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Holy CRAT! Options for Taxpayers After Early Court Losses

by Hale E. Sheppard

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In this article, Sheppard explores the IRS's challenges to specific charitable remainder annuity trust transactions, he examines the outcomes in the first two Tax Court cases, and he explains remaining options for taxpayers.

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I. Introduction

The IRS appears to be on its way to stopping taxpayers from taking positions that it believes are improper regarding charitable remainder annuity trusts (CRATs). The IRS has prevailed in the first two Tax Court cases concerning these transactions, securing rulings that rejected all the taxpayers' arguments — and then some. Consequently, taxpayers with similar CRATs must soon make a critical decision. Should they hunker down and prepare to fight, or is proactively approaching the IRS a better option?

Making a good choice requires knowledge, which this article seeks to provide. It supplies an overview of tax issues concerning CRATs, explains various actions taken by the IRS and its brethren to halt what it deems abusive behavior, analyzes the relevant Tax Court decisions from 2022 and 2023, and examines several options remaining for taxpayers with imminent CRAT problems.

II. Overview of Tax Rules

This article is not a treatise on tax and estate planning, so a deep dive into all things CRAT is unnecessary. However, for readers to appreciate the significance of the recent Tax Court cases, some context is necessary.[1]

A CRAT is one type of charitable remainder trust.[2] A donor/beneficiary transfers cash or other property to an irrevocable trust. This often consists of appreciated property, meaning property whose fair market value at the time of the transfer is higher than the basis of the donor/beneficiary in that property. This occurs, for instance, when a taxpayer purchases property, holds it, allows its value to rise thanks to the passage of time and economic factors, and then considers his options. The taxpayer could sell the property directly, but this would trigger immediate gain on which he would have to pay income taxes. Another option, which is explored in this article, is to transfer the appreciated property to a CRAT.

The donor/beneficiary is not required to recognize gain (and thus is not hit with income taxes) when he transfers appreciated property to the CRAT.[3] Moreover, he might be able to claim a charitable tax deduction for part of the property's value.[4] The tax deduction generally equals the FMV of the property donated, minus the present value of the annuity the CRAT later purchases.[5]

The CRAT gets the same basis in the appreciated property as the donor/beneficiary previously had. This is called a carryover basis. The CRAT generally does not acquire a stepped-

[1]This overview of CRATs is based on the following sources: 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).

[2]Reg. section 1.664-1(a)(1)(iii)(a); reg. section 1.664-2.

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

[4]Section 664(e); reg. section 1.664-2(d).

[5]Reg. section 1.664-2(c); section 170(e) (describing limits to charitable deductions).

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up basis in the property, meaning an increased basis equal to the FMV of the property at the time of the transfer.[6] This occurs only in situations in which the donor/beneficiary pays gift taxes when transferring property to the CRAT, which is rare. Why is the concept of tax basis important? Among other things, it dictates whether, or to what extent, the subsequent sale of the property by the CRAT will trigger a gain that ultimately is taxable to the donor/beneficiary.

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 funds, such as a single-payment insurance annuity (SPIA). Thanks to its status as a tax-exempt entity, selling the property does not cause an income tax liability for the CRAT.[7]

The CRAT then makes distributions to the donor/beneficiary for a period of up to 20 years or throughout his lifetime.[8] The donor/beneficiary must pay income taxes when he receives those distributions, under specific rules.[9] Distributions by the CRAT over the years are taxed in the following order. First, payments are considered ordinary income to the extent the CRAT had ordinary income for the year of the distribution or accumulated 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 to the donor/beneficiary are considered nontaxable returns of the corpus.[10]

When the donor/beneficiary dies or the distribution period otherwise ends, the assets remaining in the CRAT pass to one or more qualified U.S. charitable organizations. Those assets must constitute at least 10 percent of the initial FMV of the property transferred to the CRAT.[11]

There are reporting requirements, of course.[12] A CRAT must issue to the donor/beneficiary an annual Schedule K-1, "Beneficiary's Share of Income, Deductions, Credits, etc.," describing the amount and character of all distributions.[13] A CRAT also needs to file an annual Form 5227, "Split-Interest Trust Information Return," with the IRS. Here, it (1) reports its financial activities, including sale of assets; (2) accounts for current and accumulated income; (3) claims deductions; (4) discloses the amount and character of distributions; and (5) attaches a copy of the Schedule K-1.[14] For his part, the donor/beneficiary reports on his annual Form 1040, "U.S. Individual Income Tax Return," all distributions received from the CRAT.

Why would someone form a CRAT? Among the benefits for the donor/beneficiary are deferring the payment of income taxes on appreciated property, creating a predictable income stream over a lifetime, obtaining a limited charitable tax deduction, and supporting altruistic endeavors.

