Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201651013**
Release Date: 12/16/2016

CC:PSI:B03:MHoward
POSTU-104922-16

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 661.01-00

date: September 08, 2016

to: Small Business/Self Employed
(Examination Operations)
Field Examination
Exam - Central Area
Territory - 5
Group 4
(Patricia M. Assalone, Supervisory/Manager)

from: Bradford R. Poston
Attorney Adviser, Branch 2
(Passthroughs & Special Industries)

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subject: Whether trust distributions are deductible under either § 642(c) or § 661

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Grantor =

Child 1 =

Child 2 =

Parent Trust =

Trust A =

Trust B =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Foundation 1 =

Foundation 2 =

a =

b =

c =

d =

e =

f =

g =

ISSUES

1. Is a trust which has been modified pursuant to a state court order entitled to a § 642(c)(1) charitable deduction for current payments to charitable organizations which could only be made because of the modification?

2. Assuming no § 642(c)(1) deduction is available, is the trust entitled to a distribution deduction under § 661 (to the extent of its distributable net income (DNI)) for the payments to charity?

3. If the trust is entitled to a distribution deduction, does its DNI include the capital gains realized in the year of the payments?

FACTS: This is a request for assistance from SB/SE Examination (Examination Operations) with regard to a taxpayer that has filed b requests for refund, totaling approximately $a; under § 6405(a). Each refund request pertains to same issues and includes facts similar to those outlined below.[1]

Grantor created the Parent Trust. Parent Trust was a simple trust for the benefit of Child 1 and Child 2 during their respective lifetimes and then for the benefit of their respective descendants, subject to testamentary powers of appointment granted to Child 1 and Child 2 to appoint the income among Grantor's descendants, the spouses of those descendants, and charities. Child 1 died in Year 1, having exercised his power of appointment over half of the income of Parent Trust in favor of his descendants. Parent Trust continued to be administered as a single trust until Year 2, distributing half its income among the descendants of Child 1 and half to Child 2.

On Date 1, the trustees and beneficiaries of Parent Trust entered into a settlement agreement dividing Parent Trust into two trusts, Trust A and Trust B, for the respective benefit of Child 1's descendants and Child 2. In general, the assets and liabilities of Parent Trust were divided into equal fractional shares, except for certain state tax items in dispute, which were allocated according to a formula, and the terms of Parent Trust otherwise continued to apply. The settlement agreement was contingent on a favorable state court order (received Date 2) and on the receipt of a private letter ruling (issued as PLR 201013018 on 11/30/09) stating that the division would not cause either Trust A or Trust B to lose its generation-skipping tax exemption, either because of the division itself or because of the state tax adjustments between Trust A and Trust B. No federal income tax rulings were requested or granted in the PLR.

On Date 3, the trustees of Trust B filed an additional petition with the state court requesting certain modifications including (1) that Child 2's testamentary power of appointment be changed to an inter vivos power and (2) that he be allowed to immediately exercise such inter vivos power to appoint c% of the income and principal to Foundation 1 and d% to Foundation 2, thus causing Trust B to terminate. Foundation

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[1]

1 and Foundation 2 are private foundations; Foundation 1 was preexisting, while Foundation 2 was newly created to receive funding at the termination of Trust B. On Date 4, the court approved the modification and termination, and the distribution of the trust assets to Foundation 1 and Foundation 2 was completed by the end of Year 2.

On its original Form 1041, U.S. Income Tax Return for Estates and Trusts, Trust B did not claim any deduction for the payments to Foundation 1 and Foundation 2. On its amended Year 2 return, filed Date 5, Trust B reported approximately $e income, of which about $f represented capital gain, and claimed a deduction for the entire amount, less about $g in attorney and preparer fees.[2] Additional information provided by Examination indicates that the taxpayers engaged in substantially similar division, modification, and partial termination transactions with other trusts created by Grantor or Grantor's spouse in Year 3, Year 4, and Year 5, with most of these trusts receiving favorable GST rulings either in PLR 201013018 cited above or in PLR 201013017 issued the same date. The Year 5 trust had previously been divided by court order in Year 6 and thus did not seek a ruling. We do not have full information on the original or amended reporting positions of these other trusts, but if they claimed either a § 642(c) or § 661 deduction for the amounts paid to Foundation 1 and Foundation 2, they would raise the same issues discussed here with regard to Trust B.

The attachment to the amended return and the Form 8275-R, Regulation Disclosure Statement for Trust B, claim the deduction under § 642(c)(1) and/or 642(c)(2), or alternatively, under § 661. We cite to the taxpayer's specific arguments under each section below.

LAW & ANALYSIS:

ISSUE 1

Section 642(c)(1) provides generally that in the case of an estate or trust (other than a trust meeting the specifications of subpart B [a "simple trust" described in §§ 651 and 652]), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by § 170(a)), relating to deduction for charitable, etc., contributions and gifts) 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 § 170(c) (determined without regard to § 170(c)(2)(A)). [emphasis added]

Section 642(c)(2) provides that in the case of an estate and in the case of certain trusts (in general, those created before 10/9/69), there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which

[2] In addition to claiming a refund based on the deduction which is the subject of this memorandum, the amended return also contests the treatment of certain receipts as ordinary interest income rather than capital gain. Solely for our purposes of this memorandum, we assume the characterization adopted by Trust B on the amended return is correct.

pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in § 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit.[3] [emphasis added]

In Old Colony Trust Company v. Commissioner, 57 S.Ct. 813 (1937), the Supreme Court reversed a decision of the First Circuit (87 F. 2d 131). A trust document authorized but did not require the trustees to make current charitable payments if they could do so without jeopardizing the payment of annuities from the trust to non-charitable beneficiaries. The Board of Tax Appeals denied most of the income tax charitable deduction under the predecessor of § 642(c)(1) because it found that the taxpayer had not met its burden of proof regarding whether most of the payments were actually made from trust income during the year made. The First Circuit denied the entire deduction because the charitable payments were "not imperatively directed" by the trust. If the trustee exercised discretion in making the payments, they were not "pursuant to" the terms of the trust. The Supreme Court referred to the plain dictionary meaning of "pursuant to" as "acting or done in consequence or in prosecution (of anything), hence, agreeable; conformable; following; according," which standard was met by the authorization in the trust instrument.

In Crown Income Charitable Fund v. Commissioner, 8 F.3d 571, 573 (7th Cir. 1993), *aff'g* 98 T.C. 327 (1992), the Seventh Circuit addressed the issue of commutation. The trust at issue in Crown contained a provision permitting the trustees to commute the charitable interest only if, as a matter of law, it was clear that doing so would not adversely affect the maximum charitable deduction otherwise available. The trustees of the Crown Income Charitable Fund distributed trust assets in excess of the annuity amount to the charitable beneficiary over a number of years and deducted, under § 642(c), the full amount distributed to the charitable beneficiaries. Both the Seventh Circuit and the Tax Court held that the excess distributions were not deductible under § 642(c) because those instruments were not made pursuant to the terms of the governing instrument.

