Publications

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Treasury Designates Certain CRAT-Annuity Arrangements as Listed Transactions: What to Review Now

Key Takeaways

- The U.S. Department of the Treasury and the IRS have designated certain charitable remainder annuity trust (CRAT) arrangements as listed transactions, targeting strategies that use a CRAT-owned commercial annuity to report beneficiary payments under Section 72 instead of Section 664(b).
- The final regulations create near-term disclosure obligations for some donors and advisors, while protecting charities that are merely named as remainder beneficiaries.
- Donors, trustees and advisors should promptly review CRATs involving appreciated property, trust-level annuity purchases and Section 72 reporting and evaluate whether prior returns require disclosure or correction.

The U.S. Department of the Treasury and the Internal Revenue Service issued final regulations on July 9 identifying certain charitable remainder annuity trust transactions as listed transactions. The final regulations target a strategy that uses a CRAT and a commercial annuity to claim that gain from appreciated property can be converted into largely tax-free payments to the donor or another beneficiary.

The rules do not challenge properly structured CRATs or charitable remainder trusts more broadly. They do, however, create significant reporting, penalty and statute-of-limitations concerns for taxpayers and advisors involved in the targeted arrangement or a substantially similar transaction.

What Treasury Is Targeting

The listed transaction generally involves five steps:

1. A donor creates a trust that purports to qualify as a CRAT under Section 664(d)(1) of the Internal Revenue Code.
2. The donor contributes appreciated property to the trust.
3. The trustee sells the property.
4. The trustee uses some or all of the sale proceeds to purchase a commercial annuity.
5. The beneficiary reports the CRAT payments under the annuity rules of Section 72

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instead of the distribution rules that apply to charitable remainder trusts under Section 664(b).

The claimed tax benefit rests on treating a portion of the beneficiary's payments as a tax-free return of investment under Section 72. The Treasury rejects that treatment.

Because the commercial annuity is owned by the CRAT — not the individual beneficiary — the resulting payments remain CRAT distributions and must be reported under the four-tier system in Section 664(b). Under that system, distributions generally carry out ordinary income first, followed by capital gain, other income and then trust principal.

The gain recognized when the CRAT sells appreciated property therefore remains in the trust's tax tier accounts and may be carried out to the beneficiary over time. It does not become tax-free simply because the CRAT purchases an annuity.

The final regulations do not state that every CRAT investment in a commercial annuity is improper. The central problem is the beneficiary's use of Section 72 instead of Section 664(b). Because the rules also cover "substantially similar" transactions, however, variations designed to produce the same tax result should be reviewed carefully.

Important Protection for Charities

The final regulations provide meaningful protection for charitable remainder beneficiaries. A Section 170(c) organization named as the remainder beneficiary is not treated as a participant in the listed transaction solely because it holds the remainder interest. Similarly, a tax-exempt organization is not treated as a party to a prohibited tax shelter transaction under Section 4965 solely because it is the designated charitable beneficiary.

This is an important practical safeguard. A donor or promoter may name a charity without involving the organization in the design or implementation of the transaction. In some cases, the charity may not learn that it has been named until years later. As a result, a charity should not face listed transaction reporting or Section 4965 excise tax exposure merely because it appears in the trust agreement.

The protection is narrower where the charity takes an active role. A different analysis may apply if the organization:

- Endorses the claimed Section 72 treatment;
- Assists in designing or implementing the transaction;
- Makes transaction-specific tax representations;
- Reviews or approves nonstandard CRAT provisions; or
- Receives fees for providing material tax-related assistance.

The Treasury also confirmed that a charity does not become a material advisor merely by suggesting that a donor consider a conventional CRAT or by providing general information about how charitable remainder trusts work. Gift planning and development professionals may continue to educate donors about legitimate charitable planning. They should avoid representing to donors that a particular arrangement will eliminate capital gain, produce tax-free income, or qualify for a particular tax result.