III. Sequence of Events

With that important background out of the way, we turn to a chronology of major events.

A. Taxpayers Engaged in Transactions

Taxpayers began participating in the so-called Hoffman strategy involving CRATs in 2015. The organizers of that strategy implemented more than 70 CRAT transactions during the first six years, and they remained active in 2022 and perhaps later.[15]

B. Tax Court Battles Begin

It appears that the IRS identified the Hoffman strategy soon after taxpayers started employing it. Audits began, parties disagreed on proper tax

[6] Section 1015.

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

[8] Section 664(d)(1)(A); reg. section 1.664-2(a)(5)(i).

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

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

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

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

[13] Section 6034(a).

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

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

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treatment, and taxpayers filed several cases in the Tax Court beginning in 2019.[16]

C. IRS Issues Guidance to Personnel

Revenue agents conducting audits began seeking guidance from attorneys in the IRS National Office. In July 2020 the IRS issued a generic legal advice memorandum that described the relevant facts, issues, and positions of the IRS regarding CRATs.[17]

The memorandum described the marketing materials, focusing on the reasoning and authorities used by the organizers to support the Hoffman strategy. It then began its analysis, diligently plodding through the two relevant tax provisions: section 664, containing rules for CRATs and similar trusts; and section 72, addressing the taxation of annuities. The memorandum explained that the threshold problem with the Hoffman strategy was that the relevant trusts did 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 memorandum noted that the organizers argued that the transfer by the donor/beneficiary to the alleged CRAT of appreciated assets, by itself, triggered a step-up basis. It swiftly rejected this notion, saying that "there is no technical basis for this assertion."[18] The memorandum broadly concluded that "none of the authorities cited in the promotional materials support the claimed ultimate benefit of permanently avoiding taxation on the gain inherent in the appreciated property donated to the trust."[19]

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

The memorandum raised another potential problem for a donor/beneficiary who transferred crops. It explained that self-employment taxes are triggered by the receipt of gross income derived from a trade or business. The memorandum cautioned that income resulting from a farmer's transfer of crops to a trust that does not meet the definition of a CRAT would represent income to that farmer subject to self-employment taxes.

The memorandum culminated with the following recommendations for IRS personnel. First, in all situations involving the Hoffman strategy, the validity of the alleged CRAT should be challenged based on both its express terms and its functioning. Second, if the IRS determines that the trust in question is not a CRAT, then it should treat it as a taxable entity from the outset. This means that the CRAT's sale of the appreciated property should immediately trigger taxable gain. Third, if the IRS concludes that the trust does not qualify as a CRAT, it also should disallow any tax deduction claimed by the donor/beneficiary for a charitable donation. Fourth, in cases involving active farmers donating crops, the IRS should assert self-employment taxes. Finally, as an alternative position, the IRS should contend that, if the trust actually meets the standards to be a CRAT, the donor/beneficiary drastically understated his income each year by reporting on his Form 1040 only the minor amount of income generated by the SPIA, while omitting other taxable distributions from the CRAT.[20]

D. Injunction and Disgorgement Action

The IRS, as it often does when facing widespread transactions it believes are abusive, turned to the Department of Justice for assistance. It filed a complaint in February 2022 asking a federal district court to do two things: stop organizers from further marketing the Hoffman

[16] *See, e.g.*, *Furrer v. Commissioner*, No. 7633-19 (T.C. petition filed May 14, 1999); *Gerhardt v. Commissioner*, No. 11127-20 (T.C. petition filed July 21, 2020).

[17] 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.

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

[19] *Id.*

[20] *Id.* at 17, Recommendation.

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strategy, and force the organizers to relinquish the money made from doing so in the past.[21]

The Justice Department offered a long list of allegations, as it tends to do in these types of cases. It claimed that taxpayers began implementing the Hoffman strategy in 2015 and that at least 70 different CRATs were used to avoid reporting a total of $17 million in taxable income.[22]

The Justice Department described the main steps taken by organizers of the Hoffman strategy, noting that they promoted it through a variety of channels, including advertisements in magazines, newspapers, online media, and websites. The organizers formed a CRAT for each customer (that is, the donor/beneficiary), naming a business associate as trustee. The trustee instructed the customer 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 the customer. This claim was based on the notion, advanced by the organizers, 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 customer (that is, carryover basis). After the CRAT sold the property to an unrelated party, the trustee distributed 10 percent of the proceeds to a charitable organization, characterizing this as a charitable donation worthy of a tax deduction for the customer. The trustee then used the remaining 90 percent to purchase an SPIA from an insurance company. Under the SPIA, the insurance company made annual payments to the customer but issued the corresponding Form 1099-R, "Distributions From Pensions, Annuities, etc.," to the CRAT. The organizers told customers that distributions received from the CRAT should be considered untaxable returns of the trust corpus, except for minor amounts of interest income.[23]

