© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

CRATs as Listed Transactions? IRS Actions and Taxpayer Options

by Hale E. Sheppard

Hale E. Sheppard

Hale E. Sheppard is a shareholder in the tax controversy section of Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta.

In this article, Sheppard describes an array of IRS efforts to curtail transactions involving charitable remainder annuity trusts, and he explains what taxpayers should consider in light of recently proposed regulations.

Copyright 2024 Hale E. Sheppard.
All rights reserved.

I. Introduction

Following a pattern that has become common in tax enforcement, the IRS has decided that it dislikes something, and it is taking methodical steps to halt it. The IRS has recently focused on several different transactions, but its indignation is now targeted at some taxpayer positions regarding charitable remainder annuity trusts (CRATs). This article, the second in a series, describes a growing list of IRS efforts to stop what it deems abusive transactions.[1] These include a legal memorandum, an injunction lawsuit, two Tax Court battles, a Dirty Dozen listing, and, most recently, regulations proposing to broadly categorize items as "listed transactions."

II. Overview of Tax Rules

A CRAT is one type of charitable remainder trust.[2] A donor transfers to an irrevocable trust cash or other property. This is often appreciated property, meaning property whose fair market value at the time of the transfer is greater than the basis that the donor has in the property. The donor is not required to recognize gain (and thus is not hit with income taxes) when she transfers appreciated property to the CRAT.[3] Moreover, she might be able to claim a charitable tax deduction for part of the property's value.[4]

The CRAT gets the same basis in the appreciated property as the donor previously had, which is called "carryover basis." The CRAT generally does not acquire a "stepped-up" basis in the property, meaning an increased basis equal to the FMV of the property at the time of the transfer.[5] That only occurs when the donor pays gift taxes when transferring property to the CRAT.

The CRAT sells the appreciated property and invests the sales proceeds. One option is to buy a financial instrument that will yield a steady stream of payments, such as a single-payment insurance annuity (SPIA). Its status as a tax-exempt entity means that selling the property does not cause an income tax liability for the CRAT.[6]

---

[1] Hale E. Sheppard, "Holy CRAT! Options for Taxpayers After Early Court Losses," *Tax Notes Federal*, May 29, 2023, p. 1489.

[2] This overview of CRATs derives from section 664; reg. section 1.664-1; reg. section 1.664-2; and John L. Peschel and Edward D. Spurgeon, *Federal Taxation of Trusts, Grantors, and Beneficiaries*, at 11-7 to 11-19 (1989).

[3] *Buehner v. Commissioner*, 65 T.C. 723 (1976).

[4] Section 664(e); reg. section 1.664-2(d). The tax deduction generally equals the FMV of the property donated, minus the present value of the annuity the CRAT later purchases. *See* reg. section 1.664-2(c); section 170(e).

[5] Section 1015.

[6] Section 664(c)(1); reg. section 1.664-1(a)(1)(i).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The CRAT then makes distributions to the donor (who essentially becomes both donor and beneficiary) for a specified period of up to 20 years.[7] The donor must pay income taxes when she receives such distributions, in accordance with specific ordering rules.[8] First, payments are considered "ordinary income" to the extent the CRAT had ordinary income for the year of the distribution and had accumulated ordinary income from earlier years. Second, after the ordinary income has been exhausted, payments are treated as "capital gains" from the sale of assets by the CRAT. Third, once the capital gains have been fully distributed, the payments become "other income." After all taxable amounts (that is, ordinary income, capital gains, and other income) have been depleted, the distributions are considered nontaxable returns of corpus.[9]

When the donor dies or the distribution period otherwise ends, the assets remaining in the CRAT pass to one or more qualified U.S. charities. Those assets must constitute at least 10 percent of the initial FMV of the property transferred to the CRAT.[10]

There are reporting requirements, of course.[11] A CRAT must issue to the donor an annual Schedule K-1, "Beneficiary's Share of Income, Deductions, Credits, etc.," describing the amount and character of all distributions.[12] A CRAT also must file with the IRS an annual Form 5227, "Split-Interest Trust Information Return." There, it reports its financial activities, discloses the amount and character of distributions, and attaches a copy of Schedule K-1.[13] The donor reports on annual Forms 1040 all distributions received from the CRAT.

Why would someone form a CRAT? Among the benefits for the donor are deferred payment of income taxes on appreciated property, a predictable income stream, a limited tax deduction, and the ability to support charitable endeavors.

III. IRS First Formalizes Its Position

Taxpayers started participating in the so-called Hoffman strategy involving CRATs in 2015.[14] Revenue agents conducting related audits began seeking guidance from the IRS National Office. In 2020, it issued a generic legal advice memorandum (GLAM) describing the relevant facts, issues, and positions of the IRS.[15]

The GLAM diligently plodded through the two relevant tax provisions. These consisted of section 664, containing rules for CRATs and similar trusts, and section 72, addressing taxation of annuities. The GLAM explained that the "threshold problem" with the Hoffman strategy was that the relevant trusts do not meet all the requirements to be considered CRATs under section 664. It further indicated that, even if the trusts did not suffer any shortcomings, the Hoffman strategy would still fail because it relies on a misreading of the CRAT rules and their interaction with section 72.