In Brownstone v. United States, 465 F.3d 525 (2nd Cir. 2006), a deceased husband's will created a marital deduction trust, which granted the husband's surviving wife a general testamentary power of appointment. When the wife died, she exercised her power in favor of her estate, the residue of which passed to charitable organizations. The trustee of the marital deduction trust distributed $1 million to the wife's estate and claimed a charitable contribution deduction under § 642(c), because the $1 million distribution passed entirely to the charitable beneficiaries under the wife's will.

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[3] Although the taxpayer cites to § 642(c)(2) as well as § 642(c)(1), the facts as presented only deal with payments to Foundation 1 and Foundation 2, rather than any amounts set aside for future distribution. Therefore, we assume that if a § 642(c) deduction is allowable, it would be under § 642(c)(1) and do not further consider § 642(c)(2).

The Second Circuit in Brownstone held that the distribution to the charities was made pursuant to the wife's power of appointment and not pursuant to the governing instrument, the deceased husband's will. The Second Circuit interpreted the definition of governing instrument narrowly, stating that an instrument subject to the creating instrument (the wife's will) could not combine with the creating instrument (the husband's will) and qualify as the governing instrument. The sole governing instrument in Brownstone was the husband's original will; therefore, the marital deduction trust was not entitled to a deduction under § 642(c) since the distribution was made pursuant to the wife's will.

In Lyeth v. Hoey, 305 U.S 188 (1938), the Supreme Court held that property received in the settlement of a bona fide will contest is treated for federal income tax purposes as passing to the beneficiaries by inheritance. In Middleton v. United States, 99 F.Supp. 801 (D.C. Pa. 1951), the court held, applying principles derived from Lyeth, that amounts distributed to a charity pursuant to an agreement compromising a will contest were made "pursuant to the terms of the will." The court concluded that the income from the property that was distributed to the charity was permanently set aside for a charitable purpose and allowed a deduction for these amounts for the years prior to the year that the parties entered into the settlement agreement. See also Estate of Wright v. United States, 677 F.2d 53 (9th Cir. 1982), cert. denied, 459 U.S. 909 (1982).

In Emanuelson v. United States, 159 F.Supp. 34 (D.C. Conn. 1958), decedent left two conflicting wills – one which left 2/3 of the residue of decedent's estate to certain charities, and another which left the entire residue to non-charitable legatees. After decedent's death, a controversy arose among the beneficiaries of the two wills. The controversy was resolved in a written compromise agreement between the two sets of beneficiaries, under which 52/480 of the residue passed to the charities named in one of the wills. Payments made to the charities under the written compromise agreement were held to be made pursuant to the will. Rev. Rul. 59-15, 1959-1 C.B. 164, citing Emanuelson, held that a settlement agreement arising from a will contest qualifies as a governing instrument.

In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to Old Colony. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor Emanuelson hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both Crown and Brownstone have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of

Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

ISSUE 2

Section 661(a) provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year; but such deduction shall not exceed the DNI of the estate or trust.

Section 663(a)(2) provides that there shall not be included as amounts falling within § 661(a) or 662(a) any amount paid or permanently set aside or otherwise qualifying for the deduction provided in § 642(c) (computed without regard to §§ 508(d), 681, and 4948(c)(4) [relating to limitation or disallowance of certain charitable deductions related to unrelated business income or private foundations]).

Section 1.663(a)-2 provides that any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in § 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under § 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under § 662. **Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in § 642(c).** For purposes of this section, the deduction provided in § 642(c) is computed without regard to the provisions of §§ 508(d), 681, or 4948(c)(4). [emphasis added]

Section 663(c) provides that for the sole purpose of determining the amount of DNI in the application of §§ 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. Rules similar to the rules of the preceding provisions of § 663(c) shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than one beneficiary as separate shares. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts or estates, including the application of subpart D [the "throwback" rules of §§ 665-668], shall be determined in accordance with regulations prescribed by the Secretary.

Sections 661(a), 663(a)(2), and 663(c) were enacted as part of the original Internal Revenue Code of 1954. The only subsequent change relevant to the current issue was the amendment of § 663(c) by § 1307 of the Taxpayer Relief Act of 1997, P.L. 105-34, to apply to estates as well as trusts. Section 642(c), discussed under Issue 1, was also

included in the original Code, and was bifurcated by § 201 of the Tax Reform Act of 1969, P.L. 91-172, into current §§ 642(c)(1) and (2), dealing respectively with deductions for current payments to charity and deductions for amounts "permanently set aside" for later payment.

The 1954 legislative history is not entirely clear on the purpose and scope of § 663(a)(2). Whereas the charitable and distribution deduction provisions had general counterparts under the 1939 Code (§§ 162(a) and (b), respectively), § 663(a)(2) was a new provision, as was the entire DNI mechanism. In general, under the 1939 Code, distribution deductions had to be actually traced to the trust's gross income, whereas such tracing is unnecessary under the 1954 and 1986 Codes, since § 661 distributions automatically take out DNI which then is generally taxable under § 662 to the beneficiaries. The tracing requirement formerly applying to all trust and estate distributions now only survives for the charitable deduction under § 642(c).

The House and Senate Reports on the 1954 Code (H.R. 8300) each explain the exclusion of § 642(c) amounts from §§ 661 and 662 with reference to the "additional" deduction which the entity would be able to claim if not for this provision, suggesting that § 663(a)(2) is meant simply as an anti-duplication measure, not that there is an underlying policy of § 642(c) exclusivity.[4] The American Bar Association's submission regarding the bill also supports the adoption of this provision as preventing an "additional" deduction for distributions for which a deduction would already be allowed under proposed § 642(c). See Senate Finance Comm. Hearings on H.R. 8300, 83d Cong., 2d Sess. 438[5]

However, the example in the Senate Report demonstrating the application of §§ 661-663 (S. Rep. 1622 at 351-353) suggests the opposite interpretation. The terms of a testamentary trust require that half of the trust income be distributed currently to the grantor's wife for life. The remaining half in the trustee's discretion may either be paid

[4] "Since the estate or trust is allowed a deduction under § 642(c) for these amounts, they are not allowed as an additional deduction for distributions, nor are they treated as amounts distributed for purposes of § 662 in determining the amounts includible in the gross income of the beneficiaries." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 205 (1954) Similar language at S. Rep. No. 1622, 83d Cong., 2d Sess. 354 (1954)

[5] The ABA comments may have greater weight than ordinary Congressional testimony in that subchapter J under the 1954 Code generally follows the ABA's prior 1952 recommendations for reform of fiduciary income taxation under the 1939 Code. Of seven major recommendations, subchapter J ultimately incorporated the general principles of six: a throwback rule to replace certain prior anti-abuse provisions; the DNI limitation on distribution deductions and beneficiary income inclusion; the ability of beneficiaries to use certain excess entity deductions at termination; the passthrough of the character of income to beneficiaries; codification of the "Clifford" grantor trust regulations; and the separate share rule. The only major recommendation not adopted was to allow estates to elect to be taxed as individuals, rather than trusts, at least for a limited period. See Senate testimony cited above at 430. Several of the ABA proposals were also included in a draft statute prepared by the American Law Institute. See generally Holland, H. Brian, et al., "A Proposed Revision of the Federal Income Tax Treatment of Trusts & Estates-American Law Institute Draft," 53 Colum. L. Rev. 316 (Mar. 1953) and Kamin, Sherwin, et al., "The Internal Revenue Code of 1954: Trusts, Estates & Beneficiaries," 54 Colum. L. Rev. 1237 (Dec. 1954).