The accountants hired by the organizers prepared tax and information returns to effectuate these tax positions. Grounded in the theory that CRATs are tax-exempt entities, the accountants did not report the income from the sale of appreciated property on Form 5227. They did not file a Form 1041 for the CRATs based on the same rationale. When it came to the customers, the accountants prepared Forms 1040, reporting only small quantities of interest income. They treated all other distributions from the CRATs as returns of the trust corpus.[24]

The Justice Department summarized its position as follows:

> In short, neither the CRATs nor their customers/beneficiaries report any taxable income from the sale of the CRAT property. [The organizers] falsely claim that any income that would ordinarily be realized by a customer from the sale of the property is eliminated or significantly reduced by disposing of the property through a CRAT organized under the Hoffman Strategy. [The organizers] know or have reason to know that these claims are false or fraudulent. In addition, [the organizers] were on notice that their claims are false because, among other reasons, the IRS informed them on several different occasions that these claims are contrary to the law.[25]

E. Tax Court Decisions

The Tax Court has rendered two decisions involving the Hoffman strategy.

1. First case.

The first case, decided in September 2022, was *Furrer*.[26]

a. Relevant facts, positions, and filings.

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 (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 approximately

[21] *Eickhoff* complaint, *supra* note 15.

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

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

[24] *Id.*

[25] *Id.*, Allegation 39.

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

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$470,000. The trustee distributed 10 percent of this amount to the charities. He used the remaining sales proceeds to buy an SPIA from Symetra Life Insurance Co. This financial instrument made payments of about $85,000 to the taxpayers in 2015, 2016, and 2017.

The taxpayers formed another CRAT in 2016 (Second CRAT). As before, the taxpayers were life beneficiaries, their son played the role of trustee, and various charities served as remaindermen. The taxpayers transferred bushels of corn and soybeans 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 the charities and used the balance to buy another SPIA from Symetra. It paid the taxpayers about $125,000 per year in 2016 and 2017.

On their Forms 1040, the taxpayers reported small amounts of interest income, consistent with the Forms 1099-R that Symetra issued to the First CRAT and Second CRAT. The taxpayers did not, however, include the larger distributions from the CRATs on the grounds that they constituted nontaxable returns of the corpus.

The taxpayers filed a Form 709, "United States Gift Tax Return," for 2015, indicating that they contributed crops with an FMV of about $469,000 and a cost basis of $0 to the First CRAT. Similarly, they filed a Form 709 for 2016, disclosing a contribution with an FMV of nearly $667,000 and a cost basis of $0 to the Second CRAT. The Tax Court made no mention of the taxpayers' paying any gift taxes.

The IRS began auditing Forms 1040. It determined, following the memorandum described earlier, that the distributions the taxpayers received from the First CRAT and Second CRAT were not nontaxable returns of corpus, but rather ordinary income. The IRS thus increased the farming income significantly for 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 First CRAT and Second CRAT 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, as required. Despite these 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.

b. Litigation commences.

The IRS ultimately issued a notice of deficiency, seeking additional income taxes and penalties. Interestingly, it was later forced to concede the penalties because the revenue agent failed to secure timely approval from his supervisor before asserting them. The IRS then modified its position, filing an amended answer with the Tax Court to disallow the charitable tax deductions the revenue agent had accepted during the audit.

Before the case was called to trial, the IRS filed a motion for partial summary judgment, asking the Tax Court to determine that the taxpayers were not entitled to charitable tax deductions and that all the amounts they received from the SPIAs or CRATs should be considered ordinary income, taxed at the highest rates.[27]

c. 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 court quickly held that the taxpayers deserved no tax deductions because they lacked the necessary appraisal, Form 8283, and other records.[28]

The court did not stop there, though. It explained that, even if the taxpayers had complied with the substantiation requirements, they still could not benefit from a charitable tax deduction. This 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 law provides that a

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

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

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deduction for contributing ordinary income property (including inventory) is limited to the donor's basis in that property. Therefore, if a taxpayer has a basis of $0 in donated property, then the deduction is also $0. The taxpayers had a basis of $0 in the donated bushels because they had already expensed the costs of growing the crops on their Forms 1040 for 2015 and 2016.[29]

d. Second issue: Taxability of CRAT distributions.