The GLAM noted that the organizers contended that the transfer by the donor to the alleged CRAT of appreciated assets, by itself, triggered a step-up basis. The GLAM rejected this notion, stating that "there is no technical basis for this assertion."[16]

The GLAM focused on the proper tax treatment of the sale of appreciated property, but it also warned about tax deductions for charitable donations. It emphasized that if a trust formed in accordance with the Hoffman strategy failed to qualify as a CRAT under section 664, either based on its terms or its operation, the donors would be unable to claim a partial charitable deduction under section 170.

The GLAM ended with various instructions for IRS personnel. First, the IRS should challenge the validity of the alleged CRAT based on both its

[7] Section 6664(d)(1)(A); reg. section 1.664-2(a)(5)(i).

[8] Section 664(b); section 664(c)(1); and *Alpha I LP v. United States*, 682 F.3d 1009 (Fed. Cir. 2012).

[9] Section 664(b); reg. section 1.664-1(d); reg. section 1.664-1(e); and *Miller v. Commissioner*, T.C. Memo. 2009-182.

[10] Section 664(d)(1)(C) and (D).

[11] Section 4947(a)(2); reg. section 1.664-1(a)(1)(ii).

[12] Section 6034(a).

[13] Section 6011; reg. section 53.6011-1(d).

[14] Complaint, *United States v. Eickhoff*, No. 2:22-cv-04027, Allegation 52 (W.D. Mo. Feb. 23, 2022).

[15] AM 2020-006. The memorandum limited itself to income tax questions; it expressly declined to discuss whether the CRAT at issue could be challenged as a threshold matter under sham trust principles, whether the situation involved a reportable transaction, or whether the CRAT should be exposed to excise taxes.

[16] *Id.* at 8, n.2.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

express terms and functioning. Second, if the IRS determines that a specific trust is not a CRAT, it should treat it as a taxable entity from the outset. This means that the sale by the trust of the appreciated property should immediately trigger taxable gain. Third, if the IRS concludes that a trust does not qualify as a CRAT, it also should disallow any tax deduction claimed by the donor for a charitable donation. Finally, if the trust meets the CRAT standards, the IRS should contend that the donor drastically understated her income each year by reporting on Form 1040 only the minor amount of income generated by the SPIA, while omitting other distributions from the CRAT.[17]

IV. An Ounce of Prevention

The IRS turned to the Department of Justice for assistance, with the hopes of stopping what it considered abusive behavior before it proliferated. The Department of Justice filed a complaint in early 2022, asking the district court to do two things: stop organizers from marketing the Hoffman strategy, and force them to relinquish all money they made from doing so.[18]

The Department of Justice claimed that taxpayers who started implementing the Hoffman strategy in 2015 had used at least 70 different CRATs to avoid reporting a total of $17 million in taxable income, and those actions deprived the IRS of more than $8 million in tax revenue.[19]

The Department of Justice described the main steps in the transaction as follows. The organizers promoted the Hoffman strategy through various channels, including advertisements in magazines, newspapers, online media, and websites. They formed a CRAT for each customer (that is, the donor), naming a business associate as trustee. The trustee instructed the donor to transfer appreciated property to the CRAT soon after it was established. The trustee then sold the property, taking the position that doing so did not trigger taxable income to either the CRAT or to the donor. That claim was based on the notion that the basis of the CRAT in the appreciated property was its FMV at that time (that is, a stepped-up basis), instead of the basis of the donor (that is, carryover basis).

After the CRAT sold the property, the trustee distributed 10 percent of the proceeds to an organization, characterizing this as a charitable donation worthy of a tax deduction for the donor. The trustee then used the remaining 90 percent to purchase an SPIA. Under the SPIA, the insurance company made annual payments to the donor, but issued the corresponding Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." to the CRAT. The organizers told donors that distributions from the CRAT should be considered untaxable returns of trust corpus, except for minor amounts of interest income. The accountants, who were hired by the organizers, prepared tax and information returns to effectuate those tax positions.[20]

V. Recent Tax Court Decisions

The Tax Court has issued two decisions since the IRS released the GLAM about abusive CRATs, as discussed below.

A. First Case

The first case, decided in September 2022, was *Furrer*.[21]

1. Key facts.

The taxpayers, husband and wife, were actively engaged in the farming business during the relevant years. After seeing an advertisement in an industry magazine for the Hoffman strategy, they formed a CRAT in 2015 (the first CRAT). They named themselves life beneficiaries, their son as trustee, and several charities as remaindermen. The taxpayers transferred many bushels of crops to the first CRAT, which it sold for about $470,000. The trustee distributed 10 percent of this amount to charities. He used the remaining sales proceeds to buy an SPIA. It made payments of around $85,000 to the taxpayers in 2015, 2016, and 2017.