to the grantor's daughter, paid to designated charities, or accumulated. At the wife's death, the entire trust principal will be payable to the daughter. In the given year, the trust income consisted of dividends, rentals, and tax-exempt interest, of which the trustee distributed half to the wife and one-quarter each to the daughter and a charity. In determining the § 661(a) distribution deduction, the example excludes the amount distributed to the charity since it was allowed as a deduction under § 642(c) to the extent that it was included in the trust's gross income. However, the entire amount paid to the charity is not deductible under § 642(c) because a ratable part of it is attributable to the tax-exempt interest which does not enter into gross income and thus fails one prong of the § 642(c) test. The example does not add the disallowed portion of the charitable payment back into § 661 for determining the distribution deduction, thus indicating that payments to charity are deductible, if at all, only under § 642(c). The example in the Senate Report was substantially adopted as the example illustrating §§ 661-662 in § 1.662(c)-4. That section and § 1.663(a)-2 were both published as part of the original subchapter J regulations, T.D.6217 (12/19/56). The latter originally only referred to limits on charitable deductions under § 681, and was later amended to include the limits under §§ 508(d) and 4948(c)(4) added by the 1969 Act.

GCM 33410 (1/10/67) is the first recorded instance in which the Service considered whether § 661 deductibility was available for charitable payments failing the requirements of § 642(c); it discusses a draft technical advice memorandum (TAM) which was never issued in its original form. A decedent's will (1) set aside a quarter of the value of her adjusted gross estate for her husband; (2) established a trust with another quarter for the life benefit of her husband with the power of appointment over the principal; (3) divided a third quarter into twelve equal parts, each payable to a different named charity; and (4) gave the remainder in trust for the life benefit of her three named nephews with the remainder to the children of those nephews. The will authorized the executor to satisfy the bequests out of any estate property of his choice. The will was silent as to the disposition of estate income received during the period of administration, but default state law required that such income ultimately be paid to the residuary beneficiary, in this case the trust for the benefit of the nephews. Although the record was not entirely clear, the estate income was apparently credited to the residuary trust but not actually paid to it; distributions were made to the other three, pecuniary beneficiaries, again presumably credited against corpus in the estate's records. The estate claimed distribution deductions under § 661(a)(2) for payments made to the charitable beneficiaries as well as those made to the husband and the trust created on his behalf. The GCM notes that this creates a loophole in that the estate or its beneficiaries are obtaining a deduction for both estate tax under § 2055 and income tax under § 661 for the same payments. However, "[u]nless qualifying language could be found elsewhere in the Code, the bare language of § 661(a)(2)… does allow a deduction here.[6] Only § 663(a)(1) might be read to bar the § 661 deduction here. Section 663(a)(1) precludes the application of § 661 and § 662 to amounts paid or

[6] The Westlaw version of GCM 33410 actually reads "does *not* allow a deduction here," but it is clear from the context and the conclusion of the memorandum that this is a typographical error.

credited in satisfaction of gifts or bequests of a specific sum of money or of specific property. Section § 1.663(a)-1(b)(1), however, removes from the operation of § 663(a)(1) and thus puts back into the ambit of § 661 and § 662 any disposition, which is the case here, in which the identity of the property used to satisfy the bequest or the amount of money specified are dependent both on the exercise of the executor's discretion and on payment of administrative expenses and other charges." The GCM notes that this regulation creating an exception within the exception for pecuniary amounts was intended to deal with formula clauses for spousal dispositions intended to qualify for the estate tax marital deduction rather than dispositions to tax-exempt charities, but nonetheless are covered by the regulatory language. It suggests that the § 663(a)(1) regulations be revised to close the loophole.

GCM 33696 (11/29/67) revisits the case discussed in GCM 33410 and revokes the earlier recommendation, concluding that § 663(a)(2) and § 1.663(a)-2 disallow the claimed deduction. The GCM argues that this reading of the regulation makes its second sentence, establishing the exclusivity of § 642(c), surplus, since the first and third sentences are all that is necessary to remove the tainted § 681 payments from §§ 661 and 662. As support for reading the second sentence of § 1.663(a)-2 as establishing an independent rule, the GCM cites to the example in § 1.661(c)-2, in which $10,000 is paid to a charity, but because the trust had tax-exempt interest income, only $8000 was allowed as a charitable deduction. The example does not allow the other $2000 as a deduction under § 661, even though it failed § 642(c) for a reason other than the application of § 681. The final issued technical advice, TAM 6802210560A, repeats this conclusion with respect to the particular taxpayer, while Rev. Rul. 68-667, 1968-2 C.B. 289, restates it in generic terms, holding that amounts bequeathed to a charity that are paid out of corpus pursuant to state law are not deductible as charitable contributions under § 642(c) or as distributions under § 661(a)(2).

Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972) *cert. denied* 93 S.Ct. 902 (1973) was the first test of the interpretation set forth in GCM 33696, TAM 6802210560A, and Rev. Rul. 68-667. A decedent left two-thirds of his estate, after the payment of debts, expenses, and specific bequests to a named charity, with the residue, including all income earned during administration, left in trust for a named individual for her life, with specified remaindermen. In 1963, the estate made a $13 million payment of corpus in partial satisfaction of the charity's bequest, with much smaller additional payments in 1964 and 1965, and also made payments to the individual beneficiary during the administration period before the creation of the trust, including a $100,000 payment in 1963. The estate claimed both an estate tax charitable deduction and income tax distribution deductions for the total amounts paid to charity, the latter based on the plain language of § 661(a)(2): "In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate… any… amounts properly paid… for such taxable year…" (the estate did not make any argument that the payments were deductible under § 642(c), admitting that they were not made out of gross income). The Court describes the government as "conceding" that a literal reading would favor the

estate. After a summary of the basic structure of subchapter J and noting the parties' agreement that none of the statutory exceptions from §§ 661-662 in § 663(a) apply by a plain reading, the Court concludes that the second sentence of § 1.663(a)-2 governs and denies the distribution deduction, and that the regulation is a reasonable interpretation not inconsistent with the statute, even though nothing in § 663(a)(2) "expressly supports the rule announced in the regulation." The opinion criticizes an overly-literal reading of § 661 insofar as such a reading would allow a distribution deduction all amounts properly paid by an estate or trust, whether or not to a beneficiary, contrary to prior caselaw.[7] Moreover, this interpretation could allow a double deduction, since many "properly paid" expenses would be deductible under § 212, without the safeguard of an explicit anti-duplication rule such as § 663(a)(2). To avoid this "absurd and abusive" result, the Court reads § 661 in conjunction with § 662 to be limited to distributions to beneficiaries, who then are generally taxed under the latter section. Since the charity is a beneficiary, this did not dispose of the question. The government had asked the Court to interpret § 661(a)(2) as applying only for distributions to *taxable* beneficiaries, but the opinion does not adopt this as a general position: "The Government's position seems to be correct in the context of this case, but we do not hold that it is a general rule which may be applied in every conceivable situation that may arise under the provisions of the Code…" Instead, it relies on the basic incompatibility of the §§ 661-662 scheme, which combines the pre-1954 conduit theory of trust and estate taxation with a conclusive presumption that distributions are distributions of income (to the extent of DNI), with § 642(c), which preserves the prior tracing requirements by the explicit reference to "gross income." Further, the allowance of distribution deductions for charitable payments would lead in some cases, including under Mott's own facts, to a distortion. Both the charity and individual are "second-tier" beneficiaries; that is, they would be receiving amounts "properly paid" under § 661(a)(2), as opposed to "first-tier" payments to mandatory income recipients under § 661(a)(1), which payments take out DNI before any second-tier payments (the Mott estate had no first-tier beneficiaries). If the payments from corpus to the charity qualify under § 661(a)(2), then the estate will pay no tax on any current income accumulated for future distribution to the individual, since that amount would be much less than the distribution deduction. The accumulated income could be distributed in a later year as income-tax free return of capital. With regard to the current distributions, the DNI would be prorated between the two income beneficiaries, with the great bulk of it going to a