The Tax Court began by reiterating that the taxpayers, upon filing their Forms 709 for 2015 and 2016, admitted that their basis in the donated crops was $0. It then explained the rules governing basis calculations, which have formed part of the IRC since 1920. The court explained that when a taxpayer transfers property by gift, the recipient's basis 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. It added that the recipient gets a basis of FMV only in situations in which the basis of the taxpayer was greater than FMV when he made the gift. According to the court, "These basic tax principles have thus been established for a very long time."[30] The court concluded that the taxpayers did not pay any gift tax when they transferred the crops to the CRATs, each CRAT acquired a basis of $0 just as the taxpayers previously had, and the FMV of the crops is irrelevant in calculating the basis of the CRATs because the basis of the taxpayers in the crops (that is, $0) was lower, not greater, than their FMV.[31]

With the question of basis thus settled, the court turned to income tax matters. It explained that the First CRAT sold the crops for about $470,000, while the Second CRAT reaped around $690,000. Given the basis of $0, all the sales proceeds represented profit. Because the taxpayers are active farmers, the crops in their hands were inventory, a type of ordinary income property. Accordingly, the profit generated by selling the crops was ordinary income, as opposed to capital gain. The court explained that the specific ordering rules in section 664 indicate that the distribution to a life beneficiary is first treated as ordinary income to the extent of the CRAT's ordinary income. Those ordering rules further dictate 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 in 2015, 2016, and 2017 should be taxed as ordinary income.[32]

The Tax Court's next task was dismantling the three arguments raised by the taxpayers. First, they argued that the basis of the First CRAT and Second CRAT 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 sold, not gifted, the crops. The court rebuked the taxpayers, saying that this 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.[33]

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 exhibited little patience for this line of reasoning, underscoring that the taxpayers "cite no legal authority to support their position, and there is none."[34] The Tax Court pointed out that section 664(c) expressly states that the CRAT itself is a tax-exempt entity, but section 664(b), which the taxpayers conveniently ignored, explains 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. Since the distributions to the taxpayers did not exceed these

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

[30] *Id.* at 9.

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

[32] *Id.* at 10.

[33] *Id.* at 11. The Tax Court also rejected the argument that it should accept the basis figures on Forms 4797, "Sales of Business Property," prepared by the son as trustee, which were "utterly implausible."

[34] *Id.* at 11.

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amounts, they should have been fully treated as ordinary income.[35]

Third, the taxpayers urged the 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 court declined this invitation for a few reasons. For starters, section 72 explicitly states that it applies only in situations in which rules are not "otherwise provided" in the relevant chapter of the IRC. Section 664, which is located in the same chapter, contains distinct rules for annuity distributions. Thus, the court explained that section 664 supersedes section 72 to the extent the two provisions are applicable and cannot be reconciled.[36] This is not the case, though. The 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.[37]

2. Second case.

The next case, *Gerhardt*,[38] was actually four battles involving various family members consolidated into one.

a. Relevant facts, positions, and filings.

The facts are somewhat convoluted because the cases involve multiple people, CRATs, and transactions. Here is a general overview.

The taxpayers learned about the Hoffman strategy in 2015 and implemented it that same year. 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 after, the trustee sold the property for close to its FMV and used approximately 90 percent of the sales proceeds to purchase an SPIA from Symetra. The taxpayers were to receive a payment of about $312,000 per year for five years from the SPIA, 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. They also filed annual Forms 1040 declaring the interest income, while omitting the remaining distributions (the big ones) from the CRAT.

The IRS audited the taxpayers, of course. It determined that the sales proceeds that the CRAT received 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 this effect, which the taxpayers challenged by filing a petition with the Tax Court.

b. Judicial analysis.

The Tax Court, much like it did in *Furrer*, described the rules concerning transfers of property to a CRAT, the basis in that property, the tax-exempt status of a CRAT, the taxability and character of distributions to the beneficiary, and more.[39] It then summarized the stance of the taxpayers, which was contrary to the foundational rules. The court explained the taxpayers' contention that all taxable gains from the sale of appreciated property donated to a CRAT "disappear" and somehow become corpus that the CRAT can either invest or return to beneficiaries on a tax-free basis. It 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."[40]

The court then turned to basis. It noted that the taxpayers argued that the CRAT's basis in the appreciated property was its FMV. However, the court emphasized that the plain language of the

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

[36] *Id.* at 12.

[37] *Id.* at 12.

[38] *Gerhardt v. Commissioner*, 160 T.C. No. 9 (Apr. 20, 2023).

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

[40] *Id.* at 26.

