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CRAT Tax Scheme on Appreciated Property Sales Brings Big Losses

By Richard L. Fox[*]

A tax elimination "strategy" widely promoting the use of a charitable remainder annuity trust (CRAT) to fully escape federal income tax on the sale of appreciated property and to fund tax-free annuity payments to noncharitable beneficiaries of the CRAT has not lived up to the promises of its promoters, and instead has brought heavy legal and monetary loss to involved parties. Indeed, courts have leveled decisions against participating taxpayers and ordered that their names be disclosed to the IRS, and the Justice Department has shut down and penalized the promoters. According to the government, at least 70 CRATs have been used in this scheme, resulting in an estimated $40 million of taxable income going unreported and at least $8 million in tax revenue being lost. The IRS has these abusive arrangements on its radar screen and is conducting audits. Taxpayers should avoid the scheme at all costs.

How the Scheme 'Works'

The CRAT tax elimination strategy (hereinafter, the "CRAT Tax Scheme") was founded and widely promoted to the public by John Eickhoff, a "certified senior advisor" with Hoffman Associates, LLC, and a licensed insurance agent. The CRAT Tax Scheme was held out as a tax strategy whereby highly appreciated property could be transferred to a CRAT and then sold by the trustee in a manner that would wholly eliminate the imposition of federal income tax, not only with respect to the gain realized on the sale of the property by the CRAT but also on the subsequent annuity payments funded with the sale proceeds.

The CRAT Tax Scheme was promoted to the public through a variety of channels, including advertisements in newspapers, online media, and the Hoffman Associates website. The steps generally involved the following:

- Convincing taxpayers to contribute property to a CRAT usually consisting of appreciated property having a fair market value substantially greater than its tax cost basis;
- Stepping-up the tax cost basis of the appreciated property contributed to the CRAT to its fair market value;
- The CRAT promptly selling the appreciated property and then using most of the sale proceeds to purchase an annuity contract under which annuity payments were made directly to the taxpayer who contributed the property to the CRAT; and
- Reporting to the IRS that the annuity payments funded by the sale proceeds were tax-free distributions of principal.

Tax Court Rejects Scheme

In *Gerhardt v. Commissioner*, 160 T.C. No. 9 (Apr. 20, 2023), the taxpayers, collectively referred to by the court as the "Gerhardts," learned about using CRATs as a "wealth-preservation strategy" from Eickhoff in 2015. Eickhoff referred the Gerhardts to Aric Schreiner of Columbia CPA Group, LLC, for tax advice. Schreiner presented the Gerhardts with the CRAT Tax Scheme purporting to wholly eliminate federal income tax in connection with a proposed sale of "high-value, low-basis real property." Soon after the presentation, the Gerhardts formed a number of CRATs with Schreiner's involvement.

Pursuant to the CRAT Tax Scheme, the Gerhardts contributed substantially appreciated real property to

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newly established CRATs, under which the Gerhardts were to receive annuity payments over a five-year period. The appreciated real property was then promptly sold by the CRATs' trustee, who used most of the sale proceeds to purchase single-premium immediate annuity contracts from the Symetra Life Insurance Co., under which the Gerhardts were designated as the recipients of the annuity payments. Symetra, therefore, directly paid the Gerhardts the annual annuity amount required under the terms of the CRATs.

Notwithstanding that the sale proceeds realized on the sale of the real property by the CRATs substantially exceeded its tax cost basis, the Form 5227, *Split-Interest Trust Information Return*, filed by the CRATs reported no taxable gain from the sale of the real property. Moreover, consistent with the tax treatment taken on the Form 5227, the Schedules K-1 (Form 1041) issued to the Gerhardts for the tax years at issue did not reflect that the annuity payments carried out any taxable gain attributable to the sale of the property. Therefore, the position taken by the Gerhardts for federal income tax purposes, as promoted by the CRAT Tax Scheme, was that both the sale of the appreciated real property and the subsequent annuity payments funded by the sale proceeds were wholly free of federal income tax.

The Tax Court applied a rather straightforward analysis in rejecting the position taken by the Gerhardts. First, the court recognized that a CRAT is statutorily exempt from income tax under Internal Revenue Code §664(c)(1), such that while a taxable gain must be recognized on the sale of appreciated property, the CRAT itself is not subject to tax on such a gain. Then the court recognized that notwithstanding the exemption from income tax otherwise accorded a CRAT, under §664(b), the annuity payments made to its noncharitable beneficiaries ''carry out [CRAT] taxable income that is subject to tax at the beneficiary level.'' Therefore, based on the statutory provisions under §664, the court concluded that the annuity payments to the Gerhardts necessarily carried out taxable income required to be recognized by the CRAT upon the sale of the contributed real property, upon which federal income tax should have been paid by the Gerhardts.