[17] *Id.*

[18] *Eickhoff* complaint, *supra* note 14.

[19] *Id.*, allegations 2, 157, and 158.

[20] *Id.*, allegations 24 through 51.

[21] *Furrer v. Commissioner*, T.C. Memo. 2022-100.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The taxpayers formed another CRAT in 2016 (the second CRAT). As before, the taxpayers were life beneficiaries, their son played the role of trustee, and various charities served as remaindermen. The taxpayers again transferred bushels of crops grown on their farm to the second CRAT, which it soon sold for about $690,000. The trustee, following the earlier pattern, sent 10 percent to charities and used the remaining 90 percent to buy another SPIA. That financial instrument paid the taxpayers about $125,000 per year in 2016 and 2017.

The taxpayers reported on their Forms 1040 small amounts of interest income generated by the SPIAs. They omitted, however, the larger distributions from the CRATs on grounds that they constituted nontaxable returns of corpus.

The taxpayers filed a Form 709, "United States Gift Tax Return," for 2015, indicating that they contributed to the first CRAT crops with an FMV of about $469,000 and a cost basis of $0. Similarly, they filed a Form 709 for 2016 disclosing a contribution to the second CRAT with an FMV of nearly $667,000 and a cost basis of $0. It appears that the taxpayers did not pay any gift taxes.

The IRS began auditing the Forms 1040. Adhering to the earlier GLAM, the IRS determined that the distributions received from the CRATs were *not* nontaxable returns of corpus, but rather ordinary income. The IRS, therefore, significantly increased the income of the taxpayers in 2015, 2016, and 2017.

The taxpayers raised a new issue amid the audit. They claimed that they should be allowed tax deductions in 2015 and 2016 for noncash charitable contributions to the CRATs for the amounts destined for the charitable remaindermen. The taxpayers neither obtained an appraisal nor enclosed a Form 8283, "Noncash Charitable Contribution," with their Forms 1040, however. Despite those critical shortcomings, the revenue agent allowed the taxpayers charitable tax deductions roughly equal to 10 percent of the proceeds generated by the sale of the crops.

2. Court analysis.

The IRS issued a notice of deficiency, seeking additional income taxes and penalties. The taxpayers challenged the IRS by filing a petition with the Tax Court. After the initial pleadings were completed, the IRS modified its litigating position, filing an amended answer with the Tax Court to disallow the charitable tax deductions that the revenue agent previously accepted during the audit.

The IRS filed a motion for partial summary judgment before the case was called for trial. It asked the Tax Court to determine that the taxpayers were not entitled to charitable tax deductions and that all amounts they received from the SPIAs or CRATs should be considered ordinary income and taxed at the highest rates.[22]

a. First issue: charitable deductions.

The Tax Court acknowledged that taxpayers are entitled to a tax deduction for transfers to a CRAT up to the value of the charitable remainder interest. However, as a condition to getting those benefits, taxpayers must meet all applicable substantiation requirements. For property worth more than $5,000, taxpayers normally must obtain a "qualified appraisal," enclose a completed Form 8283 with their tax return, and retain all records proving the donation. The Tax Court held that the taxpayers deserved a tax deduction of $0 because they failed to meet all three obligations.[23]

The Tax Court went further and explained that, even if the taxpayers had complied with the substantiation duties, they still could not benefit from a charitable tax deduction. That is because they donated bushels of crops, which were "ordinary income property," not "long-term capital gain property," in their hands as active farmers. The relevant law provides that a deduction for contributing ordinary income property (including inventory) is limited to the donor's basis in the property. The taxpayers in *Furrer* had a basis of $0 in the donated bushels because they had already expensed the costs of growing the crops on their Forms 1040. Thus, the charitable tax deduction was also $0.[24]

b. Second issue: taxability of CRAT distributions.

The Tax Court reiterated that the taxpayers, upon filing their Forms 709 for 2015 and 2016, admitted that their basis in the donated crops was

[22] *Id.* at 4-5.

[23] *Id.* at 5-6.

