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by Tom Cullinan, J. Scot Kirkpatrick, Steven M. Wyatt, Emily A. Dabney, and Asher Fried

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Tom Cullinan, J. Scot Kirkpatrick, and Steven M. Wyatt are shareholders, Emily A. Dabney is an associate, and Asher Fried is senior counsel with Chamberlain Hrdlicka.

In this article, the authors examine charitable remainder annuity trust transactions, which the IRS has included on its "Dirty Dozen" list, and they explore options for taxpayers who may have invested in them.

For the second year in a row, the IRS's annual "Dirty Dozen" list includes a strategy involving a charitable remainder annuity trust (CRAT).[1] When it comes to promoted transactions, the list operates as the proverbial canary in the coal mine — if the transaction appears on the list, rest assured that significant IRS time and resources follow. The identified CRAT transaction proves that point, as we have already seen two court cases involving investors and one involving an alleged promoter.[2] Most recently, in May, a U.S. district court permanently barred five defendants from promoting a CRAT transaction (among other sanctions).[3]

It appears that the IRS intends to increase the pressure even further. The IRS has historically "listed," by notice, transactions that it has determined are abusive. There has been a great deal of recent litigation, however, about whether the listing must be done through a regulation after notice and comment. Given the hazards on that issue, the IRS (and Treasury) have turned to listing transactions through regulations instead of a simple notice. One consequence of that is that the public can now see what the IRS and Treasury are working toward listing, as the government publishes a list of regulations in progress. That list shows that Treasury and the IRS are working on regulations that would "identify certain charitable remainder annuity trust (CRAT) transactions and substantially similar transactions as listed transactions." We suspect the transaction that the IRS is working on listing is the same as the one identified on the "Dirty Dozen" list.

We begin this article with a brief overview of how CRATs work and the conventional tax benefits they provide. We then examine some generally accepted planning techniques that can make CRATs even more appealing. Finally, we discuss the CRAT transaction that the IRS has placed on the list, and we provide some thoughts for taxpayers who may have invested in one.

I. Charitable Remainder Trusts, Generally

Charitable remainder trusts (CRTs), which arise directly from section 664, enable individuals to support charities while retaining income from the trust for themselves or their loved ones. The two main types include the CRAT and the charitable remainder unitrust (CRUT).

A CRAT guarantees a fixed annual payment (an annuity payment) of no less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed into the trust. The CRAT then makes the annuity payment for a specified term of up to 20 years or for the lifetime of an individual or individuals named in the CRAT. Upon termination, the CRAT transfers its remaining assets to a charity or retains those assets for charitable purposes.

On the other hand, a CRUT pays an annual fixed percentage of the yearly net fair market value of its assets, ranging from 5 to 50 percent (the unitrust amount). The CRUT makes that payment to one or more beneficiaries for a specified term of up to 20 years or for the lifetime

[1] IR-2023-65.

[2] *Gerhardt v. Commissioner*, 160 T.C. No. 9 (2023); *Furrer v. Commissioner*, T.C. Memo. 2022-100.

[3] *United States v. Eickhoff*, No. 2:22-cv-04027 (W.D. Mo. 2023).

of individuals named in the CRUT. Like CRATs, upon termination, the CRUT transfers its remaining assets to a charity or retains those assets for charitable purposes.

The net income CRUT, net income with makeup CRUT, and flip CRUT allow the CRUT to be tailored to hold illiquid assets that may not sell before the due date of the initial unitrust payment. Net income CRUTs distribute the lesser of the trust's net income or a fixed percentage. This is ideal for maximizing charitable contributions. On the other hand, net income with makeup CRUTs include a "make-up" provision that compensates for income shortfalls from previous years. This is useful for donors who might need relatively more income in the future. Flip CRUTs switch from an income-based payout to a fixed percentage payout as the result of a nondiscretionary event. This is fitting for donors who desire steady income after the sale of an illiquid asset, such as appreciated real property.

