

fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

For treatment of distributions by an estate to a charitable remainder trust, see paragraph (a)(5)(iii) of § 1.664-1.

[T.D. 7357, 40 FR 23740, June 2, 1975; 40 FR 24361, June 6, 1975, as amended by T.D. 9102, 69 FR 17, Jan. 2, 2004]

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

(a) *Income in respect of a decedent.* For purposes of §§ 1.642(c)-1 and 1.642(c)-2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(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.* If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c) (1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)-1 or § 1.642(c)-2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of § 1.642(c)-2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in

section 1222(7)) shall be taken into account.

(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

### § 1.642(c)-3

### 26 CFR Ch. I (4-1-14 Edition)

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.* For examples showing the determination of the character of an amount deductible under § 1.642(c)-1 or § 1.642(c)-2, see examples 1 and 2 in § 1.662(b)-2 and paragraph (e) of the example in § 1.662(c)-4.

(c) *Capital gains included in charitable contribution.* Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c) (1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)-1 or § 1.642(c)-2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

*Example 1.* Under the terms of the trust instrument, the income of a trust described in § 1.642(c)-2 (b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of \$100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes \$100,000 in gross income but is allowed a deduction of \$50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of \$50,000 under section 642(c)(2) (\$100,000 permanently set aside for charitable purposes less \$50,000 allowed as a deduction under section 1202 with respect to such \$100,000).

*Example 2.* Under the terms of the will, \$200,000 of the income (including \$100,000 capital gains) for the taxable year 1972 of an es-

tate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of \$200,000, long-term capital gains of \$100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of \$100,000 are included in the gross income of the estate for 1972, and N University receives \$100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of \$25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to \$25,000 [(\$100,000 capital gains less \$50,000 capital gains includible in income of individual beneficiaries under section 662)  $\times$  50%]. Since the whole of this \$25,000 deduction under section 1202 is attributable to the distribution of \$50,000 of capital gains to N University, the deduction allowable to the estate in 1972 under section 642(c)(1) is \$75,000 [\$100,000 (distributed to N) less \$25,000 (proper adjustment for section 1202 deduction)].

*Example 3.* Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)-2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of \$100,000, long-term capital gains of \$15,000, short-term capital gains of \$1,000, long-term capital losses of \$5,000, and short-term capital losses of \$2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of \$116,000 [\$100,000 (ordinary income) + \$16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of \$30,000 (\$100,000  $\times$  30%). The balance of \$78,500 [(\$116,000 less \$7,500 capital losses) - \$30,000 distribution] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of \$7,500 (\$5,000 + \$2,500) are allowable in full under section 1211(b)(1). The net capital gain (capital

gain net income for taxable years beginning after December 31, 1976) of \$8,500 (\$16,000 less \$7,500) is the excess of the net long-term capital gain of \$10,000 (\$15,000 less \$5,000) over the net short-term capital loss of \$1,500 (\$2,500 less \$1,000). The deduction under section 1202 is \$4,250 (\$8,500×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is \$74,250 [\$78,500 (set-aside for M) less \$4,250 (proper adjustment for section 1202 deduction)].

*Example 4.* During the taxable year a pooled income fund, as defined in § 1.642(c)-5, has in addition to ordinary income long-term capital gains of \$150,000, short-term capital gains of \$15,000, long-term capital losses of \$100,000, and short-term capital losses of \$10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of \$5,000 (\$15,000 less \$10,000) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to \$25,000 [(\$150,000 (long-term capital gains) less \$100,000 (long-term capital losses))×50%]. Since the whole of this deduction under section 1202 is attributable to the set-aside for charitable purposes, the deduction of \$50,000 (\$150,000 less \$100,000) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is \$25,000 [\$50,000 (set-aside for public charity) less \$25,000 (proper adjustment for section 1202 deduction)].

*Example 5.* The facts are the same as in example 4 except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of \$165,000 (\$150,000+\$15,000). In determining taxable income for the taxable year the capital losses of \$110,000 (\$100,000+\$10,000) are allowable in full under section 1211(b)(1). The net capital gain of \$55,000 (\$165,000 less \$110,000) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the net long-term capital gain of \$50,000 (\$150,000 long-term gains less \$100,000 long-term losses). The deduction under section 1202 is \$25,000 (\$50,000×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is \$25,000 [\$50,000 (set-aside for public charity) less

\$25,000 (proper adjustment for section 1202 deduction)]. The \$5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) *Disallowance of deduction for amounts allocable to unrelated business income.* In the case of a trust, the deduction otherwise allowable under § 1.642(c)-1 or § 1.642(c)-2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) *Disallowance of deduction in certain cases.* For disallowance of certain deductions otherwise allowable under section 642(c) (1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) *Information returns.* For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

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#### § 1.642(c)-4 Nonexempt private foundations.

In the case of a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a) for the taxable year, a deduction for amounts paid or permanently set aside, or used for a purpose specified in section 642(c) (1), or (2) shall not be allowed under § 1.642(c)-1 or § 1.642(c)-2, but such trust shall, subject to the provisions applicable to individuals, be allowed a deduction under section 170 for charitable contributions paid during the taxable year. Section 642(c)(6) and this section do not apply to a trust described in section 4947(a)(1) unless such trust fails to meet the requirements of section 508(e). However, if on October 9, 1969, or at any time thereafter, a trust is recognized as being exempt from taxation under section 501(a) as an organization described in section 501(c)(3), if at such time such trust is a private