Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: August 14, 2017

to: Small Business/Self Employed
(Examination Operations)
Field Examination
Exam - Central Area
Territory - 5
Group 4
(Mary Unger, Supervisory/Manager)

from: Bradford R. Poston
Senior Counsel, Branch 3
(Passthroughs and Special Industries)

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subject: Response to Trust's Protest Letter

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

LEGEND

Grantor =

Child 2 =

Parent Trust =

Trust =

Foundation 1 =

Foundation 2 =

State =

FACTS: In response to the advice this office provided to SB/SE (Examinations) on September 15, 2016 and the subsequent proposed denial of Trust's claims for refund by SB/SE Examination, Trust filed protests to the proposed denials. SB/SE has provided us with the protests and has requested assistance in drafting responses. Below please find a summary of Trust's arguments along with the Service's responses.

ARGUMENTS:

1. Trust's Argument: The Plain Language of § 642(c)(1) Allows a Deduction for Any Charitable Deduction that is Not *Ultra Vires*

Service's Response: Section 642(c)(1) Requires that the Charitable Distribution to be Made Pursuant to the Terms of the Governing Instrument and A Court Order Modifying the Will in the Absence of a Controversy Involving the Interpretation of the Instrument is Not "Pursuant to the Terms of the Governing Instrument"

Trust cites to Old Colony Trust Company v. Commissioner, 301 U.S. 379 (1937), John Allan Love Charitable Foundation v. United States, 710 F.2d 1316 (8th Cir. 1983), and Crown Income Charitable Fund v. Commissioner, 8 F.3d 571, 573 (7th Cir. 1993), *aff'g* 98 T.C. 327 (1992) as primary support for its argument that that a deduction under § 642(c)(1) should be available for any distribution to charity that is authorized by the trust instrument.

As discussed in our previous memo, § 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]

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, in its reversal of the First Circuit's opinion, 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 John Allan Love Charitable Foundation v. United States, 710 F.2d 1316 (8th Cir. 1983), the trust seeking the § 642(c)(1) deduction was an inter vivos revocable trust that held the assets of John Allan Love during his life and contained his estate plan. The trust provided for the bulk of the trust fund to be paid over to any trust created by Love's will which was created exclusively for charitable purposes and which provided that the ultimate beneficiary shall be the John Allan Love Charitable Foundation. At the time of his death, Love's will did not include a trust for the benefit of the foundation, but trustees distributed assets to the foundation nonetheless. The 8th Circuit disallowed the deduction because it was "beyond dispute that the terms of the Trust instrument did not authorize the trustee to make the payments in question." The court stated that the trustees had no authority under the trust instrument to make the distributions to charity and denied that deduction under § 642(c)(1).

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.

Trust argues that the State court granted Child 2 inter vivos powers of appointment through a modification order (the "Modification Order"), which he exercised in favor of Foundation 1 and Foundation 2. The Modification Order modified Trust to allow Child 2 to appoint income during his lifetime to Foundation 1 and Foundation 2. Under the laws of State, a modification order will be approved by the court if the modification is not inconsistent with a material purpose of the trust and is not contrary to the grantor's probable intention in order to achieve the grantor's tax objectives. Therefore, Trust argues, the distributions made by Trust to the Foundations were not *ultra vires*, like the distributions in Love and Crown, but rather, were required by the Trust instrument.

The fact that the distributions in Love and Crown were *ultra vires* does not prove that the distributions in the current case were authorized by the governing instrument as required by § 642(c)(1). Similar to the facts in Love, the Parent Trust as executed by the grantor in this case did not authorize distributions to charity during the lifetime of the beneficiaries. This fact is undisputed. Rather, the Modification Order entered into by the parties did. For reasons that were discussed in our previous advice, as well as for the reasons discussed below, the Modification Order is not treated as the governing instrument in this case. Specifically, the Modification Order was not the subject of a conflict and the terms of the Parent Trust were unambiguous.