Upon funding the trust, the grantor of a CRT receives charitable income and gift tax deductions under sections 170 and 2522 for the present value of the remainder interest. CRTs remain exempt from income tax but may be subject to an excise tax if they have unrelated business taxable income for the tax year. The private foundation rules generally apply to CRTs. Deciding between a CRAT and a CRUT requires consideration of several factors. For example, CRATs offer a stable yearly income and make things simpler for the trustee because the distribution does not need to be recalculated regularly, but in an inflationary environment, the payment stream may be worth less than anticipated. On the other hand, CRUTs could increase in value over time and are more adaptable for nonliquid assets (because a CRAT must begin making distributions to the beneficiary even if the contributed assets have not yet been sold to purchase an annuity). CRUTs also show more resilience during economic downturns and, in some cases, can accept additional contributions after the initial funding.

II. Generally Accepted Planning Techniques

Charitable giving makes up an important component of many individual estate plans. However, individuals may struggle to balance charitable intent against passing wealth to future generations or providing for themselves. Using a CRT can provide income tax savings during the grantor's lifetime and reduce estate tax upon the grantor's death, at the cost of giving the asset to charity.

CRUTs or CRATs, when combined with purchasing life insurance policies, provide an appealing solution that enables individuals to meet both charitable planning and wealth transfer goals. This process is known as wealth replacement because individuals use life insurance to replace the value of assets that they donated to the CRUT or CRAT. The life insurance proceeds, in turn, increase the individuals' gross estates, enabling them to pass more wealth to future generations.

During the grantor's lifetime, a CRUT or CRAT can provide a client with a steady stream of income for a period at a fixed percentage of the trust's value. With a CRAT, the annuity payment derives from the initial value of the trust assets. CRATs prove most useful in a low inflationary environment because of the fixed measure for distributions. Income distributions from a CRUT derive from the value of the assets in the CRUT, recalculated annually. Therefore, the unitrust payout from a CRUT may, depending on the asset value, increase or decrease each year. Because the unitrust payout derives from the asset's value, a CRUT may prove more fruitful in an inflationary environment since the unitrust payment fails to keep pace with inflation. The section 7520 rate remains an important factor in calculating the present value of the charitable beneficiaries' remainder interest, which must equal at least 10 percent of the value of the trust assets at the time of contribution. When rates are higher, a charitable deduction may be larger because the present value of the remainder interest would be higher. This, in turn, means income distributions may be lower as well. At the end of the term, the CRUT or CRAT would distribute its remaining assets to the charitable beneficiaries.

For example, a typical CRUT structure involves a grantor creating a CRUT and then funding the trust with a gift of appreciated assets — often marketable securities. Thus, a 65-year-old donor who created a CRUT reserving an 8 percent unitrust interest and funding it with $1 million worth of marketable securities would have an

$80,000 initial annual distribution, which would most likely be taxed as capital gain, and a charitable deduction of almost $305,000. At a 40 percent effective tax rate, this transaction generates income tax savings of about $120,000. If the assets of the CRUT grow more than 8 percent annually, the unitrust distribution will increase, and vice versa. Of course, the CRT's assets pass to charity at the donor's death.

During life, the individual receiving the annuity payment or unitrust distribution (the income recipient) may use a portion of the income from the CRUT or CRAT to purchase life insurance to be owned by an irrevocable life insurance trust. If the income recipient owned the policy outright, the insurance policy proceeds would be included in their taxable estate, reducing the estate tax benefits of this strategy. However, the use of an irrevocable life insurance trust causes the death benefit to pass outside the transfer tax system. In this scenario, the income recipient's children, and potentially the spouse, would benefit from the irrevocable life insurance trust.

By creating a CRUT or CRAT and purchasing life insurance with the income stream therefrom, an individual may make substantial charitable donations without reducing the size of their estate. Wealth replacement strategies such as this make CRUTs and CRATs appealing to many high-net-worth individuals.