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relevant provision, section 1015, "flatly contradicts" that position.[41]

Next, the court examined the claim that the rules in section 72 governing annuities should apply. The court said the problem is that the taxpayers did not buy any annuities from Symetra. 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 constituted amounts distributed by the CRAT, which would be governed by section 664, not the special annuity rules in section 72.[42]

Finally, the IRS upheld accuracy-related penalties against one set of taxpayers. The Tax Court acknowledged that taxpayers often deserve penalty waiver when they reasonably rely in good faith on qualified, informed, objective, tax or legal professionals. Citing relevant case law, the Tax Court clarified that reliance by taxpayers might be unreasonable when it is placed on insiders, promoters, or persons with inherent conflicts of interest of which they should have been aware. The court ultimately upheld the penalty because the taxpayers, who have the burden of presenting the evidence, failed to show the qualifications of the advisers, the nature of the communications with them, or the quality and objectivity of the advice they rendered.[43]

F. 'Dirty Dozen' Declaration

The IRS has included the abuse of CRATs in its "Dirty Dozen" list for 2023,[44] describing them 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 a [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.[45]

The IRS has also identified for the public what it considers illegal uses of CRATs. These include inflating the basis of property to its FMV when it is transferred to the CRAT to improperly minimize or eliminate income upon the future sale of the property. Another inappropriate use, according to the IRS, is mischaracterizing amounts from the CRAT as nontaxable returns of corpus, as opposed to taxable distributions of ordinary income or capital gain.[46]

The IRS has also warned taxpayers that they, not the persons encouraging their participation in improper CRAT transactions, are ultimately liable for the resulting tax liabilities, penalties, and interest charges. The IRS offered the following admonishment: "The IRS reminds taxpayers that they are legally responsible for what is on their tax return, not the practitioner or promoter who entices them to sign on to an abusive transaction."[47]

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[41] *Id.* at 27.

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

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

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

[45] *Id.*

[46] IRS, "Charitable Remainder Trusts."

[47] IRS, *supra* note 44.

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IV. Potential Solutions for Taxpayers

The IRS announced its positions regarding the Hoffman strategy in the generic legal advice memorandum, the Justice Department enhanced that stance when it launched the injunction and disgorgement action in district court, the Tax Court then provided vindication by ruling in favor of the IRS in *Furrer* and *Gerhardt*, abusive transactions involving CRATs appear in the "Dirty Dozen" list, and IRS enforcement is on the uptick thanks to expanded funding from Congress. Together, these items make it decision time for taxpayers who participated in the Hoffman strategy or its like. Following are some potential options.

A. Do-Nothing Approach

Some will stay the course. Taxpayers in this category are gambling that the IRS will not audit them, or they cling to the belief that the positions they took under the Hoffman strategy were correct, regardless of what the IRS, Justice Department, and Tax Court say. Taxpayers identified by the IRS can expect to face the following contentions, and perhaps others:

- The trust does not qualify as a CRAT under section 664 because of its initial terms and/or its subsequent operations. Consequently, the alleged donor/beneficiary cannot claim a tax deduction for any amounts destined for the charitable remaindermen; the sale of the appreciated property by the trust immediately triggers taxable gain; and in situations involving active farmers donating crops, self-employment taxes apply, too.
- If the trust meets the standards to be treated as a CRAT, then all distributions to the donor/beneficiary from the CRAT should be treated as taxable income under the ordering rules in section 664, and not as nontaxable returns of trust corpus.
- In addition to tax increases (resulting from the disallowance of charitable tax deductions, treatment of all distributions as taxable income, and application of self-employment taxes), penalties are warranted. Probable candidates are sanctions equal to 20 percent of the liability for negligence or a substantial understatement of tax, as well as those reaching 75 percent if the IRS can prove civil fraud.[48]
- The donor/beneficiary owes taxes and penalties, plus interest accrued on both.[49]
- The IRS normally has three years from the time a taxpayer files a tax return to identify it as problematic, conduct an audit, and issue a final notice proposing adjustments.[50] However, the IRS has plenty of time in these circumstances based on two theories. First, the IRS has six years instead of three because the donor/beneficiary had a "substantial omission of income." This means that the distributions from the CRAT that were improperly treated as nontaxable returns of corpus exceeded 25 percent of the gross income that the donor/beneficiary actually reported on his Forms 1040.[51] Alternatively, the IRS has no time restrictions whatsoever because the donor/beneficiary supposedly filed a false or fraudulent Form 1040 with the intent to evade tax.[52]

B. Proactive Approach

Following are several options for taxpayers who participated in the Hoffman strategy or something similar and are realistic about the probability of being audited by the IRS at some point.

1. Filing qualified amended returns.

In the case of an individual taxpayer, a tax underpayment generally means the difference between the tax liability reported on the Form 1040 and the tax liability that should have been reported if the taxpayer had correctly completed his Form 1040 in the first place.[53] For instance, if the taxpayer's true tax liability was $100,000 but he reported only $80,000 on his Form 1040, then the IRS ordinarily could assert a penalty of $4,000

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[48] Section 6662; section 6663.

[49] Section 6601(a); reg. section 301.6601-1(a); section 6621.

[50] Section 6501(a).

[51] Section 6501(e)(1)(A).

[52] Section 6501(c)(1); section 6663; *Meier v. Commissioner*, 91 T.C. 273 (1988); *Toushin v. Commissioner*, 223 F.3d 642 (7th Cir. 2000); *Bradford v. Commissioner*, 796 F.2d 303 (9th Cir. 1986).