[24] *Id.*

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

$0. It then described the rules governing basis calculations. The Tax Court explained that when a taxpayer transfers property by gift, the basis of the recipient in the gifted property will be the same as it was in the hands of the taxpayer, increased by any gift tax paid by the taxpayer. According to the Tax Court, those "basic tax principles have thus been established for a very long time."[25] The Tax Court concluded that the taxpayers did not pay any gift taxes when they transferred the crops to the first and second CRATs and that each CRAT acquired a basis of $0 — just as the taxpayers previously had.[26]

The Tax Court then turned to income tax matters. It explained that the first CRAT sold the crops for about $470,000, while the second CRAT pocketed around $690,000. Given the basis of $0, all the sales proceeds represented profit. Because the taxpayers were active farmers, the crops in their hands were inventory, a type of ordinary income property. Thus, the profit generated by selling the crops was ordinary income, as opposed to capital gain. The Tax Court explained that the specific ordering rules in section 664 dictate that the distribution to a life beneficiary is first treated as ordinary income. Such rules further state that all ordinary income must be distributed before any other items, including nontaxable corpus, can be released. Therefore, the full payments by the SPIAs or CRATs to the taxpayers should be taxed as ordinary income.[27]

The Tax Court's next task was dismantling the three arguments raised by the taxpayers. First, the taxpayers argued that the basis of the CRATs in the crops was their FMV at the time of the transfer; that is, the CRATs had a stepped-up basis instead of a carryover basis. In support of this position, the taxpayers suggested that they had sold, not gifted, the crops. The Tax Court rebuked the taxpayers, saying that such a notion "does not pass the straight-face test" for several reasons. Namely, the taxpayers originally filed Forms 709 with the IRS classifying the transfers as gifts, the CRATs had no assets other than the crops with which to purchase anything, and the taxpayers did not report the supposed sales of crops as farming income on their Forms 1040.[28]

Second, the taxpayers contended that section 664(c), titled "Taxation of Trusts," supposedly means that CRATs, as well as all their distributions to beneficiaries, should be free from income taxes. The Tax Court pointed out that the taxpayers "cite no legal authority to support their position, and there is none."[29] The Tax Court explained that section 664(c) expressly states that the CRAT itself is a tax-exempt entity, but section 664(b), which the taxpayers conveniently ignored, describes the taxability and character of distributions by a CRAT to a beneficiary. The Tax Court recalled that the first CRAT sold crops for about $470,000 and the second CRAT did so to the tune of $690,000, thereby generating ordinary income. Because the distributions to the taxpayers did not exceed these amounts, they should have been fully treated as ordinary income.[30]

Third, the taxpayers urged the Tax Court to rule that the distributions should be taxed under the special rules for annuities in section 72, not the principles applicable to CRATs in section 664. The Tax Court declined this invitation for a couple reasons. For starters, section 72 explicitly states that it only applies when rules are not "otherwise provided" in the relevant chapter of the code. Section 664, which is located in the same chapter, contains distinct rules for annuity distributions. Thus, section 664 would supersede section 72 to the extent the two provisions were applicable and cannot be reconciled.[31] That is not the case, though. The Tax Court indicated that section 72 does not govern because it allows an exclusion from income only to the extent that a taxpayer has an "investment in the contract," as this phrase is uniquely defined. Neither the taxpayers nor the CRATs had an "investment in" the SPIAs because they were purchased with sales proceeds from crops with a basis of $0.[32]

[25] *Id.* at 9.

[26] *Id.* at 9-10.

[27] *Id.* at 10.

[28] *Id.* at 11.

[29] *Id.*

[30] *Id.* at 11-12.

[31] *Id.* at 12.

[32] *Id.*

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

B. Second Case

The next case, *Gerhardt*, was decided in April 2023.[33]

1. Key facts.

The taxpayers in *Gerhardt* implemented the Hoffman strategy in 2015. They formed a CRAT, named themselves as beneficiaries, appointed a law firm as trustee, and identified several qualified charities as remaindermen. The taxpayers transferred appreciated real property to the CRAT. Soon thereafter, the trustee sold the property for close to its FMV and used approximately 90 percent of the sales proceeds to purchase an SPIA. The taxpayers were to receive a payment from the SPIA of about $312,000 per year for five years, starting in 2016.

The CRAT issued Forms 5227 to the taxpayers characterizing nearly the entire annual distribution as a nontaxable return of corpus, with a small amount shown as interest income. The CRAT also issued Schedules K-1 to the taxpayers reflecting the same.

The taxpayers, for their part, filed a Form 709 reporting the contribution of appreciated real property to the CRAT in 2015 as a gift. Also, they filed annual Forms 1040 declaring the interest income from the SPIA, while omitting the remaining distributions from the CRAT.

The IRS audited. It determined that the proceeds from selling the appreciated real property constituted ordinary income. Thus, all distributions by the CRAT to the taxpayers in 2015 and 2016 should be taxed as ordinary income under section 664. The IRS issued a notice of deficiency to that effect, which the taxpayers disputed by filing a petition with the Tax Court.