[7] The Mott Court cites specifically to Thomas Lonergan Trust, 6 T.C. 715 (1946), which denied a distribution deduction for amounts paid to a creditor in satisfaction of a claim against the estate. See also Rev. Rul. 68-48, 1968-1 C.B. 301 (amounts paid by bankruptcy estate to creditors are not deductible under § 661 since payments not made to beneficiaries). Authority subsequent to Mott holds that amounts paid to a beneficiary are not deductible under § 661 if paid outside of the fiduciary relationship. See Rev. Rul. 73-322, 1973-2 C.B. 44 (Interest required to be paid under state law on delayed payments of specific sums of money or specific property was deductible under § 163 rather than § 661 since the relationship between the parties is that of debtor-creditor rather than fiduciary-beneficiary; under current § 163(h), such amounts would be non-deductible personal interest resulting in double taxation to the entity and recipient) and DuPont Trust v. Comm., 66 T.C. 761 (1976) (testamentary trust paid for maintenance of property inhabited by primary trust beneficiary under lease entered into before creation of trust; not deductible under § 661).

tax-exempt party (only about 1/133 of the $100,000 paid to the individual would consist of taxable income in 1963 given the relative size of the payments to the two beneficiaries).

Three subsequent cases have revisited the Mott issue in some detail:

In O'Connor v. Commissioner, 69 T.C. 165 (1977) *en banc*, a decedent's will divided his net estate into two equal shares, after the disposition of his real property and tangible personal property. The first share was bequeathed in trust to his widow, who had a right to all its income, a power to withdraw any or all the corpus, and a general testamentary power of appointment over the corpus "in favor of such persons and/or corporations as she may appoint." The second share, after some pecuniary bequests, was to be divided into three equal parts, each held in trust with the income paid or applied for one of the decedent's three nieces and nephews. Within the year of the decedent's death, the widow exercised her withdrawal power over the entire marital trust corpus and on the same day assigned that corpus and the income therefrom to the preexisting private foundation created by her and her husband; she filed a gift tax return for that year reporting a contribution of about $25 million. In each of its three fiscal years ending after the date of the widow's withdrawal and assignment, the estate made partial distributions to the marital trust in excess of the estate's DNI (the major distribution of $18.5 million coming in the second year when DNI was only $500,000), with the marital trust almost immediately redistributing these amounts to the foundation. In these years, the estate also made considerable income payments to the nieces and nephews representing their income rights under their trusts, but only nominal funding payments to the trusts themselves. The estate did make an initial argument that the payments to the marital trust (and through it, the foundation) qualified under § 642(c) but the Court rejected this in a summary fashion, finding that the reference to the widow having the power to appoint to "corporations" did not cause the transfer to the foundation to be "pursuant to the terms of the governing instrument." The Court then chose to disregard the existence of the marital trust altogether for tax purposes and treated the payments as being made directly from the estate to the foundation (this aspect of the decision was the subject of several dissents and of subsequent criticism, but we do not need to discuss it for purposes of this memorandum). Therefore the remaining question was the availability of a distribution deduction under § 661(a)(2) and the application of § 1.663(a)-2. Although noting a factual distinction with Mott, in that that case only dealt with corpus distributions, whereas the foundation received both corpus and income, the Court agreed with Mott that the regulation was a reasonable interpretation of the statute. They noted that both § 661(a) and § 642(c) could be applied to the facts, but that the former is general and the latter specific. Further, they recognized the distortion in allowing § 661 distributions to charities, in that an amount will be allocated to such distributions (and thus avoid tax altogether) that bears no relationship to the amount of income actually paid to the charity. Following the Mott court, the opinion does note "that there may be a situation where the mechanical application of [the] regulation would be unwarranted." Given its conclusion, the court did not have to consider alternative arguments put forth by the government that the

foundation was not a "beneficiary" or that distribution deductions are only available for payments to taxable beneficiaries. The opinion then considers issues not relevant to the current case, including the effect of the disallowance on the distribution deduction related to the non-charitable beneficiaries and the taxation of the individual beneficiaries on the amounts received directly from the estate. One judge dissented, citing to the legislative history discussed above as support for § 663(a)(2) only applying to prevent a double deduction under § 661(a)(2) and § 642(c).[8]

In Pullen v. U.S., 1979 WL 1518 (D.Neb.), *aff'd by* No. 80-1034 (8th Cir., 9/29/80), the decedent's will left two-thirds of his net estate to his family's private foundation, with the property so transferred required to be representative of the property of the estate. In partial satisfaction of this provision, the executor transferred an interest in real property to the foundation later in the year of death. The estate claimed an estate tax charitable deduction under § 2055(a)(2), but apparently acknowledged that this transfer of corpus would not support a § 642(c) deduction due to the gross income requirement, and instead claimed a distribution deduction. Extensively citing to Mott, the Court disallowed the deduction, noting in particular the possible abuse: "The estate could trickle out corpus to the foundation each year during the administration of the estate in an amount equal to DNI for that year. All the DNI would therefore be allocated to the foundation. The income earned each year would not be taxed, and could be accumulated by the estate. Later on, the accumulated income could be distributed tax-free. Thus, it would be possible to completely eliminate tax on the income earned by the assets of the estate by means of successive transfers to a charitable foundation, even though none of these transfers were of gross income as required under § 642(c)." The Court also cited to the Supreme Court's statement in United California Bank v. U.S., 439 U.S. 180, 191, that "charitable distributions or set asides are not within the conduit system applicable to non-charitable beneficiaries," the specific issue in that case being whether long-term capital gains set aside for charity by an estate were excluded from determining the estate's income tax base under the then-existing "alternative tax." The Court noted however that its holding did not deny the estate a benefit from the charitable contribution or interfere with any statutory policy encouraging such contributions, since the payments of corpus to the foundation were allowable as estate tax deductions under

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[8] This dissent also discusses the argument which the majority had declared moot that a distribution deduction must be matched with an inclusion to a taxable beneficiary under § 662. It notes the Service has acknowledged in other contexts that there does not have to be a perfect match between deduction and inclusion amounts. In Tait v. Comm., 11 T.C. 731 (1948), *remanded by stipulation in compromise* (4th Cir. 7/20/49), *holding of T.C. case not followed by* 1950-2 C.B. 58, the government ultimately agreed that an estate could take a distribution deduction under the predecessor of § 661 for payments to nonresident alien beneficiaries even though those amounts would be excluded from gross income under treaty provisions. Subsequent to O'Connor, in Rev. Rul. 74-299, 1974-1 C.B. 154 (concerning facts previously discussed in GCM 34064 (3/5/69)), the Service concluded that a § 661 distribution deduction was allowed to a non-exempt employee-benefit trust even though the inclusion to the employee-beneficiaries would be determined under § 402(b) rather than § 662. Rev. Rul. 2007-48, 2007-30 I.R.B. 129 amplifies Rev. Rul. 74-299, maintaining this bifurcated treatment. In the post-O'Connor cases, the government seems to have abandoned the alternative argument for disallowance based on deduction-inclusion mismatch and we do not consider it further here.