Rev. Rul. 59-15, 1959-1 C.B. 164, and case law provide that a settlement agreement arising from a will contest qualifies as a governing instrument. However, those authorities do not 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. When there is a conflict regarding the terms of the governing instrument, the court must resolve the conflict as to the true meaning of the terms of the governing instrument. Thus, court orders resulting from conflict are intended to clarify the terms of the original governing instrument. By contrast, modification orders such as the one in this case change the terms of the governing instrument beyond its original intended terms.

Trust cites numerous Private Letter Rulings issued by the Service wherein the Service respected reformation orders that were entered by a state court in order to effectuate a grantor's original intent when drafting a trust.[1] In those cases, the original document executed by the grantor contained an error that did not allow the trust to function in the manner in which the grantor originally intended. These PLRs are easily distinguished from the case at hand; here there was no question as to the grantor's intent at the time the Parent Trust was created. Although the standard for granting the Modification Order is that the changes to the trust not be inconsistent with a material purpose and not contrary to the grantor's probable intention in order to achieve the settlor's tax objectives that is different than requiring that the modification be necessary in order to effectuate the grantor's intent. As the Service has noted, reformation that occurs prior to the event that would give rise to the federal tax will be respected when necessary to carry out the grantor's original intent. See Rev. Rul. 73-142, 1973-1 C.B. 405. "The negative implication is that a post-event reformation will undergo much more rigorous scrutiny before it is respected for federal tax purposes. In this regard, courts have distinguished between reformations that seek to carry out an intention that existed at the time the mistake was made from reformations that seek to retroactively change a bad result." Robert E. Hamilton, Representing Estate and Trust Beneficiaries and Fiduciaries, Modifying Irrevocable Trusts, ALI-ABA Course of Study (July 16-17, 2009).

In Harris v. Commissioner, 461 F. 2d 554 (5th Cir. 1972), federal tax consequences were not affected by a retroactive reformation where taxpayer failed to prove that the amended trust carried out an intent that existed at the time the original trust was

[1] It should be noted that PLRs may not be cited as precedent and a PLR is only binding as between the Service and the particular taxpayer who requested it. I.R.C. § 6110(k)(3).

executed. In cases like this, the "reformation" appears to be more of a modification. Similarly, in this case, the purpose of the Modification Order was not to resolve a conflict regarding the terms of the Parent Trust, nor was it necessary to resolve a controversy involving the grantor's original intent. Its purpose was to fundamentally modify the terms of the Parent Trust to allow Child 2 to exercise a power of appointment during his lifetime. Accordingly, the distributions to Foundation 1 and Foundation 2 were outside of the terms of the governing instrument and do not qualify for the deduction under § 642(c)(1).

2. Trust's Argument: Crown and Brownstone Do Not Support a Narrow Interpretation of § 642(c)(1)

Service's Response: The Service's Interpretation of § 642(c)(1) is a Plain Language Reading of the Statute and Case Law Supports this Interpretation

Trust cites Crown for the proposition that the only restriction on the deduction under § 642(c) is that the trustee must not disregard the terms of the trust instrument when making the charitable distribution. Trust argues that Crown is not relevant because in Crown, the charitable distributions were not authorized and in this case, they are because the Modification Order provides as much. Trust is attempting to make an argument in its favor by citing to a case that does not provide a foundation for its reasoning. Trust's assertion ignores the fact that the Modification Order is not the governing instrument for these purposes and any attempt to draw a parallel with Crown to the contrary is circular.

Trust also argues that Brownstone v. United States, 465 F.3d 525 (2nd Cir. 2006), would likely not be followed in another jurisdiction because it goes against the policy that charitable deductions are not to be narrowly construed.

As noted in our previous advice, in Brownstone, 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.

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.