2. Court analysis.

The Tax Court, much like it did before in *Furrer*, described the rules concerning transfers of property to a CRAT, the basis in such property, the tax-exempt status of a CRAT, the taxability and character of distributions to the beneficiary, and more.[34]

The Tax Court then clarified the idea advanced by the taxpayers, which was that all taxable gains from the sale of appreciated property donated to a CRAT somehow "disappear" and become nontaxable corpus. The Tax Court was having none of that, declaring that "the gain-disappearing act the [taxpayers] attribute to the CRATs is worthy of a Penn and Teller magic show . . . but it finds no support in the [Internal Revenue Code], regulations, or caselaw."[35]

The Tax Court next turned to basis. It noted that the taxpayers argued that the CRAT's basis in the appreciated property was its FMV. However, the plain language of the relevant provision, section 1015, "flatly contradicts" that position.[36]

The Tax Court also examined the taxpayers' claim that the rules in section 72 governing annuities should apply. The problem, said the Tax Court, was that if it were to respect the formalities of the transactions at issue, the taxpayers never bought the SPIA in the first place. Instead, the CRAT purchased the SPIA and then directed how the annuity payments were to be made. The result is that any payments from the SPIA constitute amounts distributed by the CRAT, which would be governed by section 664, not the special annuity rules in section 72.[37]

Finally, the Tax Court upheld penalties against one set of taxpayers. It acknowledged that taxpayers might deserve penalty waiver when they reasonably rely in good faith on qualified, informed, and objective tax or legal professionals. Citing relevant case law, the Tax Court clarified that reliance by taxpayers is unreasonable when it is placed on insiders, promoters, or persons having inherent conflicts of interest of which they should have been aware. The Tax Court ultimately blessed the penalties proposed by the IRS because the taxpayers failed to show the qualifications of their advisers, the nature of their communications with them, or the quality and objectivity of the advice they rendered.[38]

---

[33] *Gerhardt v. Commissioner*, 160 T.C. No. 9 (Apr. 20, 2023). The facts are somewhat convoluted because the consolidated cases involve multiple people, CRATs, and transactions.

[34] *Id.* at 22-26.

[35] *Id.* at 26.

[36] *Id.* at 27.

[37] *Id.* at 27-28.

[38] *Id.* at 34-35.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

VI. There Is Such a Thing as Bad Publicity

The IRS, still critical of some uses of CRATs, included them in its Dirty Dozen list for 2023. It described the situation 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 [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 an [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.[39]

VII. IRS Warns of Listed Transaction Status

The IRS, following a traditional path, upped the ante in March 2024. It released regulations designed to label some CRATs listed transactions, with all that entails (proposed regulations).[40]

A. Comments From the Preamble

The preamble to the proposed regulations contains a segment called "tax avoidance transactions using a CRAT." It first describes what the IRS considers the appropriate tax treatment for CRATs receiving appreciated property, selling it, using most of the proceeds to purchase an SPIA, and then making periodic distributions to the donor. The positions in the proposed regulations are nothing new; they were previously raised in the GLAM, the two Tax Court cases analyzed above, and the Dirty Dozen announcement for 2023. The IRS flatly concluded that "the claimed application of sections 664 and 72 to the transactions is incorrect."

The proposed regulations then take things a step further, suggesting that some features of the relevant trusts might cause them not to meet all the eligibility requirements. In other words, the IRS maintains that some entities claiming to be CRATs are not, and that characterization changes everything. The proposed regulations begin by acknowledging that the IRS has previously supplied eight sample CRAT forms in revenue procedures. They further recognize that many of the supposed CRATs "generally resemble" one of the samples. The problem, argues the IRS, is that they often have one or more "significant modifications" that prove fatal.

The IRS offers several illustrations in the proposed regulations; this article does not cover them because, well, it would be too tedious for readers who are not enamored with discussions about sections, subsections, paragraphs, subparagraphs, clauses, and other aspects of the Internal Revenue Code. Suffice it to know that the proposed regulations conclude as follows:

> The significant modifications . . . deviate from the sample CRAT Revenue Procedures in ways that prevent the qualification of the trust as a valid CRAT under Section 664, regardless of the actual administration of the [supposed] CRAT. These modifications are made in these transactions in order to effectuate the structure [and] violate mandatory requirements of a valid CRAT.

---

[39] IR-2023-65 (IRS "Dirty Dozen" list).

[40] REG-108761-22 (Mar. 25, 2024); and Chandra Wallace, "Treasury and IRS Propose Naming CRATs as Listed Transactions," *Tax Notes Federal*, Apr. 1, 2024, p. 161.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

B. Explanation of the Provisions

With the obligatory background out of the way, the proposed regulations explain the rules that the IRS wants to implement. Importantly, they broadly define what the IRS will consider a "listed transaction," going beyond the so-called Hoffman strategy in various ways. The situation under fire by the IRS is comprised of the following five steps:

(1) The grantor creates a trust purporting to qualify as a CRAT under section 664.

(2) The grantor funds the trust with property that has an FMV exceeding its tax basis; that is, appreciated property.

(3) The trustee sells the contributed property.