[53] Section 6664(a); reg. section 1.6664-2(a). The definition of underpayment is considerably more complicated, but a simplified and abbreviated version suffices to make the critical points in this article.

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(that is, a $20,000 tax understatement multiplied by 20 percent).[54]

An obscure mechanism exists whereby taxpayers can eliminate a tax underpayment after filing the original Form 1040 with the IRS: the qualified amended return (QAR). In essence, an individual taxpayer who files a Form 1040 and later realizes that it showed a tax underpayment has a limited opportunity to submit a QAR to rectify the situation and avoid penalties. The taxpayer obtains the benefit in the following manner: The tax liability shown on the original Form 1040 is deemed to include the amount of additional tax reflected on the subsequent QAR.[55] Modifying the basic example above, if the taxpayer filed a Form 1040 showing a tax liability of $80,000 but later submitted a QAR indicating a revised liability of $100,000, then no underpayment would exist, and the IRS would thus have no grounds for asserting an accuracy-related penalty.

The purpose of the QAR rules is "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."[56]

One of the biggest challenges for taxpayers, of course, is convincing the IRS and the courts that their Form 1040X, "Amended U.S. Individual Income Tax Return," constitutes a QAR.[57] The IRS has modified the standards over time because it believed earlier versions of the rules might "encourage taxpayers to delay filing [QARs] until after the IRS has taken steps to identify taxpayers as participants in potentially abusive transactions."[58] In other words, the IRS wanted to "discourage the wait-and-see approach of some taxpayers."[59]

A Form 1040X will *not* be a QAR, unless the taxpayer files it before the following[60]:

- The date on which the IRS contacts the taxpayer about a civil examination or criminal investigation of the relevant Form 1040.[61]
- The date on which the IRS contacts "any person" concerning a tax shelter promoter investigation under section 6700 for an activity for which the taxpayer claimed a tax benefit on Form 1040, directly or indirectly through an entity, plan, or arrangement.[62]
- For items attributable to a passthrough entity (for example, partnership, subchapter S corporation, trust), the date on which the IRS first contacts the passthrough entity in connection with the civil examination of its return.[63]
- The date on which the IRS serves a summons concerning the tax liability of a person, group, or class that includes the taxpayer for an activity for which the taxpayer claimed a tax benefit on Form 1040, directly or indirectly.[64]
- The date on which the IRS announces a settlement initiative to compromise or waive penalties for a listed transaction, and the taxpayer participated in that transaction during the relevant year.[65]

Taxpayers often face challenges in convincing the courts that what they filed with the IRS constitutes a QAR. Here are just a few of the many examples. In *Perrah*,[66] the Tax Court rejected QAR status because the Forms 1040X were filed with the IRS service center after the IRS had begun an

[54] Section 6664(c)(1).

[55] Reg. section 1.6664-2(c)(2).

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

[57] To follow the evolution of the QAR criteria, see T.D. 8381; Notice 2004-38, 2004-21 IRB 1; T.D. 9186; and T.D. 9309.

[58] T.D. 9186, Preamble, Explanation of Provisions, Background.

[59] *Id.*

[60] Reg. section 1.6664-2(c)(3)(i). The ability to eliminate an underpayment by filing a QAR disappears when the position taken on the Form 1040 triggering the underpayment was fraudulent in the first place. *See* reg. section 1.6664-2(c)(2).

[61] Reg. section 1.6664-2(c)(3)(i)(A).

[62] Reg. section 1.6664-2(c)(3)(i)(B).

[63] Reg. section 1.6664-2(c)(3)(i)(C); the term "passthrough entity" is defined by cross-reference in reg. section 1.6662-4(f)(5).

[64] Reg. section 1.6664-2(c)(3)(i)(D)(1).

[65] Reg. section 1.6664-2(c)(3)(i)(E). An expanded set of criteria applies in situations involving undisclosed listed transactions. *See* reg. section 1.6664-2(c)(3)(ii).

[66] *Perrah v. Commissioner*, T.C. Memo. 2002-283.

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examination of the taxpayer. Likewise, in *Wilkerson*,[67] the Tax Court refused to classify Forms 1040X as QARs when the taxpayer filed them with the Appeals office after the IRS issued a notice of deficiency and after the taxpayer filed a petition with the Tax Court. Finally, in *Bergmann*,[68] the Tax Court held that the taxpayer had not filed QARs because, by the time the Forms 1040X reached the IRS, it had already started a promoter investigation and issued summonses for the pertinent transactions and years.

