Estates With Charities As Beneficiaries: How Do We Protect Their Interests?

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A. Estates With Charities As Beneficiaries Pose Unique Problems

1. Not only are the qualification rules for post-mortem income tax charitable deductions different from the qualification rules for an estate tax deduction, but the income tax rules for deductibility of income paid to charity during administration are different from the rules for deductibility of distributions to non-charitable beneficiaries. Every attorney representing a beneficiary that will receive charitable bequests (particularly bequests of residue) should advise the charity to request copies of any federal estate tax return filed for the estate, as well as accountings, income tax returns, and, of course, the will or trust giving rise to the bequest. Only in this way will the charities be able to assure themselves that they have received everything to which they are entitled. This outline will highlight the kinds of questions that charitable beneficiaries of estates should be asking—or that we should be asking for them. Unless otherwise indicated, all section references are to the Internal Revenue Code.

2. *Are Income Taxes Being Paid Unnecessarily?*

   a. The section 642(c) deduction, which permits estates and (for current distributions) trusts to deduct from income amounts distributed to charity, is often poorly understood or ignored by practitioners and is even less likely to be understood by our charitable clients. But the issues posed by section 642(c) arise surprisingly frequently. Take, for example, this very typical situation: Residuary estate is left to charity. Income is accumulated during administration years 1 and 2 and is distributed with the residue of the estate in year 3. Is the income generated in years 1 and 2 taxable? In which years? Does the distribution to charity in year 3 carry out income to the charity? From which years?

      i. Section 642(c) provides for deductions from gross income in two specific cases: (1) when income is *actually distributed* (section 170(c)(1)) and (2) when the income is *set aside* for future distribution to charity (section 170(c)(2)).

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ii. The general rule set forth in section 642(c)(1) is that estates and complex trusts are permitted a deduction in computing taxable income (in lieu of the deduction allowed under section 170(a)) for any amounts of gross income, without limitation, that pursuant to the terms of the governing instrument are paid during the taxable year for a purpose specified in section 170(c) determined without regard to section 170(c)(2)(A).

iii. Several things are notable about the general rule.

(1) Amounts are deductible without limitation. Although trusts and estates generally compute their income in the same manner as individuals, section 642(c) overrides section 170, with its percentage limitations. If all income is distributed to charity during the taxable year, all is deductible without regard to percentage limitations.

(2) Income is deductible if paid for a purpose specified in section 170(c) determined without regard to section 170(c)(2)(A). Section 170(c)(2)(A) refers to organizations created in the United States. Therefore, distributions to foreign charities are deductible for income tax purposes under section 642(c) even though such gifts would not be deductible for income tax purposes by individuals under section 170.

(3) Section 642(c)(1) includes an election to treat distributions to charity made in one year as if they were made in a prior year. This is similar to the 65-day rule applicable to complex trusts, except it is a 365-day rule in the case of charitable distributions.

iv. *Gross Income Requirement.* One of trickiest issues in connection with distributions to charity is the requirement that a distribution be from the estate or trust's gross income.

(1) This is inconsistent with the general philosophy of subchapter J, which does not require tracing of sources of income in most cases. A distribution, whether in cash or in kind, to an individual will carry out income to the extent of distributable net income (DNI) without regard to whether the amounts being distributed are income or principal for fiduciary accounting purposes. This no-tracing rule greatly simplifies taxation of trusts and estates.

(2) Section 642(c), on the other hand, requires that the amounts distributed, to be deductible, must be from gross income, which for this purpose means fiduciary accounting income. This rule can serve to deny deduction in some cases. For example, when property is sold to raise money to pay a charitable bequest, a distribution of the cash realized on the sale will not be deductible because the distribution was not required to be paid out of the sale proceeds.

(3) What about the case in which a substantial partial distribution is made to a charity? Does the distribution carry out income? If the distribution is one of corpus under state law the deduction will not be permitted under section 642(c) because the distribution is not from income as determined by state law.

(A) Is it in that case deductible as a distribution deduction under section 661? Section 663(a)(2) provides that there shall not be included as amounts falling within section 661(a) any amount paid or permanently set aside or otherwise qualifying for the deduction under section 642(c). It would appear that the purpose of this provision is to deny a double deduction; the section denies a distribution deduction if the charitable deduction is also available, so the same distribution cannot be deducted under both sections. But *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), upheld the IRS's position that distributions to charity are deductible only under section 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 distributions of corpus, not income, and so did not qualify under section 642(c). Ferguson, Freeland, and Ascher, in their invaluable treatise *Federal Income Taxation of Estates, Trusts, and Beneficiaries,* note that the *Mott* case perhaps reached this result because the effect would have been shifting almost all of the DNI to the charity so that the other beneficiaries would have paid very little tax. But the authors feel these cases are wrongly decided.