(4) The trustee uses some or all the sale proceeds to buy an annuity.

(5) On her Form 1040, the beneficiary of the trust treats the amounts payable from the trust (that is, the distributions) as if they were, completely or partially, annuity payments subject to the special rules in section 72, instead of as ordinary income, capital gain, or other income in accordance with section 664(b).

C. 'Substantially Similar' Transactions

The proposed regulations clarify that they might encompass situations that do not strictly meet the five steps described above. Indeed, they state that the rules and duties cover any transaction "that is the same as, or substantially similar to" the relevant CRAT transaction.

That phrase generally means any transaction, which is expected to obtain the same or similar tax consequences as a reportable transaction, and which is either factually similar or based on a similar tax strategy.[41] Taxpayers must broadly construe the concept of "substantially similar" in favor of making disclosures to the IRS. The regulations state that a transaction may be substantially similar to a reportable transaction even though it involves different entities or different tax provisions. The regulations contain several examples demonstrating just how liberally the IRS interprets the notion of substantially similar.[42] The IRS has also issued much guidance over the years concluding that specific transactions are substantially similar to one reportable transaction or another.[43] The courts, likewise, have expansively interpreted the concept of substantially similar.[44]

VIII. Effects of Listed Transaction Status

Some readers, particularly those not heavily involved in tax controversy matters, might wonder whether classification as a "listed transaction" or something "substantially similar" is a big deal. The short answer is, yes. Details follow.

A. Participants

Taxpayers participating in reportable transactions, including a listed transaction like the one featured in the proposed regulations, generally must file Forms 8886, "Reportable Transaction Disclosure Statements," with the IRS in two ways.[45] They must enclose Forms 8886 with their tax returns for every year of participation and send copies for the first year to the Office of Tax Shelter Analysis.[46]

Participants also must retain a copy of "all documents and other records" related to a transaction disclosed on Form 8886 that "are material to an understanding of the tax treatment or tax structure of the transaction."[47] Among the items that might need to be retained are (1) marketing materials, (2) written analyses used in decision-making, (3) correspondence and any agreements between the taxpayers and any adviser, lender, or other party to the transaction,

[41] Reg. section 301.6011-4(c)(4).

[42] Reg. section 301.6011-4(c)(4), Examples.

[43] *See, e.g.*, LTR 201017076, FSA 200218014, ILM 200712044, and ILM 200929005.

[44] *See, e.g.*, *Polowniak v. Commissioner*, T.C. Memo. 2016-31; *Blak Investments v. Commissioner*, 133 T.C. 431 (2009); and *Our Country Home Enterprises Inc. v. Commissioner*, 145 T.C. 1 (2015).

[45] REG-108761-22, Explanation of Provisions, Section V(B) (stating that an organization under section 170(c) whose only role in the transaction is serving as a charitable remainderman will not be considered a "participant").

[46] Reg. section 1.6011-4(d) and (e).

[47] Reg. section 1.6011-4(g)(1).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(4) documents discussing, referencing, or demonstrating the purported tax benefits, and (5) documents referencing the business purposes for the transaction.

The concept of "participation" varies, but it generally means that a taxpayer's tax return "reflects the tax consequences or a tax strategy" described in the relevant IRS guidance, such as the proposed regulations.[48]

Noncompliance by participants triggers various sanctions. For example, if they fail to timely file or complete Forms 8886, the IRS can assert a penalty equal to 75 percent of the tax savings resulting from their participation.[49] For a listed transaction like the one identified in the proposed regulations, the maximum penalty for individual taxpayers is $100,000, while the cap for entities is $200,000.[50] No "reasonable cause" exception to the penalty exists.[51]

The IRS can inflict pain in other ways, too. If a taxpayer participates in a reportable transaction, and the IRS later disallows the benefits claimed, the IRS can impose a special penalty under section 6662A equal to 20 percent of the tax increase.[52] The rate increases to 30 percent if the participant fails to file a Form 8886.[53]

Time can also be a problem for participants. When a participant does not enclose a Form 8886 with a tax return, the assessment period for the entire tax return can remain open for a long time. Specifically, it extends until one year after either the participant eventually files Form 8886 or the material adviser remits the relevant records to the IRS, whichever occurs earlier.[54] During the prolonged period, the IRS has authority to assess any taxes, penalties and interest, regardless of whether they are directly related to the undisclosed listed transaction.[55]

B. Material Advisers

Classifying a transaction as "listed" has significance for material advisers, too.