Donors May Have an Immediate Disclosure Obligation

Taxpayers who participated in the listed transaction generally must disclose the transaction on Form 8886, Reportable Transaction Disclosure Statement. The final regulations may apply to transactions completed before July 9. A taxpayer who previously filed a return reflecting the targeted tax treatment may have a current disclosure obligation if the applicable assessment period remains open. For some prior transactions, the Form 8886 deadline may be as early as **Oct. 7**.

The final regulations also provide that participation includes tax consequences affecting a gift tax return, whether or not the return was actually filed. A review should therefore include income tax, trust and gift tax reporting. Failure to disclose a listed transaction can result in substantial penalties. Nondisclosure may also extend the period during which the IRS may assess tax relating to the transaction.

Filing Form 8886 does not correct the substantive tax treatment reported on a prior return. Depending on the circumstances, affected taxpayers may also need to consider amending income tax, trust or gift tax returns.

Advisors Should Review Their Files

The final regulations also affect attorneys, accountants, trustees, financial advisors, insurance professionals, promoters and others who assisted with these transactions. A person may be a material advisor if the person provided material assistance or advice, made a tax-related statement and received fees above the applicable threshold.

Material advisors generally must:

- File Form 8918;
- Maintain lists identifying affected taxpayers; and
- Produce those lists if requested by the IRS.

An advisor who met the applicable requirements before the transaction became listed may be treated as becoming a material advisor on July 9. For those advisors, the Form 8918 filing deadline may be **Nov. 2**.

The review should extend beyond formal tax opinions. Relevant materials may include emails, tax projections, insurance illustrations, trust administration instructions, return preparation advice, seminar materials and compensation or referral arrangements.

Estate Planning Implications for High-Net-Worth Clients

Properly structured CRATs remain available and may continue to serve legitimate charitable and estate planning objectives. A CRAT can provide:

- A fixed payment stream;
- An actuarially determined charitable deduction;
- Diversification of appreciated assets;
- Deferral of gain recognition under the Section 664 rules; and
- A meaningful remainder gift to charity.

The final regulations do foreclose, however, the use of a CRAT and a commercial annuity to claim that gain from appreciated property has effectively been converted into tax-free payments.

For high-net-worth clients, the benefit of a charitable remainder trust should be described as tax deferral and orderly recognition of income, not permanent exclusion of gain. Clients should also consider whether a CRAT is the right charitable remainder trust for the particular asset and planning objective. A CRUT, net-income CRUT, or FLIP-CRUT may be more appropriate where the contributed asset is illiquid, the timing of a sale is uncertain, or the client wants payments tied to trust value. Other alternatives may include outright gifts of appreciated property, donor-advised funds, private foundations, charitable gift annuities issued directly by a charity, or charitable planning used alongside separate wealth-transfer strategies.

For closely held business interests and other significant appreciated assets, the analysis should also address assignment of income, prearranged sale concerns, valuation, unrelated business taxable income, trust qualification, and the economic value of the charitable remainder.

Steps Donors, Advisors and Charities Should Take Now

Donors, advisors and charities should consider taking the following steps now:

1. Identify potentially affected arrangements. Review CRATs involving appreciated property, a sale by the trust, the purchase of a commercial annuity, and beneficiary reporting under Section 72.

2. Evaluate disclosure and correction obligations. Determine whether Forms 8886 or 8918 are required and whether prior income tax, trust, or gift tax returns should be amended.

3. Update charitable planning procedures. Charities should confirm that planned giving personnel provide general educational information without endorsing transaction-specific tax treatment. Nonstandard CRAT agreements and CRAT-annuity arrangements should be referred for tax and legal review.

The final regulations are a targeted response to a particular tax strategy, not a broader challenge to charitable remainder trusts. For donors and advisors involved in the identified arrangement, however, the reporting deadlines and potential penalties require prompt attention.

For more information, contact L. Maverick Flowers, Jeffrey Glogower or your preferred Polsinelli attorney.