Gerhardt v. Commissioner, 160 T. C. No. 9 (2023)

In Gerhardt v. Commissioner, the U. S. Tax Court ruled that payments received by taxpayers from annuities purchased by their charitable remainder annuity trusts (CRATs) are taxable as ordinary income under IRC § 664. The decision underscores the tax implications of using CRATs to sell appreciated assets and invest in annuities, emphasizing that such transactions do not provide tax-free income to beneficiaries.

Parties

Plaintiffs: Gladys L. Gerhardt et al. (Petitioners), including Alan A. Gerhardt, Audrey M. Gerhardt, Jack R. Gerhardt, Shelley R. Gerhardt, Tim L. Gerhardt, and Pamela J. Holck Gerhardt. Defendant: Commissioner of Internal Revenue (Respondent).

Facts

The Gerhardts contributed high-value, low-basis real estate and other property to CRATs. The CRATs sold the contributed properties and used most of the proceeds to purchase five-year single premium immediate annuities (SPIAs), naming the Gerhardts as recipients of the annuity payments. The Gerhardts reported minimal interest income from the CRAT-funded SPIAs on their 2016 and 2017 tax returns, asserting that the majority of the payments were not taxable. The Commissioner examined the returns and determined deficiencies, asserting that the payments were taxable as ordinary income under IRC §§ 664 and 1245. Additionally, Jack and Shelley Gerhardt engaged in a like-kind exchange under IRC § 1031 and sold another property, while Tim and Pamela Gerhardt faced an accuracy-related penalty under IRC § 6662(a).

Procedural History

The Commissioner issued notices of deficiency to the Gerhardts for 2016 and 2017, determining that the annuity payments were taxable as ordinary income. The Gerhardts petitioned the U. S. Tax Court for a redetermination of the deficiencies. The cases were consolidated for trial. The parties submitted the cases fully stipulated under Tax Court Rule 122. The court addressed the main issue of the taxability of CRAT-funded annuity payments and additional issues related to Jack and Shelley Gerhardt’s like-kind exchange and Tim and Pamela Gerhardt’s penalty.

Issue(s)

1. Whether the annuity payments received by the Gerhardts from CRAT-funded SPIAs in 2016 and 2017 are taxable as ordinary income under IRC § 664? 2. Whether Jack and Shelley Gerhardt’s gain from the disposition of the Armstrong Site in a like-kind exchange under IRC § 1031 should be recognized as ordinary income under IRC § 1245? 3. Whether Tim and Pamela Gerhardt are liable for an accuracy-related penalty under IRC § 6662(a) for 2016?

Rule(s) of Law

1. IRC § 664(b) governs the taxation of distributions from charitable remainder trusts, stipulating that distributions are taxed to beneficiaries in the order of ordinary income, capital gain, other income, and trust corpus. 2. IRC § 1245(a) requires recognition of gain as ordinary income when depreciated property is disposed of, including in like-kind exchanges under IRC § 1031. 3. IRC § 6662(a) imposes a penalty for substantial understatements of income tax, which can be avoided if the taxpayer shows reasonable cause and good faith under IRC § 6664(c)(1).

Holding

1. The annuity payments received by the Gerhardts from CRAT-funded SPIAs in 2016 and 2017 are taxable as ordinary income under IRC § 664. 2. Jack and Shelley Gerhardt's gain from the disposition of the Armstrong Site in a like-kind exchange is taxable as ordinary income under IRC § 1245. 3. Tim and Pamela Gerhardt are liable for the accuracy-related penalty under IRC § 6662(a) for 2016 as they did not establish reasonable cause and good faith.

Reasoning

The court's reasoning focused on the statutory framework of IRC § 664, which requires that distributions from CRATs follow a specific ordering rule for taxation. The court rejected the Gerhardts' argument that the basis of assets donated to a CRAT should be their fair market value, citing IRC § 1015, which states that the basis in the hands of the CRAT is the same as in the hands of the donor. The court also dismissed the Gerhardts' reliance on IRC § 72, as the SPIAs were purchased by the CRATs, not the Gerhardts directly, and thus did not alter the tax treatment under IRC § 664. The court found that the CRATs' sale of contributed properties resulted in ordinary income under IRC § 1245, which was then distributed to the Gerhardts. For Jack and Shelley Gerhardt's like-kind exchange, the court upheld the Commissioner's determination that the gain from the Armstrong Site was subject to IRC § 1245 and thus taxable as ordinary income. Regarding Tim and Pamela Gerhardt's penalty, the court found that they did not meet their burden to prove reasonable cause and good faith reliance on tax advisors, as they failed to provide sufficient evidence of the advisors' qualifications and the nature of their reliance.

Disposition

The court upheld the Commissioner's determinations on all issues and entered decisions under Rule 155, reflecting the findings and the parties' concessions.

Significance/Impact

Gerhardt v. Commissioner reinforces the principle that distributions from CRATs are taxable to beneficiaries according to the ordering rules under IRC § 664. It clarifies that the use of CRATs to sell appreciated assets and invest in annuities does not provide a tax-free income stream to beneficiaries. The decision also underscores the application of IRC § 1245 in like-kind exchanges and the stringent requirements for avoiding accuracy-related penalties under IRC § 6662(a). This case is significant for tax practitioners and taxpayers utilizing CRATs, as it highlights the need to carefully consider the tax implications of such trusts and the importance of documenting reliance on professional advice to avoid penalties.