Proposed treasury regulations target CRAT transaction with single premium immediate annuities

April 2, 2024

In brief

What happened?

On March 25, the Internal Revenue Service (IRS) issued proposed regulations (REG-108761-22) that would identify certain charitable remainder annuity trust (CRAT) transactions that involve single premium immediate annuities (SPIA) and substantially similar transactions as listed transactions, which is a type of reportable transaction. The proposed regulations would affect taxpayers who participate in these transactions, as well as material advisors who provide assistance or advice with respect to these transactions. However, the charitable remaindermen will not be treated as participants or parties to the listed transaction.

Why is it important?

Taxpayers, including individuals, trusts, estates and others, who are required to file a tax return must file a disclosure statement for listed transactions and 'substantially similar' transactions or face significant fines.

Actions to consider

Taxpayers that are considering a gift to a CRAT that invests in a SPIA should carefully review the proposed regulations to determine their impact if enacted. Additionally, taxpayers that may have already created a CRAT that has invested in a SPIA should also carefully examine the impact of the proposed regulations because if a transaction is deemed to be a listed transaction after a return is filed, but before the statute of limitations closes, then the taxpayer must file a disclosure statement. A public hearing on the proposed regulation is scheduled for July 11, 2024.

In detail

A CRAT is a type of irrevocable trust that is created to pay a fixed annuity based on a percentage of the initial FMV of the property transferred to the trust, to one or more non charitable beneficiaries. The annuity payment, which cannot be less than 5% and no more than 50% of the initial FMV of the contributed property, must be paid to the non charitable beneficiary at least annually for a specified term of years (not to exceed 20 years) or for the life (or lives) of the designated non charitable beneficiary. Once the annuity term expires, the property remaining in the trust transfers to charity. In the year the CRAT is funded, the donor is generally entitled to a charitable deduction equal to the actuarial present value of the remainder interest that will transfer to the charity (subject to limitation based on the donor's adjusted gross income). The actuarial present value of the remainder interest earmarked for charity must be equal to at least 10% of the value of the entire property transferred to the trust.

Because a CRAT is a tax-exempt entity, it generally does not pay income tax on investment earnings (dividends, interest or capital gains). This permits the trust to sell appreciated property without paying current income tax, capital gains tax, or the 3.8% NIIT on the gain at the trust level. However, the income beneficiary (that is, the non charitable beneficiary) of the trust is subject to income tax on their annuity payments using a tiering system based on the amounts and types of income earned within the trust pursuant to Internal Revenue Code (IRC) section 664(b). Essentially, the income of the trust is taxed to the beneficiary through the beneficiary's receipt of the annuity payment. Trust income in excess of the annuity payment is not taxed to the beneficiary until subsequently distributed.

The flagged transactions

The proposed regulations identify the new listed transaction as one that utilizes a CRAT and a SPIA to "permanently avoid recognition of ordinary income and/or capital gains." As explained by the proposed regulations, a SPIA is a type of annuity contract that provides a fixed stream of payments for a specified period or for life, in exchange for a single lump-sum payment. The payments from a SPIA are generally taxable to the recipient under IRC section 72, which allows a portion of each payment to be excluded from gross income as a return of the original investment.

In these transactions, a donor creates a trust purporting to qualify as a CRAT and funds it with appreciated property, which the trust then sells and uses the proceeds to purchase a SPIA. On their tax returns, the beneficiaries of the CRAT treat the annuity payments as if they were SPIA payments subject to IRC section 72, instead of CRAT payments subject to IRC section 664(b), which requires ordinary income and capital gains to be reported by the beneficiary. Consequently, the beneficiaries include a smaller portion of the annuity payments as income and exclude the rest as a return of the investment in the SPIA. The SPIA also permits the trustee to preclude the gain from the sale of the appreciated property from taxation under IRC section 664(c)(1). The IRS was also concerned with trustees who may assert that the trust receives a step-up in basis to FMV on the transfer of the appreciated property as if it had been sold to the trust. It made clear its position that a transfer to a CRAT is a gift for which the trust would not receive a step up in basis.

Observation: Because transfers to a CRAT are considered gifts for Federal tax purposes, the trust's basis in contributed property is generally the donor's carryover basis (plus any gift tax paid on the transfer but not to exceed FMV on the date of transfer) pursuant to IRC section 1015.

Reporting requirements

Form 8886 must be completed to disclose information for each reportable transaction in which a taxpayer participated and attached to their federal income tax form. A CRAT that already has completed transactions involving a SPIA may be required to disclose the listed transaction shortly after the regulations are final. Under regulation section 1.6011-4(e)(2)(i) “if a transaction becomes a listed transaction … after the filing of a taxpayer’s tax return (including an amended return) reflecting the taxpayer’s participation in the listed transaction … and before the end of the period of limitations for assessment for any taxable year in which the taxpayer participated in the listed transaction, then a disclosure statement must be filed with the [Office of Tax Shelter Analysis] within 90 calendar days after the date on which the transaction becomes a listed transaction.”

Material advisors must also disclose any reportable transaction on Form 8918, *Material Advisor Disclosure Statement,* in detail along with any potential tax benefits resulting from the transaction. The material advisor’s disclosure statement must be filed by the last day of the month that follows the end of the calendar quarter in which the advisor becomes a material advisor with respect to the reportable transaction.

Possible penalties imposed

The failure to disclose a reportable transaction may result in the following penalties:

- IRC section 6707A(b): A penalty equaling 75% of the decrease in tax shown on the return as a result of the reportable transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes), subject to minimum ($5,000 for individuals, $10,000 for all others) and maximum ($100,000 for individuals, $200,000 for all others) in the case of a listed transaction.

- IRC section 6662A: A 20% accuracy-related penalty on any understatement attributable to a reportable transaction that has been adequately disclosed. This penalty increases to 30% of the understatement if the taxpayer had a requirement to disclose the transaction but did not do so.

- A charitable remainder beneficiary of the CRAT could technically be subject to an excise tax under IRC section 4965 if it knowingly participates in a tax shelter transaction. For this purpose, the charity is attributed knowledge of its managers, directors, etc. The IRS has acknowledged that a charitable remainder beneficiary may not become aware of its interest in the CRAT until it receives a distribution at the end of the term of the CRAT, and so, a charity will not be subject to a reporting requirement or the excise tax under IRC section 4965. However, if the directors and managers of the charity are also person related to the CRAT (e.g., grantor or trustee), it is possible that the charity may become subject to the reporting requirements and the excise tax.

Taxpayers who are required to disclose a listed transaction and fail to do so are subject to an extended period of time for assessment of any tax with respect to the transaction. Under IRC section 6501(c), the period of time for assessment will not expire before the date that is one year after the date the taxpayer discloses the transaction, or the date a material advisor discloses the participation pursuant a written request by the Secretary under IRC section 6112(b) relating to such transaction with such taxpayer.

Let’s talk

If you have questions about the scope and impact of these proposed regulations, please contact:

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