(B) Now that the separate share rule applies to estates, the abuse the courts worried about in *Mott* and *O'Connor* is not possible. Is the time ripe for the courts to reconsider those cases?

v. What should the executor do in these cases? First, it is essential that, for fiduciary accounting purposes, distributions to charity be made from income and denominated as such. It may be good practice to make two distributions with two checks, one an income distribution from fiduciary accounting income denominated as such, and the other a corpus distribution. If the administration is no more than two years, it may be that a section 642(c) election can be made to treat the distribution as made in the prior year, but the distribution must still be from gross income.

vi. If trust residue is distributable to charity, must the charitable deduction be reduced by income taxes payable out of the residue? In other words, should the income tax deduction be figured on a "straight" basis or an interrelated basis requiring an algebraic solution? Under some sets of facts, this question can determine whether there is a full deduction or no deduction at all. In *Hartwick College v. United States,* 801 F.2d 608 (2d Cir. 1986), the court held that the deduction would be figured on a "straight" deduction basis.

(1) How did the court reach this result? Section 2055(c) provides that no estate tax charitable deduction is allowed for any portion of a charitable bequest that is used for payment of estate taxes. Since section 642(c) does not include similar disallowance language, the court ruled that in fact that entire amount would be deductible. The court noted Justice Holmes's remark in Edwards v. Slocum, 264 U.S. 61 (1924), that "algebraic formulae are not lightly to be imputed to legislators."

vii. *The Charitable Set Aside Deduction.* Section 642(c)(2) provides a special deduction for amounts not currently distributed, but set aside for future distribution to charity. It applies to estates, but does not apply to trusts except for grandfathered trusts created on or before October 9, 1969. The set aside deduction is very useful in the case of a probate estate that cannot distribute income currently. This will, of course, often be the case because of uncertainty as to estate tax liability, will contests, or other fiduciary concerns that warrant holding the estate intact during an administration period.

(1) Because the set aside deduction applies only to certain pre–Tax Reform Act of 1969 trusts, revocable trusts may not avail themselves of the set aside deduction.

(2) Until the recent addition of section 645 to the Code, this posed a significant hardship on revocable trusts that could not make current distributions of income.

(3) Section 645 permits a trustee of a revocable trust and the executor (if any) of an estate to treat both entities for income tax purposes as part of the estate. This means that, for the first time, income set aside in a revocable trust for eventual distribution to charity will qualify for the set aside deduction. Since a revocable trust will now qualify for the set aside deduction, one wonders why section 642(c) should not simply be amended to provide that a revocable trust after death will be permitted a set aside deduction in the same manner as a probate estate.

(4) The section 645 election is effective for two years after the decedent's death when no estate tax return is required to be filed, and until six months after the date of final determination of liability of estate tax when a return is required to be filed.

(5) Even probate estates can fall into a set aside trap. In Estate of *Berger v. Commissioner,* 60 T.C.M. (CCH) 1079 (1990), the Tax Court disallowed a set aside deduction to an estate when the estate administration was unduly prolonged. The court treated the estate as having terminated and taxed it instead as a trust, which was not allowed a charitable set aside deduction.

B. Delayed Funding Of Charitable Remainder Trusts

1. A number of issues can arise in connection with delayed funding of charitable remainder trusts.

   a. A first issue that can arise is the question of whether the private foundation rules apply to an estate during the period of trust administration and before the trust is funded. Treasury Regulation §53.4947–1(c)(6)(i) provides that a testamentary charitable remainder trust will be treated as a split interest trust from the time of the testator's death. This contradicts the provision in the regulations to the effect that a charitable remainder is not deemed created until it is first funded. See Treas. Reg. §1.664–1(a)(4). Note that the regulations provide differently for revocable trusts that continue for a period of administration before the charitable remainder trust is funded. In this case the regulations provide, in section 53.4947–1(c)(6)(iii), that only after a reasonable period of settlement as defined in the regulations will the split interest trust be deemed created.

   b. Even a probate estate can be subject to the private foundation rules (particularly the self–dealing rules) if there is any delay from the time the estate is considered terminated under the section 641 regulations until funding of the charitable remainder trust.

   c. For all of these reasons, care should be taken even during administration and before funding with regard to self-dealing transactions with the entity that will eventually fund the charitable remainder trust.

   d. Another issue that is the source of considerable confusion is the question of deferred payments from testamentary unitrusts. The Internal Revenue Service requires that when a charitable remainder