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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SBSE
Salt Lake City

FROM: Frances Schafer
Counsel to the Associate Chief Counsel
(Passthroughs & Special Industries) CC:PSI

SUBJECT: Simple Trust Charitable Deductions

This Chief Counsel Advice responds to your memorandum dated June 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE: Whether a trust whose governing instrument does not authorize the trustee to make charitable contributions may claim a charitable deduction for its distributive share of a charitable contribution made by a partnership, in which the trust is a partner.

CONCLUSION: A trust whose governing instrument does not authorize the trustee to make charitable contributions may claim a charitable deduction for its distributive share of a charitable contribution made by a partnership provided that all other requirements of § 642(c) have been met, including the application of § 681.

FACTS: T is a trust that was validly formed pursuant to state law. T's governing instrument may require that all the income be distributed currently or may provide for discretionary payments of income or for accumulation of income. T's governing instrument does not authorize the trustee to make charitable contributions. T claims a charitable deduction for its distributive share of charitable contributions made by a passthrough entity in which T has an interest.

LAW AND ANALYSIS: Section 642(c) provides that a trust (other than a trust meeting the specifications of subpart B) is allowed as a deduction in computing its taxable income (in lieu of the charitable deduction allowed by § 170(a)) for any amount of gross income, without limitation, that pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in § 170(c).

Section 651(a) defines a simple trust as a trust the terms of which (1) provide that all of the trust's income is to be distributed currently, and (2) do not provide that any amounts are to be paid, permanently set aside, or used for the charitable purposes specified in § 642(c). With regard to the second requirement, § 1.651(a)-4 of the Income Tax Regulations provides that a trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable purposes for any taxable year for which it is not allowed a charitable deduction under § 642(c). An additional requirement to be a simple trust is that no amounts other than trust income are distributed during the taxable year.

A trust that does not meet the requirements to be a simple trust is a complex trust subject to the provisions of § 661. Section 1.651(a)-1 provides that a trust may be a simple trust for one year and a complex trust for another year.

Section 681 limits a trust's charitable deduction if the trust has unrelated business income. Specifically, § 681(a) provides that no amount otherwise allowable as a deduction under § 642(c) shall be allowed as a deduction with respect to income that is allocable to the trust's unrelated business income (UBI) for the taxable year. The term "unrelated business income" means an amount equal to the amount which, if such trust were exempt from tax under § 501(a) by reason of § 501(c)(3), would be computed as its unrelated business taxable income under § 512 (relating to income derived from certain business activities and from certain property acquired with borrowed funds).

Section 1.681(a)-2(a) provides that for purposes of the computation under § 512 the term "unrelated trade or business" includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. A partial deduction is allowed for amounts paid to charity allocable to UBI by operation of § 512(b)(11). This deduction is subject to the percentage limitations applicable to contributions made by individuals under § 170(b)(1)(A) and (B). See § 1.681(a)-2(b) and (c) for rules concerning the computation of the partial deduction.

One of the threshold requirements of § 642(c) is that the charitable contribution be made pursuant to the terms of the trust's governing instrument. Thus, in order for a contribution to be deductible the trustee must be authorized by the governing instrument to make a distribution of income for a charitable purpose. This statutory

requirement is an essential element for an allowable deduction with regard to any charitable contributions made directly by a trust.

The question arises as to whether failure to meet the governing instrument requirement is automatically fatal to a deduction when the charitable contribution has been made by a passthrough entity in which the trust has an interest. Thus, the issue presented is whether a trust (T) may claim a charitable deduction for its share of a charitable contribution made by a passthrough entity, where the governing instrument of the trust does not authorize the trustee to make charitable contributions. There are three possible types of entities in which T may have an interest, but this memorandum focuses primarily on T owning an interest in a partnership.

There has been a suggestion that T is part of a tiered-trust scheme. Apparently, the upper-tiered trust, pursuant to the terms of its governing instrument, contributes amounts of its gross income to charitable organizations and attempts to pass the charitable deduction through to T, a lower-tiered trust. As your memorandum points out, a trust takes charitable contributions into account in determining its own taxable income but cannot pass charitable deductions or any other deductions (with the exception of depreciation and depletion) through to its beneficiary. Rather, the amount of net income that a trust passes through to a beneficiary (even if the beneficiary is a lower-tiered trust) is, in essence, the amount of cash distributed to that beneficiary, not to exceed the beneficiary's share of distributable net income. Any attempt to pass a charitable deduction from one trust to another trust as its beneficiary is improper and impermissible.

Another possibility is that the passthrough entity is an S corporation and the trust is an electing small business trust (ESBT). Issues regarding an ESBT's deduction for its share of charitable contributions made by the S corporation are addressed in the proposed ESBT regulations.