The IRS defines "material adviser" broadly. It ordinarily means a person who provides material aid, assistance, or advice regarding organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and that person derives some amount of gross income from doing so.[56] Persons have "material" involvement in this context if they (1) make or provide a "tax statement," (2) directly to, or for the benefit of, taxpayers or other material advisers, (3) before the first tax return reflecting the benefits of the transaction has been filed with the IRS, and (4) derive a specific amount of income from doing so.[57] A tax statement means *any* statement, oral or written, that relates to any tax aspect of a transaction that causes it to be reportable to the IRS.[58]

Material advisers normally must submit Forms 8918, "Material Advisor Disclosure Statement," to the Office of Tax Shelter Analysis soon after they achieve this status.[59] The IRS asserts penalties when violations occur, of course. When it comes to cases involving list transactions — think CRAT transactions described in the proposed regulations — the sanction for unfiled Forms 8918 is $200,000 or 50 percent of the gross income derived by the material adviser, whichever amount is higher.[60]

Material advisers also must maintain a list of information about their clients, the transactions in which they participated, the amounts they invested, the tax benefits they derived, etc.[61] They must safeguard those lists for seven years and

[48] Reg. section 1.6011-4(c)(3)(i)(A); and REG-108761-22, Explanation of Provisions, Section II.

[49] Section 6707A(a), (b); and reg. section 301.6707A-1(a).

[50] Section 6707A(b)(2); and reg. section 301.6707A-1(a).

[51] Section 6707A(d)(1); *Barzillai v. United States*, 137 Fed Cl. 788, 121 AFTR 2d 2018-1582 (Apr. 30, 2018); and *Larson v. United States*, 888 F.3d 578, 121 AFTR 2d 2018-1598 (Apr. 25, 2018).

[52] Section 6662A(a); REG-108761-22, Explanation of Provisions, Section IV.

[53] Section 6662A(c).

[54] Section 6501(c)(10); and REG-108761-22, Explanation of Provisions, Section IV.

[55] Reg. section 301.6501(c)-1(g)(7); *See also* reg. section 301.6501(c)-1(g)(8), Example 14.

[56] Reg. section 301.6111-3(b)(1).

[57] Section 6111(b)(1)(A); and reg. section 301.6111-3(b)(2)(i).

[58] Reg. section 301.6111-3(b)(2)(ii)(A).

[59] Section 6111(a); reg. section 301.6111-3(a); reg. section 301.6111-3(d)(1); reg. section 301.6111-3(g); reg. section 301.6111-3(e).

[60] Section 6707(b)(2).

[61] Section 6112; reg. section 301.6112-1; and REG-108761-22, Explanation of Provisions, Section IV.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

provide them to the IRS upon written request.[62] If they fail to supply the list within 20 days of a written request, the IRS ordinarily can assert a penalty of $10,000 per day.[63]

C. Return Preparers

The IRS might also pursue penalties against accountants, enrolled agents, or other persons serving as return preparers.[64] The proposed regulations do not mince words here, expressly warning that the IRS might impose sanctions against others involved with the relevant CRAT transactions, including "the penalty under Section 6694 for understatements of a taxpayer's liability by a tax return preparer."[65]

The IRS generally can penalize a return preparer under section 6694 when all the following factors are met: (1) the preparer prepared a tax return or refund claim (2) that contains a position that results in an understatement of the taxpayer's liability, (3) the preparer knew or reasonably should have known about the position, (4) the position relates to a reportable transaction, including a listed transaction, and (5) it was not reasonable for the preparer to believe that the position would more likely than not be upheld if the IRS were to challenge it.[66] The penalty for violations equals the larger of $1,000 or 50 percent of the income that the preparer derived (or will derive) regarding the relevant tax return or refund claim.[67]

D. Promoters

The proposed regulations warn that, in appropriate circumstances, the IRS might initiate "promoter investigations" under section 6700 based on the theory that the CRAT transaction is not only a listed transaction, but also an "abusive tax shelter."[68] In cases involving false or fraudulent statements, the penalty equals 50 percent of the income that the promoter has already derived, or will derive, from the activity.[69] When situations involve gross valuation overstatements, the penalty is the lesser of $1,000 per activity or 100 percent of the income.[70]

E. Persons Aiding and Abetting

The proposed regulations emphasize that other civil penalties might apply, too[71] The IRS can sanction persons under section 6701 for aiding and abetting a tax understatement in some instances. Penalties apply when (1) a person assists in, procures, or advises on the preparation of any portion of a return, affidavit, claim, or other document; (2) that person knows (or has reason to know) that such portion will be used in connection with a material tax matter; and (3) that person knows that such portion will result in a tax understatement to the IRS.[72] The type of person on whom the IRS may impose this penalty is broad; it is not limited to traditional accountants, enrolled agents, and other return preparers.[73] The courts have confirmed that, like promoter penalties under section 6700, there is no time limit on when the IRS may assess the aiding and abetting penalty.[74]

IX. IRS Encourages Immediate Surrender

When a tax underpayment is attributable to one of several things, the IRS can assert accuracy-related penalties.[75] They ordinarily equal 20 percent of the underpayment amount.[76] An obscure mechanism allows taxpayers to eliminate the tax "underpayment" after filing the original tax return, such as a Form 1040, with the IRS. It is called the qualified amended return (QAR). In essence, if a taxpayer files a Form 1040 and later realizes that it showed a tax underpayment, she

---

[62] Section 6112(b)(1); and reg. section 301.6112-1(b), (d), and (e).

