How NOT to Use a Charitable Remainder Trust

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Overview

A charitable remainder trust can be a useful estate planning tool for a farmer or rancher, particularly one that is ready to retire from farming or ranching. Instead of selling the last crop and reporting the income along with the income from the previous year's crop that has been deferred to the current year, the crop can be transferred to a charitable remainder trust. Doing so avoids having to report the sale of the crop and the associated self-employment tax that would be triggered. But, a charitable remainder trust is a complex estate planning device that should only be utilized by professionals the understand the rules. A recent Tax Court case involving an Indiana farm couple illustrates how badly things can turn out with a charitable remainder trust if the rules aren't closely followed.

Charitable remainder trusts – it's the topic of today's post.

Background

A charitable remainder trust is an irrevocable trust to which you can donate property, cash or other property. The trust takes a carryover income tax basis in the transferred asset(s). The trust then sells the transferred assets (the sale is not taxable because the seller is a charity) and uses the income from the sale to pay the donor (or other designated person(s)). The payments continue for a specific term of up to 20 years of the life of one or more beneficiaries (typically the transferor). At the end of the term, the remainder of the trust passes to at least one designated charity. The remainder donated to the charity must be at least 10 percent of the initial net fair market value of all of the property placed in the trust.

Types. There are two types of charitable remainder trusts. The type of trust is tied to how payment from the trust is made. A charitable remainder unitrust (CRUT) pays a percentage of the trust value annually to noncharitable beneficiaries. The payments must be at least five percent and not exceed 50 percent of the fair market value of the trust's assets, valued annually. A charitable remainder annuity trust (CRAT) pays a specific dollar amount each year. The amount is at least 5 percent and no more than 50 percent of the value of the trust's property, valued as of the date the trust was established.

Tax on payments. Payments from a charitable remainder trust are taxed to the non-charitable beneficiaries. The non-charitable beneficiaries report the income on Schedule K-1 (Form 1041) as distributions of the trust's income and gains.

The distributions are reported in a particular order.

- Payments are considered to be ordinary income first to the extent the trust had ordinary income for the year and undistributed ordinary income from prior years. This means that if the trust had enough ordinary income to cover all of the payments, all of the payments are taxed as ordinary income. As a result, it is not advisable to transfer ordinary income property to the trust – particularly not ordinary income property with low or no income tax basis.
- Once the trust's ordinary income is exhausted, payments are taxed as capital gains based on the sale or disposition of the trust's capital assets. The payments are taxed as capital gain to the extent of the trust's capital gain for the current year and any undistributed capital gain income from prior years.
- After all of the trust's ordinary income and capital gain have been distributed, any additional payments are then characterized as other income to the extent of the trust's current year and accumulated other income.
- Finally, after the first three-tiers of distributions have been made, any further payments are considered to be from the "principal" of the trust and are not taxable.

Charitable deduction. The contribution to a charitable remainder trust will qualify for a partial charitable deduction. The deduction is partial because it is limited to the present value of the charitable organization's remainder interest calculated as the value of the donated property minus the present value of the annuity that the trust pays to the non-charitable beneficiary (or beneficiaries). Treas. Reg. §1.664-2(c). The deduction is also subject to adjusted gross income and other limits set forth in I.R.C. §170(e).

Tax filing requirements. A charitable remainder trust must file Form 5227 every year. A beneficiary must report any payments received from the trust on Schedule K-1 of Form 1041.

IRS concerns. The IRS closely monitors the use of charitable trusts. It is critical to not inflate the basis of assets transferred to the trust as well as failing to account for the transfer of any assets to the trust. It's also important to not mischaracterize the distributions of ordinary or capital gain income as distributions of corpus. The ordering rules must be closely followed. There can also be no self-dealing, making an upfront cash payment to a charitable beneficiary in lieu of the remainder interest, or a transfer of the trust's remainder interest to a non-qualified organization. Also, personal expenses can't be paid with trust funds, and funds can't be borrowed from the trust. It's also prohibited to use loans or forward sales of assets or other financial schemes to hid capital gains or income in the trust.

