Estate & Succession Planning Corner

By Lawrence I. Richman

Two Recent Revenue Rulings Highlight the Different Treatment of Charitable Contributions Under Subchapters J and K

Two recent revenue rulings highlight the tension in the tax law between the ability of a trust to take a deduction for a contribution to charity made directly by its trustee and the ability of such trust to take a charitable contribution deduction for its distributive share of a charitable contribution made by a partnership in which it is a partner.

In Rev. Rul. 2003-123,[1] the IRS restated its position that a trust is neither allowed a charitable deduction under Code Sec. 642(c) nor a distribution deduction under Code Sec. 661(a)(2) for a contribution of trust principal to charity. The 2003 revenue ruling involved a qualified conservation easement under Code Sec. 170(h). Under the facts in the ruling, the property made subject to the qualified conservation easement was part of the original corpus/principal of the trust. In the year of contribution, the trust had gross income of $20x and the conservation easement was valued at $10x. The 2003 revenue ruling held that "a trust is not allowed a charitable contribution deduction under §642(c) and is not allowed a distribution deduction under §661(a)(2) with respect to a contribution to charity of trust principal that meets the requirements of a qualified conservation contribution under §170(h)." The 2003 ruling is consistent with the express language of Code Sec. 642(c) and the provisions of Code Sec. 663(a) and Reg. §1.663(a)-2, which provide that charitable deductions are allowed trusts exclusively pursuant to Code Sec. 642(c).

This Code section allows as a deduction in computing the taxable income of a trust "any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) …" Thus, Code Sec. 642(c) allows a trust a charitable contribution deduction under subchapter J when it meets the following requirements:

- The contribution must be sourced (*i.e.,* traced) to the trust's gross income.
- The contribution must be made pursuant to the terms of the governing instrument (*e.g.,* the trust).
- There must be an actual payment during the tax year.
- The contribution must be paid for a purpose specified in Code Sec. 170(c).

These requirements are not consistent with the general principles of fiduciary income taxation under subchapter J. In subchapter J, Congress adopted a conduit approach for taxing trusts in which a trust is considered a separate taxable entity. Under this conduit approach, a trust is taxed on income that is not deemed distributed to the trust's beneficiaries. Discretionary distributions to a trust beneficiary cause the beneficiary to be deemed to receive income to the extent of a trust's distributable net income (DNI). The DNI rules, central to the conduit approach of the fiduciary income tax system, prohibit tracing by deeming a beneficiary to have received all or a proportionate share of the trust's income items comprising DNI.

Unlike other provisions of subchapter J, Code Sec. 642(c) requires that the source of the charitable contribution be traced. Thus, in the 2003 revenue ruling, it was irrelevant whether the trust did or did not have gross income, if the conservation easement originated in property that was part of the principal of the trust estate.

A reason for the tracing requirement of Code Sec. 642(c) was offered in *United States Trust Co.*[2] in which the court stated that "Congress intended that the benefit for a charitable bequest be conferred only

Lawrence I. Richman is a Partner with Neal Gerber & Eisenberg in Chicago.

once—either as an offset against gross value of the estate or as an offset against income."[3] Accordingly, if charity and members of a family were beneficiaries of a single discretionary trust and if amounts were distributed to each beneficiary, the members of the family would be subject to tax to the extent DNI was deemed distributed and the distribution to charity would only result in a deduction if the funds distributed could be traced to the gross income of the trust.

Earlier this year, in Rev. Rul. 2004-5,[4] the IRS held that "a charitable deduction under §642(c) for a trust's distributive share of a charitable contribution made by a partnership from the partnership's gross income is not prohibited even though the trust's governing instrument does not authorize the trustee to make charitable contributions." This 2004 ruling allowed a trustee who was not authorized to make charitable contributions under the terms of the trust agreement, as required under Code Sec. 642(c), to take a charitable contribution deduction under Code Sec. 642(c). Consistent with case law, the IRS read out of the tax code the express requirement of Code Sec. 642(c) that a charitable contribution is only deductible if it is pursuant to the terms of the governing instrument by determining that the partnership tax rules under Code Sec. 702 trump Code Sec. 642(c). The ruling states, "In the case of a trust's investment in a partnership, the partnership may make a charitable contribution from the partnership's gross income, and that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits."

While the ruling focuses on how the partnership tax rules trump the governing instrument requirements of the Code Sec. 642(c) under the fiduciary income tax rules, it offers no analysis of the fiduciary income tax rules that require the tracing of gross income under Code Sec. 642(c). Indeed, as a practical matter, there can be no tracing for fiduciary income tax purposes.

If one revisits the conservation easement deduction that was the subject of Rev. Rul. 2003-123 and instead places it in the partnership context of Rev. Rul. 2004-5, it would appear that the 2004 revenue ruling mandates an opposite result. This is due to the fact that, unlike trusts, which are separate taxpaying entities taxed under conduit principles, partnerships are generally not. Instead, when determining the tax treatment of charitable contributions, partnerships are not treated as an entity, but rather as an aggregate under Code Sec. 702(a)(4). By providing that in determining a partner's income tax, each partner shall take into account separately the partner's distributive share of the partnership's charitable contributions, Code Sec. 702(a)(4) causes partners to treat these items in terms of their own tax posture.

In light of the fact that one of the requirements under Code Sec. 642(c) is that a trust's contribution must be sourced to the trust's gross income, it is interesting to review how the 2004 revenue ruling uses the words "gross income." In the 2004 ruling, the words are used in reference to the partnership's gross income, a term that really only refers to the tax consequences to a partner on account of the partnership's activities. In the partnership context, any actual distribution of cash or other property is governed by Code Secs. 731 through 736 and Code Sec. 751 and is not tied to how the gross income of the partnership is reported.

Accordingly, the 2004 revenue ruling does not appear to alter the partnership tax rule that a partner may claim a charitable contribution deduction for its distributive share of a partnership's contribution to charity regardless of whether the source of that charitable contribution is current income, retained earnings or the partner's contributions to capital (provided that the allocation of the charitable contribution deduction has "substantial economic effect" within the meaning of Code Sec. 704(b)). This results, however, in a taxpayer like the one in the 2003 revenue ruling who was not allowed a charitable deduction for a conservation easement because it could not be traced to the gross income of the trust, experiencing an opposite result under the 2004 revenue ruling if the same taxpayer were a partner in a *bona fide* partnership with the income amounts reflected in the 2003 revenue ruling and that partnership granted the identical conservation easement in connection with its business activities.

In a tax world where the barriers to creating a partnership and establishing the substance of the contribution are relatively minor, the policy purposes of Code Sec. 642(c) require re-examination. If the legislative goal is to avoid a charitable contribution deduction for both income and estate tax purposes for the same charitable transfer, the result could be achieved simply by so stating. An important consequence would be increased harmony between subchapter J and subchapter K of the Code.

ENDNOTES

[1] Rev. Rul. 2003-123, IRB 2003-50, 1200.

[2] *United States Trust Co.*, CA-5, 86-2 USTC ¶9777, 803 F2d 1363.

[3] *Id.*, at 1366.

[4] Rev. Rul. 2004-5, IRB 2004-3, 295.