There is no indication that Brownstone would not be followed in this case. Furthermore, Trust attempts to cloud the issue by arguing that the Service allows powers of appointment exercised in favor of charities under trusts to qualify for the deduction under § 642(c)(1) and therefore, the Service's reliance on Brownstone in this case is misplaced. The Trust's claims in this case were not denied merely because Child 2 exercised a power of appointment in favor of Foundation 1 and Foundation 2. They were denied because the Parent Trust did not provide for that lifetime power of appointment. The lifetime power of appointment only exists because of the Modification Order issued under the laws of State. The Modification Order does not qualify as the governing instrument, which is the essential point to this case. Brownstone stands for the proposition that the governing instrument is what governs the charitable intent of the grantor, not the Modification Order to which the grantor was not a party.

3. Trust's Argument: Bosch and Revenue Ruling 73-142 Require the Service and the Federal Courts to Give Effect to the State Court Decree

Service's Response: The State Court Decree Was Not Issued by the Highest State Court and The Service is Not Bound by it when Determining Federal Tax Consequences

Trust argues that under the principles of Commissioner v. Bosch's Estate, 387 U.S. 456 (1976), the Service must respect the modification of Trust under the laws of State and therefore, treat the Modification Order as the governing instrument for purposes of § 642(c)(1).

In Bosch, the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in a federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

Trust is misplacing reliance on the holding in Bosch in this case. The decree issued by the State court was not issued by the highest court of State. Rather, it was entered through a procedure under the laws of State that allows for the parties to a trust to agree to such modifications upon notice to all interested parties so long as the modifications are not inconsistent with a material purpose of the trust and are not contrary to the grantor's probable intention in order to achieve the grantor's tax objectives.

The Service is not arguing that the Modification Order is invalid or that is not binding on the parties to the State law procedure. However, the decree does not determine the federal tax consequences of the modification; it only determines the rights of the parties under the Modification Order under the laws of State.

Trust also cites to Rev. Rul. 73-142 as support for its argument that the Modification Order must be respected as the governing instrument. Rev. Rul. 73-142 respected a lower court's interpretation of a trust agreement that found that the grantor could only substitute a trustee one time and after that substitution, the power was extinguished. The grantor had made one substitution, and the Service respected the court's decree and found that the value of the trust estate was not includible in the decedent's gross estate. This was despite the fact that the lower court opinion was in conflict with higher court decisions within the same jurisdiction. The lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, regardless of how erroneous the court's application of the state law may have been. Consequently, after the time for appeal had expired, the grantor did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of the Code were thus effectively cut off before his death.

Estate of Rapp v. Commissioner, 140 F.3d 1211 (9th Cir. 1988) addressed both the Bosch and Rev. Rul. 73-142 holdings in the context of a will reformation. The issue in Rapp was whether a QTIP trust would be respected for federal tax purposes based on a state probate court's reformation of the decedent's will. In Rapp, as in the present case, the modification sought was not to effect the testator's intent, but rather to avoid taxes. The will itself did not create the QTIP trust, but the California probate court's reformation did. The 9th Circuit noted that the holding in Bosch requires the highest court to affirm a lower court's result before it will be binding upon the Service. Absent that affirmation, the federal agency must interpret the state's law. The Tax Court in Rapp noted that as a general rule, state law determines the property rights and interests created by a decedent's will, but federal law determines the tax consequences of those rights and interests. T.C. Memo. 1996-10 (citing De Oliveira v. United States, 767 F.2d 1344, 1347 (9th Cir. 1985)).

The 9th Circuit stated that in Rev. Rul. 73-142 it mattered that the lower court decree was issued before the testator's death because it allowed the testator to carry out the intention of his estate plan. Unlike the situation in Bosch, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power.

Additionally, the court noted that Bosch stands only for the proposition that the federal court is not bound by the state court proceedings for determining federal estate taxes; to this end, the Tax Court decision did nothing to upset the actual outcome of the probate court proceedings. Mrs. Rapp still enjoyed the benefits of the reformation for which she petitioned in probate court. The estate simply did not receive the federal tax benefits of a QTIP trust. Similarly in our case, a denial of the refund would not upset the outcome of the reformation. The charities will still receive the distributions, but for federal income tax purposes, Trust will not receive a deduction for these distributions.