§ 2055. The allowance of corpus deductions under the estate tax and income deductions under the income tax is a "symmetry" that "insures that all contributions result in a tax benefit, but precludes a double benefit… Congressional policy is exemplified under § 642(g), which insures that any deduction which might be allowable for both income and estate tax purposes is taken only once."[9]

In U.S. Trust v. I.R.S., 803 F.2d 1363 (5th Cir. 1986), the Circuit Court reversed the taxpayer victory at the District Court level (617 F.Supp. 575 (S.D. Missi. 1985)), but in terms that do not make the scope of the decision entirely clear. The decedent's will left "10% of the value of my gross testamentary estate as finally determined" for estate tax purposes to a charitable foundation, "provided that such bequest is deductible from my gross estate." In 1975, the estate's taxable year following death, the estate made a series of payments of both cash and stock, fulfilling most of the bequest to the foundation, with the remaining payments made the following year. The account from which the payments were made contained both corpus and income of the estate, but the Court notes that, at all times during 1975, the amount of current year income exceeded the amount distributed to the foundation and necessary to pay the estate's administrative expenses, and the government conceded that no deductions claimed were in excess of DNI. During 1975, no payments were made to the estate's non-charitable beneficiaries. The estate claimed a § 2055 deduction for the entire bequest to the foundation. Of the $1.5 million in cash distributed in 1975, the estate claimed a distribution deduction for about $1.25 million (the entire DNI). It did not claim any income tax deduction for the stock distributions. The estate did not contest the ineligibility of the payments for § 642(c) treatment, given that the will did not specify that they should come from gross income. Citing to the plain language of § 663(a)(2), the legislative history discussing "additional deductions" and several cases indicating that charitable deductions should be generously construed, the District Court opined that "the second sentence of § 1.663(a)-2 is entitled to no great deference and should not be enforced to preclude the subject deduction." The opinion discusses the Mott, O'Connor, and Pullen decisions, but points out the Mott court's refusal to adopt the government's argument that only distributions to taxable beneficiaries are covered by § 661 and notes the O'Connor dissent adopting a narrow anti-duplication interpretation of the statute.

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[9] The reference to § 642(g) in Pullen is troublesome in that that section generally disallows as an income tax deduction (or offset against sales price) to the estate or any other person any amount allowable as an estate tax deduction under § 2053 or § 2054, unless a waiver is filed stating that the amounts have not and will not be claimed for estate tax purposes (since Pullen, §642(g) has been amended to extend to deductions allowable under the generation-skipping transfer tax as well as estate tax). Section 2053 relates to administrative expenses, indebtedness, and certain taxes, while § 2054 includes losses; charitable deductions under § 2055 are not subject to § 642(g) and thus a citation to that section for a general anti-duplication policy is problematic. See the U.S. Trust discussion in the main text. Note also that there is a situation in which a double deduction is uncontroversial, when a bequest is made of items of income in respect of a decedent (IRD) described in § 691. IRD items, which would include, for example, a decedent's individual retirement accounts (less any non-deductible contributions) and other forms of deferred compensation not subjected to income tax during life, are both assets of the gross estate and income to the estate or other recipient. Because there are two inclusions, there may also be two deductions.

The government apparently made a general argument that duplicative income and estate tax deductions should not be allowed, but the Court cited the general proposition that the income and estate tax regimes are independent and the specific failure of § 642(g) to preclude § 2055 double deductions in addition to those under § 2053 and § 2054. Although referring to the double deductibility as a "loophole," the Court concluded that it was the responsibility of Congress to close it, rather than the Service or the courts. The Circuit Court disagreed, finding that the "plain language" of §§ 642(c) and 2055(a) demonstrates the intent that the benefit for a charitable bequest be conferred only once, as an income tax deduction for gross income or as an estate tax deduction for corpus (the Circuit Court does not mention § 642(g)). Further, the Circuit Court notes that Congress refused to incorporate charitable contributions into the conduit scheme of §§ 661-662 in 1960 by failing to pass H.R. 9662, which would have repealed § 642(c) and incorporated charitable distributions into the distribution deduction provisions. Language in the legislative history of that bill suggests that Congress interpreted current law as taking any distributions to charities entirely out of § 661, e.g., "[t]herefore, although under State law a charitable beneficiary is as much a beneficiary as any other beneficiary, the code literally requires two separate rules for the two types of beneficiaries and two separate sets of computations in preparing the income-tax return of the estate or trust." S. Rep. No. 1616, 86th Cong., 2d Sess.40 (1960) The court notes an inconsistency in the taxpayer's argument; although the taxpayer concedes that the statute cannot be read literally as to allow payments to creditors as amounts "properly paid" under § 661 and that a distribution deduction is only allowed for amounts paid to beneficiaries, their claimed deduction is not under § 661(a)(1), which would necessarily consist of payments to beneficiaries ("any amount… required to be distributed") but under § 661(a)(2) which literally could encompass non-beneficiary payments. Finally, the Circuit Court noted that the contested regulation had been enacted shortly after the statute, and had not been overturned by statute or amended by the Service in that time. Although upholding § 1.663(a)-2 in its entirety, the decision specifically references only the double deduction situation: "Therefore, the taxpayer is not entitled, as a matter of law, to a deduction under § 661(a)(2) for the distribution of present income when that distribution had already been the basis of an estate tax deduction…"[10] The current taxpayer cites

[10] O'Connor, Pullen, and the two U.S. Trust decisions include the most considered post-Mott discussion of this issue, but subsequent caselaw and guidance have also supported the government's position. In TAM 8031024, an estate did not have sufficient assets at death to pay all the charitable bequests, but did have enough income during administration to make up the shortfall. The § 2055 deduction was not allowable because the income was not an item included in the gross estate and the § 642(c) deduction also failed because it was not pursuant to the governing instrument. Noting Mott, a distribution deduction was also denied. In Crown v. Comm., discussed under Issue 1 above, the relevant portion of the Tax Court decision concluded that certain payments to charity in excess of a fixed annuity, which the governing instrument allowed, but only if the annuity interest was commuted to the extent of such payments, were not pursuant to the governing instrument under § 642(c) when no such commutation had occurred. Citing Mott and O'Connor, the court disallowed an alternative deduction under § 661(a)(2). The Circuit Court affirmed, but its opinion discusses only the gift tax issues in the case. In Crestar Bank v. IRS, 47 F.Supp.2d 670 (E.D. Va. 1999), the estate claimed both a § 642(c) and § 2055 deduction for a contribution of an asset owned by the decedent; the Court denied the income tax deduction because it was not traceable to gross income and because an estate tax deduction had already been allowed.

the District Court decision in U.S. Trust, which it describes as “reversed on other grounds,” in support of its position that the regulation is invalid to the extent it does more than prevent a double income tax deduction. The taxpayer does not cite the other cases and authorities discussing this issue in the materials we have reviewed.

