Comparing Charitable Deductions

Take-Away: All discretionary trusts should contain a provision that authorizes the trustee to make distributions of the trust's gross income to public charities to enable the trustee to manage the trust's federal income tax liability.

Background: Many trustees are surprised to learn that their distributions from the trust to a charity do not qualify for a federal income tax charitable deduction. We have covered these charitable tax deduction rules in the past, but they bear repeating, since many individuals are now seriously considering the adoption of a SLAT or other *dynasty*-type discretionary irrevocable trusts to 'soak up' their currently large federal transfer tax applicable exemption amount.

Charitable Income Tax Deduction: The use of a charitable income tax deduction by a trust is important because of the compressed federal income tax brackets faced by an estate or an irrevocable trust, where the highest marginal income tax bracket is encountered once its taxable income exceeds $15,200 for the calendar year. This exposure to the highest federal income tax bracket often puts the fiduciary in a bind, since a trust is often used by its settlor to keep assets (and income) away from the beneficiary's control, yet by holding the income inside the trust results in a 37% federal income tax liability. Accordingly, the trustee is confronted with a choice- either make a distribution of income to the trust beneficiary (which is then arguably available to the beneficiary or his/her creditors) at his/her much lower income tax bracket or accumulate the income inside the trust and expose it to the marginal 37% federal income tax rate. The trustee may want to manage that federal income tax liability by distributing income, not to the beneficiary, but to a charity. But to do so, the trustee will have to satisfy the rules of the Tax Code. Consequently, it is important to remember that the rules to claim a federal income tax charitable deduction by a trust or an estate are much different from the federal income tax charitable deduction rules that an individual must meet.

Trusts and Estates: An irrevocable trust, or a decedent's estate, can deduct contributions to a charity for federal income tax purposes only if the fiduciary follows the rules of IRC 642(c). IRC 642(c) has only two important rules that must be met by the estate or trust: (i) the amount paid by the fiduciary to a charitable organization must be from gross income; and (ii) the amount paid to the charitable organization must be paid pursuant to the governing instrument.

Gross Income: Gross income is described in IRC 643(b), which means taxable income, not trust accounting income. Accordingly, the amount that must be paid from the trust to the charitable

organization has to be *taxable* income, which means that the trustee can pay an amount that is capital gain or income in respect of a decedent that is normally allocated to trust accounting income because those items are *taxable* income and thus qualify for the federal income tax charitable deduction.

Governing Instrument: The *taxable* income paid by the trustee must be paid pursuant to the governing instrument, which means that the trust instrument must expressly authorize distributions of the trust's gross income to a charity. This express authority can be either expressed in the Will or the trust instrument, which directs the payment of gross income to a charity. The absence of this express direction or authority will mean that the fiduciary will not be able to make a tax-deductible distribution to any charity. Nor can a trust instrument be amended, modified, or decanted to add this missing provision of authority to distribute gross income to a charity- it must be included in the initial instrument when the instrument is first created.

Discretionary Distributions: A fiduciary's discretion to make distributions of gross income to a charity will nonetheless satisfy the requirement of IRC 642 that there must be express authority to distribute gross income to a charity. The Supreme Court held, well over a hundred years ago, that simply having the discretion to pay the amount to charity will allow the fiduciary to qualify for a federal income tax charitable deduction.

Comparison with an Individual's Charitable Income Tax Deduction: There are a few big distinctions between an individual's federal income tax charitable deduction and a trust or estate's federal income tax charitable deduction.

Amount: An individual's federal income tax charitable deduction is limited to a percentage of the individual's adjusted gross income (AGI.) A charitable deduction authorized by IRC 642 for an estate, or an irrevocable trust is for an unlimited amount- there is no artificial limit to the amount that can be claimed as a deduction.

No 'Fallback' Position: There is no *fallback* position available to the fiduciary that makes a distribution of gross income to a charity if IRC 642(c) is not satisfied. In other words, if a trust fails to contain an express authorization for the trustee to make a distribution of gross income to a charity, and the trustee nonetheless makes such a distribution to a charity, the fact that the trust instrument did not contain, or is silent, regarding that express authorization to pay gross income to the charity is fatal. The trustee cannot still take an income distribution deduction to reduce the trust's reported taxable income.

Timing of Claimed Deduction: A fiduciary can either claim a charitable deduction that is paid in the current year, meaning it pays the amount this year and it takes a federal income tax charitable deduction, or alternatively it could pay the amount next year yet still claim the deduction for this calendar year. Consequently, the fiduciary has a two-year window period where it can claim a federal income tax charitable deduction. That flexibility is not available to an individual who contributes to a charity- the individual's income tax deduction must coincide with the charitable gift that is made in the same calendar year.

Foreign Charities: As a generalization, an individual cannot claim a federal income tax charitable deduction for contributions that are made to a foreign charity. That is not the case with an estate or trust which can make a charitable contribution from gross income to a foreign charity under IRC 642.

Estate *Set-Aside* Deduction: An IRC 642(c) tax deduction is essentially allowed for an amount that is set aside for an estate. An estate can claim a charitable income tax deduction if it simply sets aside the amount for charity, even though it does not have to pay that amount immediately. This rule also applies, meaning it is a special exception, for some trusts that were created before 1969, which can also claim a set-aside charitable deduction. Generally, however, most trusts, but not estates, must timely pay the amount to a charity.

Public Charity: One other distinction, but which can also be viewed as a risk, is that the Tax Code provides that the amount paid by a trust or an estate to a charitable organization must be for a *purpose* that is described in IRC 170(c). This means that the amount distributed to the organization does not actually have to be a public charity, which is a restriction or limitation that an individual must deal with to claim a charitable deduction. It would seem wise to assure the trustee a charitable income tax deduction for a trustee to limit distributions to a public charity and not set them aside for a charitable *purpose.*

Conclusion: When faced with the highest marginal federal income tax bracket of 37% when its gross income exceeds $15,200 in a year, enabling the fiduciary to make distributions of gross income to a public charity, like the settlor's donor advised fund, seems like critically important flexibility to build into the estate or irrevocable trust instrument. When reviewing a proposed Will or trust instrument it will be important to keep a close eye out for the express authority to make gross income distributions to a public charity which will give to the fiduciary considerable flexibility when managing the estate or trust's federal income tax liability.

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