In Estate of Aronson v. Commissioner, T.C. Memo. 2003-189, the Tax Court held that the state surrogate court did not merely clarify decedent's will, but rather, it changed it to create a QTIP trust. The court held that although it will look to local law to determine the nature of the interests provided under a trust document, they are not bound to give effect to a local court order that modifies that document after the Commissioner has acquired rights to tax revenues under its terms. (citing Estate of Nicholson v. Commissioner, 94 T.C. 666, 673 (1990)). The court further held that the law is clear that it is not bound by the action of a state trial court, such as the surrogate's court, that has not been affirmed by the state's highest court. (citing Bosch). The court found that the petition was solely brought for the purposes of tax planning. The court held that even if law and public policy favor the marital deduction and presume the taxpayer's wish to take advantage of it, the taxpayer's express direction in the documents overrides this presumption. Therefore, the QTIP trust was not valid for federal estate tax purposes.

Additionally, since we issued our previous advice, the Tax Court has issued Hubbell v. Commissioner, T.C. Summ. Op. 2016-67 (2016), a summary opinion on the issue of deductibility of payments made to charities under § 642(c)(2). This opinion touches on a number of issues relevant to Trust's case, including Trust's argument that the Service must treat the Modification Order as the governing instrument pursuant to Bosch. While a summary opinion cannot be cited as precedent in a court proceeding, it does offer insight into the Tax Court's views on the issues at hand.

Per the facts of the case, Mr. Hubbell's will, after his death in 1957, created a trust that made small annuity payments to certain friends and relatives monthly for their lives, and following the death of the last of them to die the trustees had the discretion to continue the trust for up to ten years and to distribute the remaining assets "as will make such uses and distributions exempt from Ohio inheritance and Federal estate taxes and for no other purpose." The trustees and their successors made the annuity payments and "[f]rom time to time, the trustees also caused the trust to make charitable contributions as defined by section 170(c)." Charitable contributions were made at least as early as 1985, and in amounts much larger than the annuity payments. In 2009, the Service disallowed a charitable contribution deduction claimed by the trust.

The Service acknowledged that the contributions during that year were paid for a purpose specified in § 170(c). Nevertheless, the Service argued that the trust was not entitled to deduct the amount contributed because none of the contributions were made "pursuant to the terms of the governing instrument", as required by § 642(c)(1). No provision of the will authorized the trustees to make charitable contributions for taxable year 2009 or for any other year. Thus, the Service asserted that the charitable contributions made during 2009 were not deductible under § 642(c)(1).

The trust asserted that it was entitled to the deduction under § 642(c)(1) on the basis of two grounds: (1) the court can go beyond the provisions of the will to determine Mr. Hubbell's intent because there is a latent ambiguity in the will; and (2) the original trust agreement was reformed by order of the probate court to retroactively allow for such payments to the charity.

Regarding the probate court order, on December 27, 2013, the trustees filed with the state probate court a complaint for Declaratory Relief or, in the Alternative, Modification of Trust. The probate court entered an agreed judgment on April 2, 2014, entered the following judgment:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust. as in this case, the trust asserted that the agreed judgment entry of the probate court is consistent with the evidence of Mr. Hubbell's intent to make charitable gifts because the judgment found that "the language of the Will authorizes, and has from the inception of the Trust, authorized the Trustees to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c) * * * both currently and upon termination of the Trust".

As in this case, the taxpayer in Hubbell cited to Bosch as support for its argument that the Tax Court should respect the probate court's reformation order. However, as the taxpayer in Hubbell correctly noted "**the Probate Court's judgment is not binding on this Court.**" (emphasis added). Rather, the taxpayer argued that the Tax Court should give proper regard to the judgment in deciding the issue before it.

The court acknowledged that as a general rule, that deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any deductions claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). It began its analysis with a review of Old Colony and then compared it with the Hubbell case. The court noted both cases involve trusts created for the purpose of paying annuities to certain specified individuals for life. The trust deed in the Old Colony authorized the fiduciary to make charitable contributions before the death of the last annuitant, and it directed the trustees to distribute the remainder of the assets to charity after the death of the last annuitant.

