When Can an Estate or Trust Distribute IRD to a Charity and Receive an Income Tax Charitable Deduction?—The Answer is not Simple

Author : Michael Yu

Date : November 15, 2018

Ladson Boyle and Jonathan G. Blattmachr, *IRD and Charities: The Separate Share Regulations and the Economic Effect Requirement*, 52 **Real Prop. Tr. & Est. L.J.** 369 (2018).

Can an estate or trust with charitable and non-charitable beneficiaries (1) receive income in respect of a decedent (IRD) proceeds, (2) distribute (or set aside) for a charitable purpose the IRD proceeds, and (3) perhaps not be allowed an Internal Revenue (IRC) code section 642(c) income tax charitable deduction? You may know that the answer is "yes." In their article, Professor F. Ladson Boyle and Jonathan G. Blattmachr not only explain when and why such income tax charitable deduction is available, but also suggest planning techniques to ensure that the deduction is, indeed, available.

To start, here are the authors' suggested solutions for ensuring that the section 642(c) income tax charitable deduction is available to the estate or trust. First, if possible, designate the charity as the direct beneficiary of the individual retirement account (IRA) or other IRD; do not have the IRD proceeds pass through the decedent's probate estate or revocable trust. (P. 413.) Second, if the charity cannot be the direct beneficiary of the IRD and if the governing testamentary instrument can be drafted or amended, then ensure that the IRD is "specifically devised to charity as a pre-residuary devise." (P. 413.) Third, if an estate is in administration, then the personal representative "might distribute the IRD in kind to the charity as a part of the residuary devise due to the charity" (but not to satisfy a specific pecuniary amount). (P. 414.)

Fourth, if none of the foregoing options are viable and the estate will receive the IRD proceeds, then the personal representative "might fully distribute the portion of the estate that is due non-charitable beneficiaries in a tax year before collection of the IRD." (P. 414.) Effectively, the charity becomes the sole beneficiary of the estate, and the IRD proceeds received will be fully offset by the charitable deduction (P. 414) (because, in the tax year when the IRD proceeds are received and distributed, there effectively are no non-charitable beneficiaries). Fifth, if the decedent had a revocable trust, the personal representative and the trustee of the revocable trust "should consider making a joint election under section 645 to treat the revocable trust as a part of the estate so that the section 642(c) charitable set aside deduction is available, if that is needed or desirable." (P. 414.)

Those are the authors' suggested solutions to the problem of a possibly unavailable income tax charitable deduction for distributing IRD to a charitable beneficiary. So, why and when is such income tax charitable deduction available? In order to answer that question, the authors must initially cover several topics, which are briefly summarized here. First, the authors note that, if both estate and income taxes must be paid, then the distribution of IRD to a non-charitable beneficiary may, ultimately, be very small. (Pp. 373-374.) Accordingly, the authors suggest that IRD be paid directly to an individual or charity; the authors note that, however, if an IRA is ultimately payable to an estate, the Service has allowed (in private letter rulings) estates to "assign IRAs and other retirement benefits to charities" (Pp. 374-375.) I wonder if seeking a private letter ruling might be a sixth suggested solution? The authors also conclude, after an extensive discussion, that "a charity's residuary interest in an estate or trust is not a separate share within the meaning of section 663(c)." (P. 397.)

The authors then narrow the income tax charitable deduction issue to "whether a direction in a decedent's will that a charity's interest in the residue of an estate or trust should be satisfied out of any IRD will be given a tax effect under the Code and Regulations." (P. 397.) The answer lies in determining whether the direction to allocate IRD assets (or their proceeds) to charity has "economic effect independent of income tax consequences," which is from Treas. Reg. section 1.642(c)-3(b)(2). (Pp. 397-398.) Determining whether a direction has such "economic effect" is, however, no simple task.

The authors first summarize the charitable ordering rules (P. 399) and then the general rules for allocating deductions against different classes of income (Pp. 400-401); both sets of rules apply because the allocation of the charitable deduction "occurs before the allocation of other allowable deductions." (P. 400.) An example in the Regulations shows one governing instrument's provision that has "economic effect independent of income tax consequences" because, under the facts of that example, "the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year." (P. 402, citing the Treasury Regulation example.)

The facts in that Treasury Regulation example are: "A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary." (P. 403.) The authors note that "the amount of cash (or other property) that is distributed to the charity is directly related to the principal that is producing the income" and that a "change in the composition of principal affects the amount the charity is to receive" (P. 404.) Accordingly, the direction in this trust to direct 100 percent of the trust's ordinary income to a charitable organization has "economic effect independent of income tax consequences."

But wait!—IRD is usually treated as accounting principal, not accounting income. Consequently, the authors re-examine the charitable ordering rules and the general rules for allocating deductions against different classes of income, this time focusing on accounting principal like IRD. The authors conclude that, to have economic effect, a direction to allocate payment to a charity must have "an impact on the underlying assets that produce the income, and therefore on the entitlement to the income the property generates." (P. 407.)

But don't forget!—at issue is the allocating of IRD to a charity, not to a non-charitable beneficiary. The authors draw and analogize from what they have already discussed (among other things, separate share regulations, and distributions of income and of principal) to conclude that "an allocation of IRD to a tax-exempt charity seems to be valid as well under the 2012 charitable ordering Regulations." (P. 408.) The authors note, however, that their conclusion is "not free of doubt, but is a reasoned analysis of the applicable Regulations." (P. 412.) They posit that the "economic effect" test may, perhaps, only be determined as an objective question of fact on a case-by-case basis. (P. 412.) Finally, the authors conclude that a personal representative having, under the governing instrument or local law, the discretion to allocate IRD to a charity likely "will be ineffective" (P. 415) for lacking "economic effect."

The authors have discussed the many legal topics invoked in answering when can an estate or trust distribute IRD to a charity and receive an income tax charitable deduction: the income taxation of trusts and estates, the income taxation of IRD, the separate shares of an estate or trust, a specific gift to a charity vs. a fractional residuary gift to a charity, the "economic effect" test of the Treasury Regulations, the charitable ordering rules, the general rules for allocating deductions against different classes of income, distributions of accounting income vs. accounting principal, distributions to charitable beneficiaries vs. non-charitable beneficiaries, and distributions pursuant to the governing instrument vs. under the personal representative's discretion—all leading to the final topic of distributions by an estate or trust of accounting principal (as part of a residuary gift) to a charitable beneficiary. The authors concluded that the availability of an income tax charitable deduction for such a distribution is not always certain. When, at the end of the article, the authors proposed their alternative actions to take in order to avoid such a distribution (and tests and rules associated thereto), I was all ears.

Cite as: Michael Yu, *When Can an Estate or Trust Distribute IRD to a Charity and Receive an Income Tax Charitable Deduction?—The Answer is not Simple*, JOTWELL (November 15, 2018) (reviewing Ladson Boyle and Jonathan G. Blattmachr, *IRD and Charities: The Separate Share Regulations and the Economic Effect Requirement*, 52 **Real Prop. Tr. & Est. L.J.** 369 (2018)), https://trustest.jotwell.com/when-can-an-estate-or-trust-distribute-ird-to-a-charity-and-receive-an-income-tax-charitable-deduction-the-answer-is-not-simple/.