III. The CRAT on the 'Dirty Dozen'

The IRS described the CRAT transaction on the "Dirty Dozen" list as follows:

> Charitable Remainder Trusts are irrevocable trusts that let individuals donate assets to charity and draw annual income for life or for a specific time period. The IRS examines charitable remainder trusts to ensure they correctly report trust income and distributions to beneficiaries, file required tax documents and follow applicable laws and rules. A charitable remainder annuity trust (CRAT) pays a specific dollar amount each year.
>
> Unfortunately, these trusts are sometimes misused by promoters, advisors and taxpayers to try to eliminate ordinary income and/or capital gain on the sale of property. In abusive transactions of this type, property with a fair market value in excess of its basis is transferred to a CRAT. Taxpayers may wrongly claim the transfer of the property to the CRAT results in an increase in basis to fair market value as if the property had been sold to the trust. The CRAT then sells the property but does not recognize gain due to the claimed step-up in basis. Next, the CRAT purchases a single premium immediate annuity (SPIA) with the proceeds from the sale of the property.
>
> By misapplying the rules under sections 72 and 664, the taxpayer, or beneficiary, treats the remaining payment as an excluded portion representing a return of investment for which no tax is due.[4]

This appears to describe a promoted CRAT strategy that was involved in the recent *Gerhardt* and *Furrer* Tax Court cases[5] and examined by the IRS Office of Chief Counsel in a 2020 memo.[6]

A. The Promoters' Legal Argument

According to the 2020 memo, the promoters make the following legal arguments in support of their CRAT strategy:

- Under section 664(b), CRAT annuity payments carry out income in the following order: (1) ordinary income, (2) capital gains, (3) nontaxable income, and (4) return of principal (distribution of corpus).
- According to Notice 2008-99, 2008-47 IRB 1194, the CRAT takes a basis in newly acquired assets equal to the proceeds from the sale of the originally contributed appreciated assets as the amount paid for those new assets rather than the grantor's basis in the appreciated assets. The notice states that because a CRT generally constitutes a tax-exempt entity under section 664, a CRT's sale of appreciated assets remains exempt from income tax, and

[4] IR-2023-65.

[5] *Gerhardt*, 160 T.C. No. 9; *Furrer*, T.C. Memo. 2022-100.

[6] AM 2020-006.

the CRT's basis in the new assets equals the price the CRT pays for those new assets.
- A CRAT avoids the requirements outlined in section 664(b) by investing the sale proceeds in a single premium immediate annuity (SPIA) that operates under its own set of rules. An SPIA is a type of annuity contract that a person purchases with a single lump-sum payment. In exchange, the insurer promises to provide the person with regular income payments, typically for the rest of their life or for a specified number of years.
- Section 72 taxes annuities using an exclusion ratio method. This method reduces the amount of taxes payable on annuity payments. Under the exclusion ratio, a portion of the income received from the SPIA is considered a return of principal, while another portion is classified as interest. Taxes are imposed only on the interest portion, which represents the realized gain. The exclusion ratio depends on various factors, including age and the chosen annuitization option. Typically, taxable interest amounts to 15-25 percent, leaving 75-85 percent as a return of principal, primarily based on the client's age. Once the CRAT pays out the entire principal, the non-interest portion of the annual payment becomes subject to capital gains tax.
- The IRS addressed the tax treatment of SPIAs in LTR 9237030, confirming that it will treat guaranteed income payments received from a CRAT as amounts received as an annuity and that the exclusion ratio for the contract will determine the portion of the received amounts excludable from gross income.
- The taxation of SPIAs is well established and not a new or revolutionary concept. Because CRATs can invest in annuities, the tax regulations pertaining to annuities must also be applicable.
- SPIAs generally exclude from taxable income the portion of the annuity payout calculated as a return of principal, also known as a distribution of corpus. Thus, because all but the interest portion of the distribution to the beneficiary constitutes a return of corpus, this eliminates built-in gain on the contributed asset.