[63] Section 6708(a)(1); and reg. section 301.6708-1(a).

[64] REG-106228-22 (June 7, 2023), Explanation of Provisions, Section III.

[65] REG-108761-22, Explanation of Provisions, Section IV.

[66] Section 6694(a)(1); and section 6694(a)(2).

[67] Section 6694(a)(1). The IRS cannot assert a penalty if the preparer demonstrates that there was reasonable cause for the tax understatement and he acted in good faith. *See* section 6694(a)(3).

[68] REG-108761-22, Explanation of Provisions, Section IV.

[69] Section 6700(a) (flush language).

[70] *Id.*

[71] REG-108761-22, Explanation of Provisions, Section IV.

[72] Section 6701(a).

[73] *Nielsen v. United States*, 976 F.2d 951, 955 (5th Cir. 1992); and TAM 200243057.

[74] *Mullikin v. United States*, 952 F.2d 920, 928 (6th Cir. 1991); and *Lamb v. United States*, 977 F.2d 1296 (8th Cir. 1992).

[75] Section 6662(a).

[76] Section 6662.

For more Tax Notes® Federal content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

has a limited opportunity to submit a QAR to rectify the situation and avoid penalties.

The purpose of the original QAR rules was "to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties by filing a [QAR] before the IRS begins an investigation of the taxpayer or the promoter of a transaction in which the taxpayer participated."[77] The regulations, consistent with that philosophy, state that a Form 1040X, "Amended U.S. Individual Income Tax Return," will not be treated as a QAR, unless the taxpayer files it before:

- the date on which the IRS contacts the taxpayer concerning a civil examination or criminal investigation regarding her Form 1040;
- the date on which the IRS contacts "any person" concerning a promoter investigation under section 6700 for an activity regarding which the taxpayer claimed any tax benefit on her Form 1040 either directly or indirectly through an entity, plan, or arrangement;
- for items attributable to a passthrough entity (partnership, subchapter S corporation, etc.), the date on which the IRS first contacts the entity in connection with the civil examination of the relevant return, such as Form 1065, "U.S. Return of Partnership Income";
- the date on which the IRS serves a summons relating to the tax liability of a person, group, or class that includes the taxpayer regarding an activity for which she claimed any tax benefit on her Form 1040; and
- the date on which the IRS announces a settlement initiative related to the listed transaction, and the taxpayer participated in the transaction during a relevant year.[78]

The proposed regulations seem to encourage taxpayers who participated in the pertinent CRAT transactions to proactively resolve matters with the IRS by filing a QAR; that is, by voluntarily relinquishing tax benefits in exchange for potential penalty waiver. The proposed regulations are both negative and obtuse in their messaging, as seen below:

> Because the IRS will take the position that taxpayers are not entitled to the purported tax benefits of the listed transactions described in the Proposed Regulations, taxpayers who have filed tax returns taking the position that they were entitled to the purported tax benefits should consider filing amended returns or otherwise ensure that their transactions are disclosed properly.[79]

X. Conclusion

According to the IRS, some taxpayers have been engaging in abusive CRAT transactions for several years, at least since 2015. The proposed regulations state, predictably, that the IRS plans to deny all tax benefits claimed by taxpayers who engaged in such transactions. Moreover, after it complies with the notice and comment procedures, the IRS intends to finalize the regulations. Implementation likely will begin soon thereafter. This means that the IRS will gather significantly more data about participants and others, thanks to Forms 8886, Forms 8918, and related audits and investigations.

The proposed regulations urge taxpayers to essentially give up without any fight, file QARs, and voluntarily back out prior tax benefits. This option might appeal to a limited number of taxpayers who took ultra-aggressive positions, did not rely on tax and legal professionals regarding the transactions, violated the terms of a trust instrument or other key documents, or have zero risk tolerance. However, history indicates that many taxpayers (as well as those the IRS has threatened to attack as material advisers, return preparers, promoters, and the like) will choose to aggressively defend themselves. Those in the latter category would be wise to assemble a qualified team, analyze strategies, and take all appropriate actions soon, while the proposed regulations are merely that, proposed. ■

---

[77] T.D. 9186, Preamble, Background.

[78] Reg. section 1.6664-2(c)(3)(i)(A) through (E); *see also* reg. section 1.6664-2(c)(3)(ii) (explaining that an expanded set of criteria applies in situations involving transactions that were the same as, or substantially similar to, a listed transaction, and that were not revealed to the IRS on Form 8886).

[79] REG-108761-22, Explanation of Provisions, Section IV.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.