



This document is scheduled to be published in the Federal Register on 04/16/2012 and available online at <http://federalregister.gov/a/2012-08996>, and on [FDsys.gov](http://FDsys.gov)

[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9582]

RIN 1545-BH66

Guidance Under Sections 642 and 643 (Income Ordering Rules)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under Internal Revenue Code (Code) section 642(c) with regard to the Federal tax consequences of an ordering provision in a trust, a will, or a provision of local law that attempts to determine the tax character of the amounts paid to a charitable beneficiary of the trust or estate. The final regulations also make conforming amendments to the regulations under section 643(a)(5). The final regulations affect estates, charitable lead trusts (CLTs), and other trusts making payments or permanently setting aside amounts for a charitable purpose.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF**

**PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Melissa Liquerman, at (202) 622-3060

(not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background and Explanation of Provisions**

On June 18, 2008, proposed regulations (REG-101258-08) were published in the **Federal Register** [73 FR 34670]. The proposed regulations contain proposed amendments to the Income Tax Regulations 26 CFR part 1, confirming that a provision in a trust, a will, or a provision of local law that specifically indicates the source out of which amounts are to be paid, permanently set aside, or used for a purpose specified in section 642(c) must have economic effect independent of income tax consequences in order to be respected for Federal tax purposes. If such provision does not have economic effect independent of income tax consequences, income distributed for a purpose specified in section 642(c) will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes. The proposed regulations also make conforming changes in the corresponding language in the Income Tax Regulations under section 643(a)(5). The trusts and estates that are the subject of the proposed regulations include, without limitation, charitable lead trusts (CLTs) and trusts and estates making payments or permanently setting aside amounts for a charitable purpose.

The proposed regulations are based on the structure and provisions of Subchapter J (of Chapter 1, Subtitle A, of the Code) as a whole, as well as on an analysis of the existing regulations with their interrelated cross-references. The IRS and Treasury Department believe that the current regulations under §§1.642(c)-3(b) and 1.643(a)-5(b) require that a specific provision of the governing instrument or a provision under local law have economic effect independent of income tax consequences in order to be respected for Federal income tax purposes. To make this clearer, the proposed regulations add the principle of economic effect directly to the regulations under

sections 642(c) and 643(a), rather than leaving this principle to be reached by cross-reference to other regulations.

Finally, the proposed regulations remove §1.642(c)-3(b)(4) because the provisions of section 116 referenced therein were repealed by the Tax Reform Act of 1986 (Public Law 99-514).

Written comments were received on the proposed regulations. Because there were no requests to speak at the scheduled public hearing, the public hearing was cancelled. The proposed regulations, with certain changes made in response to the written comments received, are adopted as final regulations.

## **Summary of Comments and Explanation of Provisions**

### Specific Provisions Must Have Economic Effect Independent of Income Tax

#### Consequences

Commentators suggested that the clarification in the proposed regulations, that a specific provision in a governing instrument or in local law that identifies the source(s) of the amounts to be paid, permanently set aside, or used for a purpose specified in section 642(c) must have economic effect independent of income tax consequences in order for the specific provision in the governing instrument or in local law to be respected for Federal tax purposes, is an interpretation contrary to the clear language of section 642(c) and 643(a)(5) and the existing regulations.

The IRS and Treasury Department have carefully considered these arguments and the analyses suggested by the commentators. The IRS and Treasury Department continue to believe that the position clarified in the proposed regulations, requiring that a specific provision of the governing instrument or a provision under local law have

economic effect independent of income tax consequences in order to be respected for Federal tax purposes, is the proper interpretation of the relevant Code provisions and is a principle that applies throughout Subchapter J.

The general rule provided in Subchapter J, which mandates that the tax character of distributions to beneficiaries consists of a pro rata portion of all types of a trust's income, appears in section 652(b) and in several different sections of the regulations under the subchapter. The only regulatory exception to this pro rata rule is for a specific provision in a governing instrument or a provision under local law that provides as to the tax character of distributions to beneficiaries. This exception to the pro rata rule must have the same meaning throughout the Subchapter J regulations. The chain of regulatory references from §§1.642(c)-3(b) and 1.643(a)-5(b), detailed in the preamble to the proposed regulations, incorporates into each of those provisions, by cross-reference to §1.662(b)-2, "the principles contained" in §1.652(b)-1 and, in turn, §1.652(b)-2(a) and -2(b), which require a specific provision to have economic effect independent of income tax consequences in order to be respected. The proposed regulations confirm this uniform principle by inserting the terms of §§1.652(b)-1 and 1.652(b)-2(a) and -2(b) explicitly into §§ 1.642(c)-3(b) and 1.643(a)-5(b).