The promoters also appear to assert that a lifetime transfer of an appreciated asset to the CRT automatically steps up the asset's basis to fair market value.

B. Rejection of the Promoters' Argument

The Office of Chief Counsel contends that none of the IRS publications cited in the promotional materials actually support built-in gain elimination. According to the 2020 memo, the promoters simply, and perhaps purposely, confuse the interplay of the rules of sections 664 and 72 and misread the IRS publications. At the core of their confusion lies the erroneous treatment of the annuity contract as an asset of the beneficiary as opposed to an asset of the CRAT:

> The promoters are treating the capital gains as being trapped in the CRAT, with the income beneficiaries only taxed on the ordinary annuity income each year as if they were themselves the owners of the SPIA, rather than it being an asset of the CRAT funding their annuity payments from the trust. To reach this result, they are misinterpreting the cited [IRS publications]. In those documents discussing a CRT holding an annuity contract, it is clear that the annuity income is included in the income of the trust, thus entering the section 664(b) tiers, not bypassing the trust and appearing directly on the income beneficiaries' returns. Put differently, the annuity is a funding mechanism for the CRT's required payments to the income beneficiaries, not an income stream of the beneficiaries in lieu of such payments.

C. The Tax Court's Holding on the Issue

In *Gerhardt* and *Furrer*, the Tax Court likewise rejected the argument that this structure eliminates built-in gain. It held that the CRAT's use of annuity funds to fulfill its mandatory annual distributions to the beneficiary necessarily subjects the beneficiary to taxation based on the section 664(b) tiers such that CRT distributions carry out the following amounts in this order:

- income (excluding capital gains) included in gross income, to the extent of the CRT's income for the year and undistributed income from prior years;
- capital gain, to the extent of the CRT's capital gains for the year and undistributed capital gains from prior years;
- other income to the extent of the CRT's other income for the year and undistributed other income from prior years; and
- CRT trust corpus.

In *Gerhardt*, the Tax Court summed up the taxpayers' legal position as follows:

> The Gerhardts resist the straightforward analysis set out above. In their telling, the Code does a lot more than exempt the CRATs from paying tax on built-in gains realized when contributed property is sold. According to the Gerhardts, the Code also relieves them from paying tax on the distributions that were made possible by the CRATs' realization of the built-in gains. As they put it, "all taxable gains (on the sale of the asset[s contributed to the CRATs]) disappear and the full amount of the proceeds [is] converted to principal to be invested by the CRAT." . . . The gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or caselaw.

In *Furrer*, the taxpayers argued that distributions from an SPIA should be taxed according to section 72, which typically exempts annuity returns proportionate to the investment in the contract. However, the court found their reliance on this section flawed for two reasons. First, this rule applies unless otherwise stated in chapter 1. Section 664(b) (included within chapter 1) provides different rules for annuity distributions from CRATs and would prevail in a conflict with section 72. Second, in that particular case, section 72 did not mandate differing treatment, as it only excludes income equal to the taxpayer's "investment in the contract," but, since neither the petitioners nor the CRATs had any investment in the annuity contracts (because they were bought with agricultural crop sales proceeds having zero basis), there was no ground for exclusion.

As to penalties, in *Gerhardt* the court sustained the IRS's assertion of an accuracy-related substantial understatement penalty. Despite the taxpayers' claim of relying on tax professionals' advice, they failed to provide evidence of the professionals' expertise or establish that their reliance was reasonable.

D. The Promoter Litigation

The Justice Department sued the promoters of the CRAT strategy used in *Gerhardt* and *Furrer* in the U.S. District Court for the Western District of Missouri, alleging that the defendants promoted the strategy and engaged in various actions to facilitate it.