Commentators are divided on the correctness of the Mott line of cases. One standard treatise supports them on two policy grounds: “All of the courts but one [U.S. Trust District Court] that have considered this issue have sustained these regulations, even though they substantially exceed the scope of the statutory language… The cases supporting the regulations take the appropriate view because a contrary rule has the effect of giving both an estate tax deduction (for the charitable disposition) and an income tax deduction (for the item distributed to charity) for the same payment. “Also, as a result of deducting distributions of corpus to charity, the non-charitable legatees in effect receive the estate’s income tax-free. The benefit of the income tax deduction inures to the noncharitable legatees, rather than to the charity, so the court decisions favoring the regulation seem fundamentally sound.” [citations omitted] Danforth,

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Although the estate did not claim a distribution deduction, the Court discussed Mott and the Circuit decision in U.S. Trust for purposes of establishing an anti-duplication reading of the statute. Rev. Rul. 2003-123, 2003-2 C.B. 1200, amplifies Rev. Rul. 68-667, specifically concerning the contribution of a conservation easement (as defined in § 170(h)), concluding that the contribution failed under § 642(c) because not traceable to gross income, and per Mott and the Circuit Court decision in U.S. Trust, was not deductible under § 661. TAM 8738007 presents a slight variation on the issue; a beneficiary had the income interest in a simple trust as defined in § 651 (all income required to be currently distributed, no provision for charitable income payments, no principal distributions in the relevant years), and made a series of assignments of portions of such interest to charities (which was not forbidden by the trust instrument or local law). The TAM concluded that these assignments did not cause the simple trust to become a complex trust. The taxpayer conceded that no § 642(c) deduction was allowed, but asked for a distribution deduction under § 651. Citing the prior cases, the TAM found that a charitable deduction was not allowed under § 651 any more than under § 661, and additionally such a deduction would create a loophole allowing avoidance of the § 681 limits on charitable contributions of unrelated business income, which only applies to complex trusts subject to § 642(c).

The Service has recognized a distinction allowing § 661 deductions for payments to charitable remainder trusts (CRTs) described in § 664, which although exempt from income tax, are not themselves charities, but instead split-interest vehicles in which non-charitable beneficiaries receive a defined payout for a term with the remainder going to charity, with that payout taxable to the beneficiary according to a statutory ordering rule (generally ordinary income, capital gains, tax-exempt income, and return of capital). In TAM 8810006, an estate was denied a § 642(c)(2) set-aside deduction for payments to a testamentary CRT, since the amounts “set aside” for the charitable remainderman had a more than remote possibility of invasion for the benefit of the non-charitable income recipients. But the estate’s payments to the CRT and to the individual beneficiaries in anticipation of the creation of the CRT during the estate’s period of administration (which were treated as if made by the CRT to those beneficiaries) were allowed as a § 661 deduction. The TAM distinguished Mott and the subsequent cases as disallowing distribution deductions to wholly-charitable beneficiaries which fail § 642(c) (on gross income, “pursuant to the governing instrument,” or § 681/508/4948 grounds) from payments to split-interest trusts never intended to be included in the exclusive § 642(c) regime. The deductibility of such funding and “in lieu” payments by estates to or on behalf of testamentary CRTs had previously been noted as an area of uncertainty. See Baetz, W. Timothy, “Tax Planning for Sophisticated Charitable Transfers: The Divide Between Downright Doable and Dangerous,” Taxes, Dec. 1984, 996, at 999.

Robert T., et al., Federal Income Taxation of Estates and Trusts [current through 2016], at 4.07[1][11]

However, at least as many secondary sources in this area disagree with the disallowance under § 661(a), at least under some facts. Another standard treatise, Ferguson, M. Carr, et al, Federal Income Taxation of Estates, Trusts, & Beneficiaries (current through 2016), states at § 6.10: "The analysis [explaining why a single payment should not allow double deduction under §§ 642(c) and § 661(a)] does not, however, answer the question whether amounts that pass to charity in such a way as not to qualify for the deduction under § 642(c), such as amounts that pass to nonqualified quasi-charitable organizations or are used for purposes that are not exclusively charitable, escape the proscription of § 663(a)(2). Obviously, such amounts do *not* qualify 'for the deduction provided in § 642(c).' Are they therefore deductible as distributions under § 661? A literal reading of the statute strongly suggests that many such amounts should be. Even an undisputedly charitable beneficiary would be treated the same as any other beneficiary under the distribution rules, if it were not for §§ 642(c) and 663(a)(2). When no deduction is available under § 642(c), § 663(a)(2) seems to plainly not apply."[12]

Ferguson then acknowledges that the Mott analysis is attractive under its facts because allowing the § 661 deduction would allow the shifting of almost all of the estate's DNI to the charity, thus causing those amounts to escape taxation altogether, with the estate and the taxable beneficiaries paying little or no tax on the amounts ultimately received by those beneficiaries. "It is hardly surprising that a court would try to avoid this sort of awkwardness. What is surprising is that the *same court* that during the *same year* resorted to an extremely literalistic interpretation of the *same statutory structure* in deciding Harkness v. U.S [199 Ct.Cl. 721 (1973), cert. denied 94 S.Ct. 115 (1973)], in which the taxpayer was unquestionably over-taxed, would have so openly defied the statute in Mott." In Harkness, a decedent's will divided the residual estate into equal

[11] Another treatise somewhat grudgingly concurs: "Otherwise, contributions from corpus are not deductible under either § 642(c) or § 661 (relating to normal complex trust distributions). The latter conclusion reflects the government's position that an estate or trust is entitled to a deduction for amounts paid or set aside for charitable purposes *only* under § 642(c). This position can be crucial where the estate or trust loses the § 642(c) deduction on technical and sometimes debatable grounds, but is also denied the benefit of a distributions deduction under § 661…Typically, the corpus contribution would be deductible for estate and gift tax purposes. This factor has encouraged some courts to uphold the validity of the income tax regulations where the requirements of § 642(c) have not been satisfied. The assumption is that the contribution should be deductible either for income or for transfer tax purposes, but not for both. It is interesting to note that Congress has expressly adopted in one area (administration expenses and losses) a denial of double deductions of the same item for both income and estate tax purposes (§ 642(g)). In contrast, § 663(a)(2) purports only to disallow a double *income* tax deduction for items that qualify under § 642 and might otherwise be deemed distributions under §§ 661 and 662. Nevertheless, the careful opinions in Pullen and the Fifth Circuit in U.S. Trust make a strong argument for a result that will strike some as a "legislative repair job" to close a loophole (compare the lower court opinion in the latter case). [citations omitted] Peschel, John L. & Spurgeon, Edward D., Federal Taxation of Trusts, Grantors & Beneficiaries [current through 2013], at 12.02[2].