Moreover, section 643(a)(7) grants express regulatory authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent avoidance of such purposes."

Income Ordering Provisions and Economic Effect Independent of Income Tax Consequences

A commentator suggested that income ordering provisions in CLTs have economic effect independent of income tax consequences because disregarding an income ordering provision could increase a CLT's tax liability, thereby reducing the value of the trust and in turn reducing the annual unitrust payments to the charitable beneficiaries and increasing the risk that the trust's assets will be depleted before the end of the trust term. Although the general pro rata allocation rule may increase a trust's tax liability and thereby reduce the value of the trust's corpus, the effect of the payment of the trust's income tax liability is not an economic effect independent of income tax consequences as described in these regulations. Any possible reduction in the unitrust amount subsequently paid to the charitable beneficiary would be the direct result of the payment of income taxes by the unitrust. The use of an income ordering rule in a CLT, directing the tax characteristics of the unitrust or annuity payments to the charity, is primarily, if not exclusively, an attempt to minimize the tax liabilities of the trust and its remainder beneficiaries. The only effects of the use of an ordering rule are in fact dependent solely upon tax consequences: specifically, the reduced amount of tax paid and the trust's retention of the income tax savings.

Ordering provisions in CLTs will never have economic effect independent of their tax consequences because the amount paid to the charity is not dependent upon the type of income it is allocated. An annuity payment is a fixed amount from year to year, and although a unitrust amount may fluctuate annually, the amount is based upon a predetermined percentage of the trust's value.

Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under

Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

#### Encouragement of Charitable Gifts

A commentator suggested that the proposed regulations are contrary to the Federal government's long standing policy to encourage charitable gifts and to benefit and protect charities.

The IRS and Treasury Department have carefully considered the merits and implications of this suggestion. The IRS and Treasury Department believe, however, that the proper interpretation of the relevant Code sections does not permit the creation of a special rule for CLTs. A CLT is treated and taxed in the same way as any other complex trust under Subchapter J. Subchapter J does not differentiate between a CLT and a different type of complex trust, and there is no provision of Subchapter J that applies exclusively and expressly to CLTs. Thus, any income tax rule applicable to a CLT will apply in the same way to every other complex trust.

#### Principal/Income Ordering Rules

A commentator requested that the proposed regulations be expanded to provide that trusts that make distributions to both charitable and noncharitable beneficiaries in the same taxable year must allocate the distributions equally to principal and income as between charitable and noncharitable beneficiaries, unless there is a provision that has economic effect independent of income tax consequences.

This request is beyond the scope of the proposed regulations and might implicate other well settled income tax rules applicable to complex trusts. Section 662 and the regulations thereunder provide the rules for distributions by complex trusts with a

charitable beneficiary, and sufficiently address the commentator's concern. If the commentator believes that further guidance is needed or would be helpful to taxpayers, a request for additional guidance may be submitted for consideration to be added to the Priority Guidance Plan.

#### Economic Effect Independent of Income Tax Consequences Example

A commentator requested an example of a provision in a governing instrument that would have economic effect independent of income tax consequences. Such an example has been added to the final regulations as Example 2.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

#### **Drafting Information**

The principal author of these proposed regulations is Melissa Liquerman, Office of the Associate Chief Counsel (Passthroughs and Special Industries).

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.642(c)-3 is amended by:

1. Revising the heading of paragraph (b) and adding a heading for (b)(1).
2. Revising paragraph (b)(2).
3. Adding a heading to paragraph (b)(3).
4. Removing paragraph (b)(4).

The revisions and addition read as follows:

§1.642(c)-3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

\* \* \* \* \*

(b) Determination of amounts deductible under section 642(c) and the character of such amounts--(1) Reduction of charitable contributions deduction by amounts not included in gross income. \* \* \*

(2) Determination of the character of an amount deductible under section 642(c).

In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the



governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See §1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See §1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:

Example 1. A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of \$10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the \$10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.

Example 2. A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

(3) Other examples. \* \* \*

\* \* \* \* \*

Par. 3. Section 1.643(a)-5 is amended by revising paragraph (b) to read as follows:

§1.643(a)-5 Tax-exempt interest.

\* \* \* \* \*

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and §1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See §1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of §1.662(b)-2 and §1.662(c)-4(e).

Linda M. Kroening,  
(Acting) Deputy Commissioner for Services and Enforcement.

Approved: April 9, 2012.

Emily M. McMahon,  
(Acting) Assistant Secretary of the Treasury (Tax Policy)

[FR Doc. 2012-8996 Filed 04/13/2012 at 8:45 am; Publication Date: 04/16/2012]