Mr. Hubbell's will, on the other hand, made no provision for the payment of any charitable contributions before the death of the last annuitant. The Tax Court noted that the opinion of the Supreme Court in Old Colony provided clear authority to Mr. Hubbell and the drafters of his will to authorize, without directing, his trustees to make charitable contributions before the death of the last annuitant. The Old Colony opinion shows that Mr. Hubbell could restrict such authority to prevent the charitable contributions from jeopardizing the payment of annuities, as was done in Old Colony. As such, the court reasoned, Mr. Hubbell's failure to grant authority to his trustees to make charitable contributions before the death of the last annuitant was intentional. The Tax Court found that there was no latent ambiguity in Mr. Hubbell's will and as such, the charitable deductions were "not made pursuant to the will, the governing instrument, and they are not deductible under section 642(c)." The Tax Court concluded by stating that "[a]ny other contentions made by the trust that we have not addressed are irrelevant, moot, or meritless." It is worth noting that the court did not address the Estate of Bosch issue in its opinion.

To summarize, Trust is arguing that its charitable distributions were authorized under the Modification Order and, pursuant to Bosch, the Modification Order should be treated as the governing document, thus allowing for a deduction under § 642(c)(1). The Modification Order was not issued by the highest court of State, nor was it the result of any conflict regarding the terms of the Parent Trust, and therefore, it is not binding on the Service for purposes of determining the federal consequences of the charitable distributions. The Modification Order is not considered the governing instrument in this case for purposes of § 642(c)(1). Because the original Parent Trust agreement is the governing instrument and it did not contain any evidence of Grantor's intent to allow the trustees to make charitable distributions, no deduction under § 642(c) is permitted in this case.

4. Trust's Argument: The Service's Interpretation of §1.663(a)-2 is Invalid under Auer v. Robbins, 519 U.S. 452, 461 (1997)

Service's Response: When Properly Promulgated and Consistent with the Statute, Treasury Regulations Typically Have the Force of Law

At issue in the second half of Trust's protest is the second sentence of §1.663(a)-2, which states "[a]mounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates and trusts only as provided in section 642(c)."[2] Trust argues that this sentence is not supported by the plain text of the regulation.

[2] For ease of reference, the regulation reads as follows: Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an

Trust argues that the Service's interpretation that the regulation disallows any deduction for charitable distributions under § 661(a), relegating them to be deducted (if at all) pursuant to § 642(c), violates the canon against surplus language. Trust's position is that this interpretation strains the plain and natural meaning of the words because it is inconsistent with both the first and third sentences of the same regulation. It argues that if the second sentence of the regulation requires charitable distributions to be deducted, if at all, pursuant to § 642(c), there is no reason to include the first sentence, which precludes deductions for the narrower category of distributions allowable as a deduction under § 642(c).

Additionally, Trust argues that the Service's broad interpretation of the second sentence is inconsistent with the third sentence of the regulation given the interpretive rule of *expression unius est exclusio alterius* (the "express mention of one thing excludes all others"). It argues that the parenthetical clause at the end of §1.663(a)-2 identifies three discrete instances in which a deduction will not be allowed under § 642(c) and the function of this parenthetical clause is to make clear that if § 642(c) deduction is unavailable for any of these three reasons, a deduction under § 661(a) should not be allowed either. This list is also contained in § 663(a)(2). Given this specific list, Trust posits that there is no room in the regulatory language for the Service to now identify additional circumstances under which no deduction is available under either provision.

Where properly promulgated and consistent with the statute, Treasury regulations typically have the force of law. See Boeing Co. v. United States, 537 U.S. 437, 447-48 (2003). In Auer, the Supreme Court held that an agency's interpretation of its own regulation is "controlling" unless it is "plainly erroneous or inconsistent with" the regulation." Auer, 519 U.S. at 461. The Tax Court has applied this principle in various contexts. See Estate of Focardi v. Commissioner, T.C. Memo. 2006-56; Rand v. Commissioner, 141 T.C. 376 (2013). Therefore, according to the standard set forth in Auer, the Service's interpretation that, pursuant to § 1.663(a)-2, a deduction is not available under § 661 for a charitable contribution made by Trust under the facts of this case is controlling. For the reasons set forth in the previous memo issued by our office, this interpretation is not "plainly erroneous or inconsistent with" § 1.663(a)-2.

