statute in cases like *Mott*, to keep the estate and its other beneficiaries from going essentially tax-free on income charity never receives. By requiring the allocation of a Subchapter J entity's DNI among each of its separate shares, the separate share rule eliminates both over-taxation in cases like *Harkness* and under-taxation in cases like *Mott*. Under current law, Mrs. Harkness would remain taxable, but only on her share of the estate's DNI. Likewise, in *Mott*, the estate and its other beneficiaries would be taxable on all of its DNI, except that portion, if any, properly allocable to the charity's separate share. In short, under current law, there is no reason, in a case like *Mott*, for the court not to interpret the statute literally, and to allow a distribution deduction under §661 for a charitable distribution that does not also qualify for the deduction under §642(c), or for a distribution to a nonqualified quasi-charity. Each of the cases to the contrary arose well before Congress's extension of the separate share rule to estates. Stripped of their rationale, they no longer deserve deference. All that remains is the innocuous sentence in the regulation, which even the *Mott* court admitted found no support in the statute. Whether the regulation, as interpreted by the Service remains valid, now that Congress has extended the separate share rule to estates, is not obvious."

The CCA punted on the third issue, which was whether capital gains includable in DNI would also be deductible under §661, in view of the fact that no deduction was permitted under that section at all.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Larry Katzenstein

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