The *Furrer* Case

If there ever was a case that provides a roadmap for farmers as to how *not* to use a charitable remainder, *Furrer v. Comr., T.C. Memo. 2022-100* is that case. Indeed, it is almost inconceivable that the farmer couple involved in the case were represented by legal counsel. The arguments made on behalf of the Furrers were that bad.

The Tax Court began its opinion by noted that the Furrers, "after seeing an advertisement in a farm magazine" formed a CRAT. The opinion goes downhill quickly from there for the Furrers. The Furrers raised corn and soybeans on their Indiana farm. In July of 2015, they formed the first of two CRATs,

naming their son as trustee. The Furrers were the life beneficiaries, and three qualified charities were designated as remaindermen. They transferred 100,000 bushels of corn and 10,000 bushels of soybeans from their farm to the first CRAT, which then sold the grain for $469,003. The CRAT distributed $47,000 to the charities and used the balance to purchase a Single Premium Immediate Annuity (SPIA), which made annual payments to the Furrers of $84,369 in 2015, 2016 and 2017. The SPIA issued a Form 1099-R to the trustee listing the annuity payments as "gross distributions" and showed a small amount of interest as the "taxable amount." The Furrers claimed a $47,000 charitable deduction.

The Furrers created a second CRAT in 2016 naming themselves as the lie beneficiaries and seven qualified charities as the remainder beneficiaries. and also funded that trust with grain that they raised. The CRAT sold the grain for $691,827 and distributed $69,294 to the charities. The annuity from this trust was payable over 2016 and 2017 in the amount of $124,921 each year. The SPIA also issued Form 1099-R to the trustee listing the annuity payments as "gross distributions" and showing a small amount of interest as the "taxable amount." They claimed a charitable deduction of $69,294.

On their 2015 and 2016 returns, they did not claim charitable deductions for their transfers to the CRATs, but reported only the interest income from the SPIA, which was reported to them by the life insurance company providing the annuity. They treated the balance of the annuity distributions that they received as a nontaxable return of corpus under I.R.C. §664(b)(4). They also reported their transfers of crops to the CRATS on Forms 709 for 2015 and 2016, which reflected the fair market value of the crops with a cost basis of zero. The CRATs reported the sales of crops as sales of business property on Form 4797, inexplicably treating the crops as having substantial basis (derived from the purported purchase of the grain at fair market value) that generated a small loss for 2015 and a small gain for 2016. Their son (as trustee) prepared the CRATs' returns.

On audit, the Furrers claimed they should be entitled to charitable deductions for the in-kind transfers of the crops that were ultimately destined for the charitable remaindermen, which were not claimed on their return. They made this claim even though they had no income tax basis in the grain that was transferred to the CRATs. Incredibly, and despite not including the proper documentation, the IRS Revenue Agent allowed the charitable deductions. But the IRS still issued a notice of deficiency for each year because of the omitted income from the annuity and increased their Schedule F income by $83,440 in 2015, and by $206,967 in 2016 and also in 2017. This resulted in tax deficiencies of $55,040 for 2015, $56,904 for 2016 and $95,907 for 2017. The IRS also tacked on an accuracy-related penalty for each year.

Note: For gifts of property (other than publicly traded securities) valued in excess of $5,000, the taxpayer generally must (1) obtain a qualified appraisal of the property and (2) attach to the return on which the deduction is claimed a fully completed appraisal summary on Form 8283. *I.R.C. §170(f)(11)(C).* A "qualified appraisal" must be prepared by a "qualified appraiser" no later than the due date of the return, including extensions. I.R.C. §170(f)(11)(E); *Treas. Reg. §1.170A-13(c)(3).* The taxpayer must also maintain records substantiating the deduction. *Treas. Reg. § 1.170A-13(b)(2)(ii)(D).* At no time did the Furrers secure an appraisal ("qualified" or otherwise) of the crops they transferred to the CRATs. They also did not attach to their 2015 or 2016 return a completed Form 8283 substantiating the

gifts, and they did not maintain the written records that the regulations required. But, even had they done so, they would not have been entitled to any charitable deduction because of the lack of an income tax basis in the grain transferred to the trusts.