5. Trust's Argument: The Service's Interpretation of § 1.663(a)-2 is Invalid under Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)

Service's Response: Section 1.663(a)-2 Is A Valid Regulation

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amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 642. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

The Third Circuit will follow a regulation unless it holds it to be invalid under the principles of Chevron. Mannella v. Commissioner, 631 F.3d 115, 121 (3rd Cir. 2011). Trust argues that the second sentence of § 1.663(a)-2 is an invalid interpretation of § 663(a)(2) under the Chevron standard. To determine whether the regulation is invalid under the principles of Chevron, the Tax Court conducts a two-part analysis. First, it must ask whether Congress has "directly spoken to the precise question at issue." Chevron, 467 U.S. at 842. If so, that is the end of the matter and the Tax Court and the agency must give effect to the unambiguously expressed intent of Congress. Id., at 842-843. If the statute is silent or ambiguous with respect to the specific issue, the Tax Court will ask whether the agency's chosen interpretation is a "reasonable interpretation" of the statute. Id., at 844. Under this analysis review is highly deferential, and the Supreme Court has held that a court may not find a regulation to be invalid unless it is "arbitrary or capricious in substance, or manifestly contrary to the statute." See Mayo Found. v. United States, 131 S.Ct. 704, 711 (2011); Chevron, 467 U.S. at 844.

Section 663 does not speak directly as to whether a deduction under § 661 is available for a charitable deduction made by a trust that does not otherwise qualify for that deduction under § 642. Furthermore, there is ambiguity because § 642(c) provides for charitable deductions that may be taken by trusts in certain situations and § 661 provides a deduction for trusts in certain situations. These statutes are not explicitly clear as to what should occur if a trust makes a distribution to a charity, but that deduction does not qualify under § 642(c). Therefore, the question for the court becomes whether the Service's interpretation of § 663 is reasonable. For the reasons set forth in the previous memo issued by this office, the interpretation espoused by the Service is a reasonable interpretation of this ambiguity.

6. Taxpayer's Argument: Section 1.663(a)-2 is Invalid under the Administrative Procedure Act because the Rulemaking Process was Arbitrary and Capricious

Service's Argument: The Service met its obligations under the Administrative Procedure Act when Promulgating § 1.663(a)-2

The Supreme Court has held that a court's role in reviewing whether agency action is arbitrary or capricious under APA section 706(2)(A) is to ensure that the agency engages in "reasoned decision making." Judulang v. Holder, 132 S. Ct. 476, 483-84 (2011); Michigan v. EPA, 135 S. Ct. 2699, 2706 (2015). The Supreme Court has also noted that APA section 706(2)(A) requires only a "minimal level of analysis" on the part of an agency, and that an agency's obligation to explain its actions will vary depending upon the circumstances and the nature of the agency action. Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117 (2016). This "minimal" standard requires only that the agency's explanation be "clear enough that its path may be reasonably discerned." Id. In State Farm, the Supreme Court articulated a set of factors that it applied in determining whether an empirical-based rule that rescinded a prior agency policy was "arbitrary or capricious" under the APA. Motor Vehicle Mfrs. Assn. of U.S., Inc. v. State

Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983). But where an agency rule does not require fact-finding or empirical analysis, the Tax Court has held that the data-based factors under State Farm do not apply. See Santos v. Commissioner, T.C. Memo. 2016-100. Therefore, the Trust's arguments concerning the "hard look" factors set forth in the State Farm case do not apply in this situation. It should be noted, however, that no preamble was published in connection with the promulgation of §1.663(a)-2, which presents a hazard to the Service under this argument.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-5055 if you have any further questions.