Taxpayers began litigating CRAT cases in the Tax Court in 2019, the IRS issued the generic legal advice memorandum in 2020, and the Justice Department launched an injunction in 2022. It thus stands to reason that many taxpayers participating in the Hoffman strategy have already been audited, their CRATs have fallen under similar scrutiny, the IRS has initiated promoter investigations, or the IRS has issued pertinent summonses. If that supposition is accurate, then taxpayers would be ineligible to file QARs to reverse the earlier tax benefits and avoid penalties. However, some taxpayers might still be able to employ this resolution method, depending on their particular situations.

[67] *Wilkerson v. Commissioner*, T.C. Summ. Op. 2004-99.

[68] *Bergmann v. Commissioner*, 137 T.C. 136 (2011). There are several other cases in which the courts declined to grant taxpayers the benefit of QAR status. *See, e.g., Perry v. Commissioner*, T.C. Memo. 2016-172 (taxpayer filed relevant Form 1040X after the IRS notified her of an examination); *Planty v. Commissioner*, T.C. Memo. 2017-240 (taxpayer filed Form 1040X after start of examination); *Scully v. Commissioner*, T.C. Memo. 2013-229 (taxpayer filed Forms 1040X and otherwise changed tax positions during the trial); *Sampson v. Commissioner*, T.C. Memo. 2013-212 (taxpayer filed relevant Forms 1040X after the IRS notified him of an examination).

2. Participate in the voluntary disclosure practice.

Another possibility for taxpayers is to settle matters with the IRS through what has been called the updated voluntary disclosure practice (UVDP).[69]

The initiative is remarkably inclusive. Indeed, in terms of what types of taxpayers can participate, Form 14457, "Voluntary Disclosure Practice Preclearance Request and Application," instructs taxpayers to check the proper box indicating individual, partnership, corporation, trust, or executor of estate.[70] The instructions to Form 14457 expand on this notion, stating that the UVDP "is available to individuals (U.S. Citizens, Green Card Holders, Non-Resident Aliens, Expatriates, etc.) and business entities (Corporations, Partnerships, LLCs, Trusts, Estates)."[71] Form 14457 goes on to confirm that the UVDP encompasses all types of matters, dividing them into the following categories: domestic, offshore, estate and gift taxes, employment taxes, virtual currency, and the catchall, "other issues."[72]

Cases addressed through the UVDP normally cover the most recent six closed tax years. There are exceptions to this general rule, though. If the IRS and taxpayer cannot resolve a case by mutual agreement, for instance, the revenue agent "has discretion to expand the scope to include the full duration of the non-compliance and may assert maximum penalties under the law with the approval of management."[73]

In terms of sanctions, the IRS generally will assert a civil fraud penalty, equal to 75 percent of

[69] The author has published a series of articles about the UVDP. *See* Hale E. Sheppard, "Involuntary Disclosure by the IRS About Voluntary Disclosure Program for Taxpayers: Analyzing Four Rounds of Guidance," 48(5) *Int'l Tax J.* 29 (2022); Sheppard, "IRS Announces Newest Version of Its Comprehensive Voluntary Disclosure Program: Analyzing the Evolution During the First Five Years," 48(3) *Int'l Tax J.* 13 (2022); Sheppard, "IRS Issues New Form 14457 and Instructions Regarding Its Comprehensive Domestic and International Voluntary Disclosure Program: Analyzing Key Aspects," 46(4) *Int'l Tax J.* 41 (2020); Sheppard, "IRS Amnesty Covers More Than Foreign Accounts: Analyzing the Updated Voluntary Disclosure Practice, New International Tax Withholding Procedure, and Guidelines for Late Returns by Foreign Corporations," 97(6) *Taxes* 19 (2019), *republished in* 45(3) *Int'l Tax J.* ___ (2019).

[70] Form 14457, at 1.

[71] Form 14457 Instructions, at 6.

[72] Form 14457, at 1.

[73] IRS Memorandum LB&I-09-1118-014 (Nov. 20, 2018).

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the tax liability, to the one year during the disclosure period with the highest tax liability.[74] In limited circumstances, however, revenue agents may apply the civil fraud penalty to more than one year, up to all six years, "based on the facts and circumstances of the case."[75] The example provided by the IRS is a situation in which a taxpayer and revenue agent cannot agree on the tax liability as part of the UVDP process.[76]

Critically, the UVDP is designed exclusively for taxpayers who engaged in willful, fraudulent, or criminal behavior. The following excerpts show the IRS's clarity on that score:

> The objective of the voluntary disclosure practice is to provide taxpayers concerned that their conduct is willful or fraudulent, and that may rise to the level of tax and tax-related criminal acts, with a means to come into compliance with the law and potentially avoid criminal prosecution.[77]

> You should consider applying for the [UVDP] if you engaged in willful non-compliance that exposes you to criminal liability for tax and tax-related crimes, you meet the eligibility requirements (discussed next), and you wish to come into tax compliance and avoid potential criminal prosecution.[78]

The taxpayers who implemented the Hoffman strategy reviewed marketing materials featuring assurances about its legitimacy, relied on advice from attorneys and accountants, and filed tax and information returns with the IRS consistent with those materials and advice, perhaps in good faith. Under these circumstances, it is improbable that taxpayers would conclude that they had the type of behavior (that is, willful, fraudulent, or criminal) for which the UVDP is designed.