In support of its conclusion, the court reviewed some of the basic principles applicable to CRATs and their beneficiaries, citing in large part the treatise written by yours truly, including the following:

> A CRAT is a type of a charitable remainder trust. I.R.C. §664. ''[A] staple among estate planners,'' a charitable remainder trust is often a vehicle used by ''individuals with substantial appreciated capital gain property, a charitable intent, and a need for a stream of income during their lifetimes.'' Richard Fox, *Charitable Giving: Taxation, Planning, and Strategies* ¶25.01 (2023), Westlaw WGL-CHARGIV (footnotes omitted).
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> ''The basic concept of a [CRAT] involves a [grantor's] transfer of property to an irrevocable trust, the terms of which provide for the payment of a specified amount, at least annually, to the grantor or other designated noncharitable beneficiaries for life or another predetermined period of time up to twenty years.'' Id. (footnotes omitted); *see also* I.R.C. §664(d). What remains in the trust after the expiration of that period (which cannot be less than ''10 percent of the initial net fair market value of all property placed in the trust,'' I.R.C. §664(d)(1)(D)) ''must be transferred to one or more qualified charitable organizations or continue to be held in the trust for the benefit of such organizations.'' Fox, supra, ¶25.01. In short, unlike an immediate gift to charity, a contribution to a CRAT ''blends the philanthropic intentions of a donor with his or her financial needs or the financial needs of others.'' Id.

The court then stated that ''[a]lthough a [CRAT] is itself exempt from income tax and, therefore, pays no tax on any of its taxable income, the annuity . . . payments made to the noncharitable beneficiaries carry out taxable income that is subject to tax at the beneficiary level. Fox, supra, ¶25.50.'' This is the case, the court noted, because when property is transferred to a CRAT, the income tax basis of the property in the CRAT's hands is the same as it would be in the hands of the grantor. And when the CRAT sells the property, it realizes gain to the extent the amount realized from the sale exceeds its income tax basis.

Despite the rather straightforward tax consequences applicable to income recognized by a CRAT and the subsequent annuity payments to its noncharitable beneficiaries, the Gerhardts argued that the ''Internal Revenue Code . . . does a lot more than exempt the CRATs from paying tax on built-in gains realized when contributed property is sold.'' According to the Gerhardts, the ''[Internal Revenue] Code also relieves [the CRAT beneficiaries, i.e., themselves] from paying tax on the distributions that were made possible by the CRATs' realization of the built-in gains.'' As the Gerhardts put it, ''all taxable gains (on the sale of the assets contributed to the CRATs]) disappear and the full amount of the proceeds [is] converted to principal to be invested by the CRAT.'' In the Gerhardts' view, ''[i]t becomes obvious that Congress intended [this treatment] to promote charitable giving while offering large tax benefits as incentives.''

The court characterized the ''gain disappearing act the Gerhardts attribute to the CRATs'' as ''worthy of a Penn and Teller magic show'' but with ''no support in the Code, regulations, or caselaw.'' Although their underlying technical tax position was not clear, the court stated that ''[a]s best we can tell, the Gerhardts maintain that the bases of assets donated to a CRAT

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are equal to their fair market values,'' a position that court summarily rejected:

> Section 1015 flatly contradicts their position. Section 1015(a) governs transfers by gift, and section 1015(b) governs transfers in trust (other than transfers in trust by gift). Under either provision, the basis in the property ''shall be the same as it would be in the hands of the donor'' under section 1015(a) or ''in the hands of the grantor'' under section 1015(b). And the Gerhardts' claim that section 1015 does not govern transfers to CRATs because it does not specifically mention them is meritless. Nothing in the text of the provision excludes CRATs from its scope.

The Gerhardts also sought shelter in the rules governing the taxation of annuities under §72. But, as the court noted, if one respects the form of the transactions the Gerhardts chose, the Gerhardts did not buy any annuities from Symetra. The CRATs did so and directed how payments under the annuities were to be made. Thus, any amounts paid by Symetra as directed by the CRATs were considered to constitute amounts distributed by the CRATs to the Gerhardts for purposes of §664(b). And, as the court noted, ''[c]ontrary to the Gerhardts' view, nothing in section 72 overrides their obligation to comply with the rules of section 664(b) with respect to those amounts.''