[12] See fn.13.

parts, one for the benefit of his wife, and the other to be further divided into four trusts for his children, with all estate and inheritance taxes to be paid out of the children's share. In a year prior to final distribution of the residue, the executors paid a series of distributions totaling approximately $27.5 million to the widow, $8.4 million to the children's trusts, and $18.9 million in state and federal estate taxes. In other words, the total payments out of each half share were very nearly equal, with the taxes and children's payments together equivalent to the widow's payments. This was intentional on behalf of the executors, who would make an equalizing distribution to one side whenever a distribution or tax payment was made on the other, with the goal of keeping the corpus balance in the remaining residue equal, so that the income tax liability would also be equal, not requiring any calculations based on one side having more or less than a half interest. This was apparently an accepted practice under state law. The Court did not accept this tracing of additional payments to corpus, but applied the general rule of § 662(a)(2) and divided the DNI proportionally to the beneficiaries based on their relative distributions, 76% to the widow rather than the claimed 50%. The Harkness dissenter actually criticizes the § 662 anti-tracing rule on Constitutional grounds as creating an impermissible unapportioned direct tax on principal. The dissent also notes that Mott *allowed* tracing to defeat the taxpayer while the majority was *disallowing* it to the same end in the present case.

Ferguson continues: "Much water has passed under the bridge since the decisions in Mott and Harkness. To be sure, Mott now has a substantial judicial following. On the other hand, in extending the separate share rule to estates, as well as to trusts, Congress has not only overruled Harkness; it eliminated the over-taxation that accompanied its literalistic interpretation of the statute. In extending the separate share rule to estates, Congress also eliminated the need to depart from the statute in cases like Mott, to keep the estate and its other beneficiaries from going essentially tax-free on income charity never receives. By requiring the allocation of a Subchapter J entity's DNI among each of its separate shares, the separate share rule eliminates both over-taxation in cases like Harkness and under-taxation in cases like Mott. Under current law, Mrs. Harkness would remain taxable, but only on her share of the estate's DNI. Likewise, in Mott, the estate and its other beneficiaries would be taxable on all of its DNI, except that portion, if any, properly allocable to the charity's separate share. In short, under current law, there is no reason, in a case like Mott, for the court *not* to interpret the statute literally, and to allow a distribution deduction under § 661 for a charitable distribution that does not also qualify for the deduction under § 642(c), or for a distribution to a nonqualified quasi-charity. Each of the cases to the contrary arose well before Congress's extension of the separate share rule to estates. Stripped of their rationale, they no longer deserve deference. All that remains is the innocuous sentence in the regulation, which even the Mott court admitted found no support in the statute. Whether the regulation, as interpreted by the Service remains valid, now that Congress has extended the separate share rule to estates, is not obvious." [footnotes omitted][13]

[13] In a footnote, Ferguson notes that Prof. Leo Schmolka also disagrees with the Mott line of decisions in his well-known article, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism", 40 Tax L. Rev. 1 (Fall 1984), at 278-295. Schmolka argues that "if, as Mott

Despite the genuine ambiguity of the statutory provisions and the legislative history, we conclude that the second sentence of § 1.663(a)-2, establishing the exclusivity of § 642(c) as a deduction for charitable payments by trusts and estates, represents a better overall reading of the law for four reasons:

1. In this case a specific statute governing income tax deductions for payments to charitable beneficiaries creates a different set of rules than the general statute which by its literal language covers distributions to all beneficiaries (and as noted above, could even be read to cover payments to non-beneficiaries, though taxpayers have not actually made that argument in the recorded cases). The specific provision should be held to control and remove determinations on distributions of this kind from the general rule altogether. Rollert v. Commissioner, 80 T.C. 619 (1983) *aff'd* 752 F.2d 1128 (6th Cir. 1985), offers a parallel, in which the specific provisions of one section of subchapter J, § 691, were held to override the conflicting general provision of § 661. In Rollert, an executive died with rights to receive a bonus that was not formally awarded until after the date of death, as well as the remaining installments on bonuses from prior years.

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held, it is implicit in the general statutory structure that a charitable distribution is nondeductible under § 661 where it is not otherwise deductible under § 642(c), a distribution deductible under § 642(c) is a fortiori nondeductible under § 661, and Congress was not obliged to enact § 663(a)(2) to accomplish that result." That is, if the statutory structure obviously precludes non-qualifying charitable deductions under § 661, it is even more obvious that it precludes qualifying ones, and § 663(a)(2) is surplusage. Secondly, the parenthetical in § 663(a)(2) removing charitable deductions disallowed by §§ 681, 508, and 4948 from the §§ 661-662 calculation would be unnecessary if such deductions were already disallowed under the stature simply by their nature as payments to charity. "In sum, it seems clear that Congress intended and expected § 661 to provide a distribution deduction unless a charitable payment in fact qualifies under § 642(c), and the language of §§ 663(a)(2) and 661 unambiguously implements that intent. This is not to say that Congress intended § 661 to be used as a ticket to wholesale tax avoidance; most likely, it overlooked that possibility. Final grades awarded in evaluating the Mott-O'Connor-Pullen trilogy therefore boil down to one's estimation of whether the cases were an appropriate exercise in judicial legislation, for they go well beyond the bounds of interpretation of either the statute or its legislative history. Faced with a loophole, the three courts simply plugged it." Schmolka wrote prior to the U.S. Trust cases or the amendment of § 663(c) to include estates.

Other authors agreeing with Ferguson and Schmolka include Carl D. Bellows, "Recent Cases & Rulings on the Taxation of Trusts & Estates", The Review of the Taxation of Individuals (Autumn 1978), at 374. Writing shortly after the O'Connor decision, Bellows criticizes it on three primary grounds. First, the literal language of § 663(a)(2) only deals with double deductions; second, the parenthetical in § 663(a)(2) only makes sense if such disallowed § 642(c) amounts would otherwise be included under § 661; and third, that § 663(a)(2) is not needed if it is otherwise clear that payments to charities can never support a distribution deduction. He notes the apparent contradiction in the legislative history between the anti-duplication language and the Senate Report example. As an alternative interpretation of the latter, he suggests that it could mean that distributions of corpus to charity could not be deducted under § 661 but that distributions of gross income failing the "pursuant to the governing instrument" requirement of § 642(c) could. Somewhat more recently, one commentator said that "the Mott case and its progeny are troublesome." (cites to Ferguson & Schmolka) Frimmer, Paul N., "Charitable Alternatives", ALI-ABA CLE Course of Study, 11/15/99. Later still, another supports the Ferguson analysis: "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?" Katzenstein, Lawrence P., "How to Protect the Interests of Estates with Charities as Beneficiaries", Practical Tax Lawyer, Summer 2011.