3. Make a quiet disclosure.

The IRS warned taxpayers when it began introducing several voluntary disclosure programs back in 2009 not to circumvent those programs by making a so-called quiet disclosure. This essentially means taxpayers attempt to resolve issues with the IRS by filing Forms 1040X and/or information returns, without officially participating in a recognized disclosure program, with hopes that the IRS will process the documents in the regular course, not start an audit, and not impose penalties. The IRS repeatedly announced that it planned to identify and harshly sanction attempted quiet disclosures.[79]

With the introduction of its comprehensive UVDP in 2018, the IRS changed course. The IRS told taxpayers that making a quiet disclosure is acceptable, as long as there is no risk of criminality.[80] The IRS said that taxpayers "who did not commit any tax or tax-related crimes" can correct their past violations "by filing an amended or past due tax return."[81] Tax professionals were suspicious about this drastic reversal by the IRS, so they asked pointed questions of a high-ranking IRS official during a tax conference. He confirmed that the IRS changed its earlier position.[82]

Taxpayers who implemented the Hoffman strategy, who do not meet the eligibility criteria to file QARs, and who reject the notion that their actions constituted willful, fraudulent, or criminal behavior that must be rectified through the UVDP, might contemplate a quiet disclosure. One would expect challenges from the IRS once the audit begins, however, with a focus on whether

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] Form 14457 Instructions, at 6.

[79] *See, e.g.*, Robert B. Stack and Douglas M. Andres, "Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax," *Tax Notes*, Jan. 30, 2012, p. 561 (saying that the taxpayer "is worried that requesting retroactive treaty relief through the letter ruling process could be deemed a quiet filing, [and] decides to enter the OVDI"); Robert Goulder, "Quiet Disclosures Get No Love From IRS," *Tax Notes*, May 17, 2010, p. 756; Marie Sapirie, "Charges Against Banker Raise Quiet Disclosure Questions," *Tax Notes*, May 23, 2011, p. 787; U.S. Government Accountability Office, "IRS May Be Missing Many Quiet Offshore Disclosures, GAO Finds," GAO-13-318 (2013) (explaining that IRS intends to identify and penalize quiet disclosures).

[80] IRS Memorandum LB&I-09-1118-014.

[81] *Id.*

[82] Andrew Velarde, "Noncooperation in Voluntary Disclosure Won't Blindside Taxpayer," *Tax Notes*, Mar. 18, 2019, p. 1410 (comments by director of withholding and international individual compliance, IRS Large Business and International Division); *see also* Nathan J. Richman, "Revisions to IRS Voluntary Disclosure Program Underway," *Tax Notes Federal*, Nov. 1, 2021, p. 714 (Daniel N. Price of the IRS Office of Chief Counsel said at the UCLA Tax Controversy Institute that taxpayers "should use another avenue to return to compliance" unless they are concerned about criminal charges, civil fraud penalties, or willful foreign bank account report penalties).

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the taxpayers had reasonable cause for their positions. The IRS, leaning on one of the most famous cases in this area, likely will claim that any reliance by the taxpayers on individuals associated with, or paid by, those organizing the Hoffman strategy should be discredited. The IRS often argues in similar situations that any purported reliance is not reasonable when the person offering advice or guidance does not possess sufficient expertise, has an inherent conflict of interest, is an insider or promoter, or lacks financial independence.[83]

V. Conclusion

Could the taxpayers in *Gerhardt* appeal and obtain a contrary, favorable result? Could another taxpayer file suit on the same CRAT issues in the Court of Federal Claims or federal district court instead of the Tax Court and procure a better outcome? Could the IRS lack the resources necessary to audit all taxpayers involved with the Hoffman strategy? Could the IRS decide to introduce an initiative, offering reasonable settlement terms, to avoid the effort required to litigate against each taxpayer individually?

Questions abound, but there are two certainties. First, the IRS has identified the transactions, announced its tax and legal positions, and convinced the Tax Court twice that it is correct. Second, taxpayers who benefited from the Hoffman strategy or something similar find themselves at crunch time. Do they hold their ground and prepare for battle with the IRS? Alternatively, do they quickly explore their options for preemptively resolving matters with the IRS on the best terms possible? Taxpayers will need specialized tax defense counsel either way. ■

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[83] *Neonatology Associates P.A. v. Commissioner*, 115 T.C. 43, at 88-94 (2000).

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