Finally, in further support of its conclusion, the court noted that in an earlier case it decided, *Furrer v. Commissioner*, T.C. Memo 2022-100, it ''considered facts and arguments nearly identical to those before us now and reached the same conclusion.'' In that case, after seeing an advertisement in a farming magazine, the taxpayers made in-kind transfers of agricultural crops to CRATs, which then used the crop sale proceeds to purchase single-premium annuity contracts from Symetra, the same insurance company involved in the *Gerhardt* case. In *Gerhardt*, the court noted that it ''invited the Gerhardts to distinguish *Furrer* and even extended the briefing schedule to allow them to do so. But, tellingly, their briefs fail to mention the case at all. Their silence confirms our view that the reasoning in *Furrer* applies with equal force here.''

Justice Department Shuts Down Scheme

On February 23, 2022, the U.S. Department of Justice filed a complaint (''Complaint''), in the U.S. District Court for the Western District of Missouri against Eickhoff and Hoffman Associates, and other parties, alleging the following:

> Defendants organize, promote, or facilitate . . . an abusive tax scheme which they claim among other things, eliminates (or ''legally forgive[s]''—as they say in their advertising) the federal capital gains tax on income derived through the sale or other disposition of property. Specifically, Defendants falsely claim that customers who participate in their scheme can sell property through a charitable remainder annuity trust (''CRAT'') arrangement and thereby eliminate the taxable income that customers would (and should) otherwise lawfully realize. (*United States v. Eickhoff, Jr.*, No. 2:22-cv-04027 (W.D. Mo. Feb. 23, 2022), ECF No. 1)

The Complaint further alleged that the Defendants were engaging in conduct that substantially interfered with the administration and enforcement of the internal revenue laws and, through their collective conduct, have caused an estimated $40 million of taxable income to go unreported, resulting in upwards of at least $8 million in tax revenue loss to the U.S. Treasury. The Complaint indicated that as of February 2022, ''dozens of customers have used or are using at least 70 known CRATs organized under Defendants' abusive tax scheme'' and the ''IRS conducted 19 audits and concluded that the Hoffman CRAT Scheme resulted in an underreporting of more than $17,000,000 in taxable income, or $900,000 in taxable income for each of the customers participating in the audited CRATs.''

In an Order issued by the court on May 23, 2023, Hoffman Associates was permanently enjoined from continuing to operate in any capacity and was required to pay a $1.1 million judgment. (*United States v. Eickhoff, Jr.*, No. 2:22-cv-04027 (W.D. Mo. May 23, 2023), ECF No. 135) Eickhoff was required to pay a judgment of $400,000 and was, among other things, permanently enjoined from organizing, promoting, selling, or marketing any plan or arrangement concerning any charitable remainder trust, including a CRAT, or marketing any single-premium immediate annuity policy. In addition, Eickhoff, on behalf of Hoffman Associates, was required to identify to the IRS the customers of Hoffman Associates who participated in the CRAT Tax Scheme.

IRS Warns Against Using Abusive CRATs

In a recent News Release (IR-2023-65, May 31, 2023), the IRS warned taxpayers about the CRAT strategy that was promoted in the *Gerhardt* and *Furrer* cases:

> In abusive transactions of this type, property with a fair market value in excess of its basis is transferred to a CRAT. Taxpayers may wrongly claim the transfer of the property to the CRAT results in an increase in basis to fair market value as if the property had been sold to the trust. The CRAT then sells the property but does not recognize gain due to the claimed step-up in basis. Next, the CRAT purchases a single premium immediate an-

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nuity (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.

The IRS News Release 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. ''The IRS remains concerned about abusive tax arrangements, and they remain a focal point for our enforcement efforts,'' said IRS Commissioner Danny Werfel. ''Taxpayers should beware of potentially abusive arrangements and promoters pushing them. People should seek out trusted, reputable tax advice and not be fooled by aggressive advertising and sales pitches.''

What CRATs Are and Are Not For

The widely promoted CRAT ''tax strategy'' utilized in the *Gerhardt* and *Furrer* cases has absolutely no basis in the law. While a CRAT can be a valuable tax planning tool for taxpayers with substantially appreciated property and a philanthropic intent, it is certainly not a device that can make a taxable gain simply disappear as promised to potential customers of promoters. Courts and the IRS are on to the scheme, and taxpayers should avoid it at all costs.

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