The government's complaint includes examples of customers allegedly harmed by the scheme. According to the government, these promoters misled customers about the tax benefits and participated in the scheme by transferring assets to a CRAT, selling them, and purchasing SPIA contracts. Improper reporting and underreporting of income resulted in significant underreporting of taxable income and tax liabilities for these customers.

The government seems to have had some early success with its suit because the court has recently permanently enjoined several defendants from engaging in various tax-related activities.

IV. CRATs May Become Listed Transactions

In June the Office of Information and Regulatory Affairs published a potential new development in this matter:

> TREAS/IRS
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> RIN: 1545-BQ58
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> Publication ID: Spring 2023
>
> Title: Charitable Remainder Annuity Trust Listed Transaction
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> Abstract:
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> This document contains proposed additions to 26 CFR part 1 (Income Tax Regulations) under section 6011 of the

> Internal Revenue Code (Code). The additions identify certain charitable remainder annuity trust (CRAT) transactions and substantially similar transactions as listed transactions for purposes of Treas. Reg. 1.6011-4 and sections 6111 and 6112.

This is the first publication of this development by Treasury in the unified agenda.[7]

The abstract does not provide any additional detail, but we assume that the "certain charitable remainder annuity trust (CRAT) transactions" that Treasury is proposing to list are connected to the CRAT transaction on the "Dirty Dozen" list.

If and when the regulation is finalized, participants in the specified CRAT transactions and any "substantially similar" transaction will be required to disclose their participation in the transaction to the IRS (unless their statute of limitations for all affected tax years is closed) or face significant penalties. If a taxpayer engages in a transaction that later becomes a listed transaction after they have filed their tax return, they must file a disclosure statement within 90 days of it being listed — again, for any year for which the statute of limitations remains open. Failure to do so will keep the time for assessment open. Assuming the disclosure is made, the IRS will have one year from the date of disclosure to assess (unless the normal statute of limitations is longer).

So-called material advisers must also disclose transactions once the regulation is finalized if they provided material aid or advice on the transaction and earned income over a specified threshold. They must disclose transactions on Form 8918, "Material Advisor Disclosure Statement," and the IRS will provide a "reportable transaction number," which must be given to all taxpayers and material advisers involved. Based on the IRS's position when listing other transactions, we would expect the IRS to require material advisers to disclose retroactively for a period of six years.

Under section 6112, material advisers involved in reportable transactions must maintain a list of individuals for whom they acted as material advisers in those transactions, along with other required information. This list must be made available to the IRS upon written request and be kept for seven years. The list should contain detailed information about each reportable transaction, including the names of involved individuals, transaction dates, amounts invested, and the intended tax treatment. Additionally, any relevant tax analyses, opinions, or documents provided to individuals involved in the transactions must be retained. Material advisers may use Form 13976, "Itemized Statement Component of Advisee List," provided by the IRS. If the IRS sends a written request for the list, the material adviser must comply within 20 business days from the date of the written request, or they may face a penalty of $10,000 per day under section 6708.

V. Taxpayer Options

If you or a client invested in this particular CRAT transaction, you have some decisions to make since the IRS is obviously focused on it and has already had some success in litigation. Taxpayers who have already engaged in transactions that the IRS is interested in have several options depending on whether they have reported the transactions on a tax return and whether the IRS has initiated an audit.

Taxpayers who have engaged in the transaction but have not yet reported it on a tax return have to decide whether they want to take the risk of continuing to press for the hoped-for tax benefits. Those who are determined to pursue the tax benefits may consider doing so through a protective refund claim, which can limit their exposure to penalties. Taxpayers already under audit can expect a thorough process that may result in an IRS appeal or litigation. Some taxpayers may choose to make deposits or prepay taxes during this period to minimize potential interest costs on additional tax owed.