The third possibility is that the passthrough entity is a partnership, and T is claiming a deduction for its distributive share of charitable contributions made by the partnership. We believe that the charitable deduction should not be disallowed merely because the trust's governing instrument does not authorize the trustee to make charitable contributions.

The Tax Court addressed the Service's disallowance of charitable deductions taken by an estate because the decedent's will did not contain a provision for charitable contributions in Lowenstein v. Commissioner, 12 T.C. 694 (1949), aff'd, 183 F.2d 172 (sub nom First National Bank of Mobile v. Commissioner)(5th Cir. 1950) and Estate of Bluestein v. Commissioner, 15 T.C. 770 (1950). Both of these cases dealt with § 162, a statutory provision that provided for charitable deductions by trusts and estates.

Section 162 provided that the estate shall be allowed a deduction without limitation for all contributions paid pursuant to the provisions of the will. While these cases dealt with the pre-1954 Code, § 642(c) is substantially the same as former § 162.

In Lowenstein, the taxpayer, decedent's estate, and two individuals each owned a one-third interest in a partnership. Subsequent to decedent's death, the partnership made charitable contributions. The amounts of the contributions were deducted in the partnership returns as ordinary and necessary business expenses. The Service disallowed the taxpayer's share of the charitable gifts reasoning that the contributions did not meet the requirements of § 162 as the decedent's will did not contain a provision allowing charitable contributions. The Tax Court, however, held for the taxpayer stating

> It is not stipulated or otherwise shown whether the respondent allowed the deduction to the active partners as ordinary and necessary business expenses, as claimed in the partnership returns or as charitable gifts by the individual partners under section 23(o), Internal Revenue Code. In any event, we think that the deduction should have been allowed to the decedent's estate, as well as to the active partners. The fact is that the estate never received the amount representing its portion of the charitable gifts. They were deducted from the partnership income before its share of the earnings was ever determined. Under the partnership agreement the estate was entitled to receive only its one-third share of the distributable earnings; and, since the active partners were charged with the management of the business, it might be said that the charitable gifts they made were actually made pursuant to the partnership agreement. What the respondent has done, in effect, is to add to the petitioner's distributable partnership income one-third of the charitable gifts, which it never received. We think that the entire amount of the gifts should have been allowed as a deduction in computing the distributable income.

Likewise, in Bluestein, the Service disallowed the charitable contribution deduction taken by decedent's estate because the decedent's will did not contain a provision for charitable contributions. The decedent's estate owned a 50 percent partnership interest with the decedent's three sons owning the remainder. The Service argued that the contributions did not meet the requirements of § 162. In holding for the taxpayer, the court stated that because the Lowenstein case was not distinguishable in principle, a deduction should be allowed for the estate's share of the charitable contributions made by the partnership in computing the gross income of the estate.

Although the court did not analyze the governing instrument requirement in the above cases, 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 those amounts. It is our contention that the court would reach the same conclusion today as it did in Bluestein and Lowenstein if the Service were to argue that the charitable deduction should be disallowed because the trust's governing instrument did not contain a provision authorizing charitable contributions.

The proposed ESBT regulations take an analogous position with respect to an ESBT's share of charitable contributions made by the S corporation. Section 1.641(c)-1(d)(2)(ii) of the Proposed Income Tax Regulations provides that if a deduction is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion of the trust pursuant to the terms of the trust's governing instrument within the meaning of § 642(c)(1). The other requirements of § 642(c)(1) must be met for the contribution to be deductible, and the deduction cannot exceed the amount of gross income of the S portion.

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 the other requirements of § 642(c)(1) must be met, and the limitations of § 681(a) must be taken into account.

One of the requirements under § 642(c)(1) is that the charitable contribution is made from gross income. For this requirement to be met with regard to a trust's distributive share of a contribution made by a partnership, the charitable contribution must be made from the partnership's gross income. In addition, to be completely deductible, the income must not be allocable to unrelated business income within the meaning of § 512. Unrelated business income includes income earned by the partnership from active trade or businesses or from certain property acquired with borrowed funds. A trust's deduction for its distributive share of a partnership's charitable contribution that is allocable to unrelated business income is subject to the limitations provided in § 681 and the regulations thereunder. Thus, a trust should be allowed a charitable deduction under § 642(c)(1) for its distributive share of charitable contributions made by a partnership from the partnership's gross income that is not unrelated business income.

The result should be the same for both simple and complex trusts. For instance, assume a trust that otherwise would be a simple trust is a partner in a partnership. Assume further that the partnership contributes some of its gross income (that is not unrelated business income) to a charitable organization during the taxable year. The trust should be allowed a charitable deduction under § 642(c)(1) for its distributive share of the charitable contribution, even though the trust's governing instrument does not authorize the trustee to make charitable contributions. The trust is a complex trust for

the taxable year because a charitable deduction under § 642(c)(1) is allowed for that year.

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Please call 202-622-3070 if you have any further questions.

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By: ______________________________
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