These rights became part of the decedent's residual estate, and the estate assigned the rights to future payments to the residuary beneficiary. Both the estate and the beneficiary treated the assignment of the rights as a distribution under §§ 661-662 of the FMV of the remaining payments. When the payments were actually received, the beneficiary only reported the increment between the amounts received and the earlier inclusion as income, essentially treating the date-of-distribution value of the rights as its basis. The Court held that the taxpayers' treatment would undermine the rule of § 691, under which the estate or other proper recipient of income in respect of a decedent (IRD) is taxed on actual receipt of the income substantially earned by the decedent during life but not includible on the decedent's final return, rather than on the transfer of the rights to such income. The taxpayers argued that the distributions of the rights literally fell within § 661(a)(2) as amounts properly paid, but the Court cited Mott and O'Connor against this literalist reading, as well as a number of authorities favoring specific statutes over general ones. "It is a well-accepted principle of law that a specific statute controls over a general one, even if the latter might otherwise appear to govern… As we have explained, there is an apparent conflict between § 691 and the distribution rules of § 661 and 662. In view of the nature of § 691 as a specific statutory scheme for the taxation of IRD, which would be largely defeated were rights to IRD allowed to acquire basis under the distribution rules, we believe § 691 must take precedence, here." Section 1014(a) generally allows a step-up in basis for property received from a decedent by reason of death, but § 1014(c) specifically excludes IRD from the general rule. The Circuit Court accepted the Tax Court's conclusion, noting that "Congress did not enact § 691 merely to have it subsumed by §§ 661 and 662."[14]

2. The general conduit structure of §§ 661-662, as modified by the introduction of the DNI mechanism in the 1954 Code, eliminates the pre-1954 requirement for tracing of payments to income or corpus. Section 642(c), by reason of its "gross income"

[14] Similarly, Rev. Rul. 68-195, 1968-1 C.B. 305, found that a distribution of the rights to § 736(a)(1) payments in liquidation of the rights of a deceased partner to the estate's beneficiary were not considered payments for purposes of § 661. If instead of distributing such rights, the estate borrowed and then distributed the proceeds to the beneficiary, the ruling concludes that this would be treated as though the estate had distributed the rights and then used the loan proceeds to purchase the rights back. The beneficiary would have IRD under § 691(a)(2) and the estate would have an asset with a § 1012 basis, but would not have the right to take a distribution deduction. In Dean v. Comm.,T.C. Memo. 1983-276, decided between the Tax and Circuit Court Rollert decisions, the decedent died with rights to future payments under a promissory note for a sale of cattle. The estate claimed a distribution deduction for the assignment of the note to its beneficiaries. Citing the Tax Court in Rollert, the opinion disallowed the deduction because of the operation of § 691. It also cites Mott for the proposition that the specific controls the general.

One commentator disagrees with Rollert because he believes there is no conflict between § 661 and § 691, arguing (following the dissenter in the Rollert Circuit Court decision) that § 691 determines who is taxed on IRD while § 661, if applicable under particular facts, determines the timing of the inclusion to such person. But he notes that the Rollert issue is largely moot under current law because of the adoption of § 643(e) under § 81(b)(2) of the Deficit Reduction Act of 1984, P.L. 98-369; under the general rule of § 643(e)(1), any distribution in kind from a trust or estate is treated as a distribution equal to the trust or estate's basis in the asset distributed, which is generally going to be zero in the case of IRD. This reaches the Rollert result by a different mechanism. See Abbin, Byrle M., Income Taxation of Fiduciaries & Beneficiaries [2016 ed.], at § 512.

limitation, preserves tracing. To include charitable payments within the conduit system eliminates a requirement which Congress expressly preserved in this narrow area. As noted by the U.S. Trust Circuit decision, Congress refused to incorporate charitable payments into the general conduit system in 1960.

3. With regard to those situations in which both an income and an estate tax charitable deduction are being claimed for the same contribution (which do not include the current case), we agree with the Pullen and U.S. Trust decisions that the basic structure of §§ 642(c) and 2055 establishes a bifurcation in which the income of the trust or estate will be deductible, if at all, under the income tax deduction provision, and the corpus or principal will be deductible under the estate tax provision. The allowance of deductions of corpus under § 661 would thus create an unintended double benefit. The latter decision describes this as a "plain language" reading of the statutes, which we admit may be overstatement, given the failure of Congress to include § 2055 with §§ 2053 and 2054 in the explicit anti-duplication provisions of § 642(g), but nonetheless §§ 642(c) and 2055, read together, seem to contemplate this division of labor between the two deductions.

4. Again as noted by the Fifth Circuit in U.S. Trust, the disputed regulation was enacted shortly after the statute it interprets and has not been subsequently overturned by Congress. If § 1.663(a)-2 as written contravened Congressional intent, there would have been action to override it, if not immediately after the promulgation of the regulations, then after those regulations were upheld in Mott and the subsequent cases.

Obviously one prior justification for the regulation provision, the possible manipulation of distributions to shift income to the tax-exempt beneficiary, no longer is relevant after the extension of the separate share rule to estates (and was never relevant to cases involving trusts such as the current one).

ISSUE 3

Section 643(a) defines the term DNI, for purposes of part I [§§ 641-685] as meaning, with respect to any taxable year, the taxable income of the estate or trust computed with certain modifications listed in §§ 643(a)(1) through (7). Section 643(a)(1) provides that no deduction shall be taken under §§ 651 and 661 (relating to additional deductions). Section 643(a)(3) provides that gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in § 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year.

Section 1.643(a)-3(a) generally provides that gains from the sale or exchange of capital assets are ordinarily excluded from DNI and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Section 1.643(a)-3(b)(3) provides, in relevant part, that gains from the sale or exchange of capital assets are included in DNI to the extent they are allocated to corpus but actually distributed to the beneficiary.

Section 1.643(a)-3(e) lists examples illustrating the rules of § 1.643(a)-3. In Example 7, under the terms of Trust's governing instrument, all income is to be paid to A during the trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in DNI. See § 1.641(b)-3 for the determination of the year of the final termination and taxability of capital gains realized after the terminating event and before final distribution.

Section 1.641(b)-3(b) generally provides that the determination of whether a trust has terminated depends on whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than on the technicality of whether or not the trustee has rendered his final accounting. The trust may continue to exist for federal purposes for a reasonable period of administration after the event causing its termination. We find no cases in which the government has challenged the validity of a trust termination under state law because that termination took place as the result of a court order or settlement agreement rather than according to the original unmodified trust terms and we do not recommend exploring such a theory to challenge the early termination of Trust B.

Section 643(a) and the regulations thereunder establish a presumption that capital gains will not be included in DNI, but the termination of the trust and distribution of all of its assets is one of the situations in which the capital gains are considered to be "actually distributed."

CONCLUSIONS:

1. Trust B is not entitled to a deduction under § 642(c)(1) for the payments to Foundation 1 and Foundation 2 because such payments are not pursuant to the governing instrument.

2. Trust B is not entitled to a deduction under § 661 for the payments to Foundation 1 and Foundation 2 because § 642(c)(1) is the exclusive income tax provision for deductibility of payments by a trust or estate to a charitable beneficiary.

3. Issue 3 is moot because Trust B is not entitled to a deduction under § 661 for payments to Foundation 1 and Foundation 2. The amount of capital gains includible in

DNI would only be relevant in the event a § 661 deduction is available to Trust B. However, were it ultimately found that Trust B was allowed to take a § 661 deduction, DNI for the taxable year including Date 1 would include capital gains.

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