Taxpayers who have already reported the transaction on a return but who are not yet under audit might have the option to amend the return

[7] Each department or agency participating in the unified agenda provides its own agenda, consisting of a preamble and various entries. These entries align with different rulemaking processes that the department or agency has in progress or intends to initiate. Each entry gives a short summary of the rule, a timeline of past actions or future plans regarding the rule's development, the importance level assigned by the agency, references to the legal basis, and a point of contact for additional information. It also includes other data fields about the rule's impact and related issues.

and remove the transaction (known as a qualified amended return), which could eliminate the risk of civil penalties. However, the technical considerations surrounding a qualified amended return necessitate professional advice. Taxpayers in this posture should consider, among other things, the strength of the reporting position, their penalty defense if the transaction is disallowed, the remaining time for the IRS to open an audit (which the IRS can extend under some circumstances), their comfort level, the amount of tax at issue, and the potential penalty.

If you or your client are ineligible to do a qualified amended return, you should note that the 2020 memo discusses two possible alternative treatments for taxpayers who reported the tax benefits claimed by the promoters, with one producing a harsher result than the other. Well-advised taxpayers might try to position themselves to avoid the harsher outcome.

A. First Alternative

The first alternative requires a retroactive disqualification of the CRAT, subjecting it to general trust taxation under section 661. Any gain from the sale of contributed appreciated assets would be taxable to the CRAT, except to the extent included in the CRAT's distributable net income as part of the annual annuity payment. Any charitable deduction would be disallowed. Note the lack of explanation of precisely how this works for tax years barred by the statute of limitations.

B. Second Alternative

The second alternative treats the CRAT as legitimate and taxes the beneficiaries as if they had received distributions from the section 664(b) tiers all along. This treatment would encompass current and undistributed ordinary income and capital gains falling within the section 664(b) tiers. This alternative operates less harshly than the first one because the CRAT does not owe any tax (tax brackets for trusts are smaller, meaning that they reach higher tax rates at lower income levels compared with individuals), and the donor retains the charitable deductions provided by the initial contribution to the CRAT. Again, note the lack of explanation of precisely how this applies for closed years.

Absent a structural defect, the Office of Chief Counsel does not seem inclined to recommend retroactive disqualification of a CRAT. Its recommendation for a fully qualifying CRAT with a beneficiary who has not adhered to the section 664(b) tier structure for distributions requires the beneficiary to treat the payments under the annuity contract as if they had been correctly routed through the CRAT according to the tiers. This treatment would result in distributions consisting of a thin layer of ordinary income with the remaining balance being current or accumulated capital gain, especially if the donor contributed highly appreciated assets that the CRAT sold soon after the contribution. It's worth noting that in both *Gerhardt* and *Furrer*, the IRS did not appear to pursue the disqualification of the CRATs.

VI. Conclusion

Properly structured and operated, CRTs remain legitimate tax structures, and numerous legitimate tax advisers can set them up without risk. Choosing a legitimate and reliable tax adviser is important. Taxpayers can take these steps to ensure the adviser's legitimacy:

- Check qualifications and credentials: Make sure the adviser is a CPA or a tax attorney. Each of these professionals has to pass rigorous exams and maintain their credentials through continuing education.
- Check experience: Look for a tax adviser who specializes in one's particular needs (for example, gift and estate tax planning, charitable lead trusts, CRTs, etc.) and who has many years of experience in that field.
- Check with professional organizations: Membership in a professional organization (like the American Institute of CPAs, the National Association of Tax Professionals, or the tax sections of the American Bar Association or state and local bar associations) is often a good sign. These organizations have ethical guidelines and frequently require ongoing education.
- Check for disciplinary actions: The IRS Office of Professional Responsibility keeps a record of tax return preparers who have faced disciplinary action. State bar associations and state boards of

accountancy keep similar records for attorneys and CPAs.

- Consider their fees: Be wary of advisers who promise big refunds. The cost of services should be based on the complexity and time required to prepare a return, not on the size of the refund.

It's essential to thoroughly research and vet tax advisers to avoid penalties, interest, or potentially being caught up in any actions the IRS might bring against them. ■