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U.S. Tax Court: Annuity payments received from charitable remainder trusts taxable as ordinary income

The U.S. Tax Court today affirmed determinations of the IRS that annuity payments received by the taxpayers from charitable remainder trusts were taxable to them as ordinary income under sections 664 and 1245.

The case is: *Gladys L. Gerhardt et al. v. Commissioner,* 160 T.C. No. 9 (April 20, 2023). Read the Tax Court's **opinion** [PDF 464 KB] (35 pages)

Summary

The taxpayers contributed high-value, low-basis real estate and other property to charitable remainder annuity trusts (CRATs). The CRATs sold the contributed property and purchased five-year single premium immediate annuities (SPIAs) with most of the proceeds, naming the taxpayers as recipients of the annuity payments. On their 2016 and 2017 tax returns, the taxpayers took the position that the payments they received from the CRAT-funded SPIAs were not subject to tax, with the exception of small amounts the taxpayers reported as interest.

The IRS examined the taxpayers' tax returns and determined deficiencies on the basis that the annuity payments the taxpayers received were distributions from the CRATs and taxable to them as ordinary income under sections 664 and 1245.

Two of the taxpayers separately relinquished rental property and cash in exchange for other rental property in 2017. On their tax return for 2017, those taxpayers took the position that gain from the disposition of the relinquished property was deferred because the transaction qualified as a like-kind exchange under section 1031. The IRS did not dispute that the transaction met the requirements of section 1031, but determined that section 1245 precluded deferral of the gain.

Those two taxpayers also sold certain property in 2017 and reported the net gain from the sale as ordinary income. The IRS recomputed the amount of the gain and characterized it as long-term capital gain.

For two other taxpayers, the IRS determined an accuracy-related penalty under section 6662(a) for 2016. Those taxpayers claim the penalty does not apply because they acted with reasonable cause and in good faith reliance on their advisers.

Tax Court decision

The Tax Court agreed with the IRS that the annuity payments the taxpayers received from the CRAT-funded SPIAs in 2016 and 2017 were distributions from the CRATs taxable to them as ordinary income under sections 664 and 1245. The court found that the taxpayers' argument to the contrary "finds no support in the Code, regulations, or caselaw." Although the court found it difficult to determine the precise basis for the taxpayer's argument, the court specifically rejected any argument that the bases of assets donated to a CRAT are equal to their fair market values. Rather, section 1015 flatly contradicts that position, providing for a carry-over basis.

In addition, the Tax Court found that the CRATs bought the annuities and directed how payments under the annuities were to be made. Therefore, any amounts paid by the life insurance company as directed by the CRATs constituted amounts distributed by the CRATs for purposes of section 664(b). Contrary to the taxpayers' view, nothing in section 72 overrode their obligation to comply with the rules of section 664(b) with respect to those amounts.

The Tax Court also agreed with the IRS that section 1245 precluded deferral of the taxpayers' gain realized from the disposition of the relinquished rental property in 2017. In addition, because those taxpayers offered no argument as to the IRS's determinations concerning the sale of the other property in 2017, the IRS's determinations with respect to that sale stand.

Finally, the Tax Court held that the two other taxpayers did not meet their burden of showing that they acted with reasonable cause and in good faith reliance on their advisers.

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