After the Furrers filed the Tax Court petition, the IRS conceded the accuracy-related penalties for lack of the immediate supervisor's approval. But, the IRS attorneys also requested leave to amend its answer to disallow the charitable deductions that the Revenue Agent allowed. The Tax Court held that the IRS carried its burden of proof on the charitable deduction disallowance issue – the Furrers did not substantiate the in-kind donations and they had no income tax basis in the crops. Thus, any charitable deduction was limited to zero regardless of whether they would have satisfied the substantiation requirements. The IRS also maintained that the annuity distributions were fully taxable as ordinary income on the basis that the grain was inventory that the Furrers held for sale to customers in the ordinary course of their farming business. The Tax Court agreed and noted that the Furrers violated the ordering rules for income tax treatment of distributions from the CRATs. The Trusts' sale of the grain involved a sale of ordinary income property (raised grain). As a result, the annuity was purchased with the proceeds of ordinary income property and any distributions from the trust to the Furrers retained that same ordinary income character. While the Furrers tried to apply the rules of I.R.C. §72 to the annuity distributions, the Tax Court noted that I.R.C. §664 provides a special rule for annuity distributions from CRATS that was not in their favor. In addition, even if I.R.C. §72 applied, the Tax Court noted that the Furrers would not have been able to use the exclusion rule because they had no "investment in the contract" – the funds used to purchase the contract had never been taxable.

Comment: I have no answer as to why this case ended up in the Tax Court. The Furrers were represented by counsel, but there appears to have been some very poor choices made on their behalf. The counsel of record is from California and the Furreres, as mentioned, farm in Indiana. I have no explanation as to how that happened. Many aspects of the set-up of the CRATs was wrong, and by not accepting the adjustment made by the IRS Revenue Agent and filing a Tax Court petition, the Furrers ended up *losing* the charitable deductions that the Revenue Agent had (mistakenly) allowed! Granted, the Furrers got the accuracy-related penalty to go away, but that was achieved at the price of losing substantial charitable deductions. I also wonder whether the IRS should have conceded on the penalty issue. The Tax Court's approach to IRS supervisory approval as a prerequisite to applying penalties has been disregarded by two Circuit Courts of Appeal. According to the 11th and 9th Circuits, supervisor approval at any time before assessment is enough to satisfy the statute. *See, e.g., Kroner v. Comr., 48 F.4th 1272 (11th Cir. 2022)* and *Laidlaw's Harley Davidson Sales, Inc. v. Comr., 29 F.4th 1066 (9th Cir. 2022).* Hopefully the Tax Court's decision will not be appealed to the Seventh Circuit. If it is, the prospect for a favorable outcome for the Furrers is slim to none.

Conclusion

The *Furrer* case illustrates that the rules surrounding the use of charitable remainder trusts are very complex. Only competent professionals that are experienced in the rules and use of such trusts should be engaged in utilizing them on behalf of clients. While the Tax Court said that the Furrers created the trusts after reading an ad in a farm magazine, I do not know the nature and extent of legal and tax advice they received (if any) in advance. If they were guided by tax counsel in setting up the

trusts, the counsel was woefully inadequate. To add insult to injury, as noted, the decision to petition the Tax Court rather than accepting the Revenue Agent's adjustments put the Furrers in a worse position.

The Tax Court has not yet officially entered its decision in the Furrer case. The 90-day timeframe for appeal does not start until the decision document (which is separate from the court's opinion) has been entered. Presently, the parties must submit their Tax Court Rule 155 calculations by December 21, 2022. Those calculations will form the basis of the decision document.

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