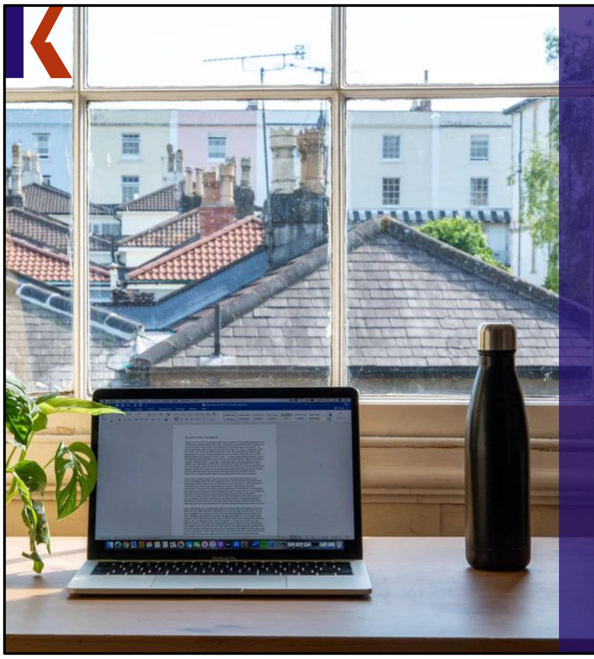

Current Federal Tax Developments

May 1, 2023

Kaplan Financial Education

This Week We Look At:

More CRAT problems - but this one the IRS had warned against using

Change of protocol underlying cryptocurrency from proof of work to proof of stake is not a taxable event

Fact some countries now treat Bitcoin as legal tender does not change its status as property, not foreign currency

Taxpayer finds they had to wait a year to claim a deduction for cashier's check purchased to settle legal dispute

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More CRAT problems - but this one the IRS had warned against using

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CRAT Transactions Fail to Achieve Promised Tax Magic

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- *Gerhardt v. Commissioner*, 160 TC No. 9, 4/20/23
  - Charitable remainder annuity trust
    - Annuity interest to individual, remainder interest to charity
    - Taxes "layers" of income accumulated as paid out as annuity
    - Deduction allowed either for estate or income tax on present value of future interests
  - But subject to very strict requirements

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CRAT Transactions Fail to Achieve Promised Tax Magic

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- *Gerhardt v. Commissioner*, 160 TC No. 9, 4/20/23
  - Taxpayers used a marketed program that claimed to eliminate all tax on gain
  - Transferred real estate to purported CRAT
  - Sold for over $1,500,000 gain inside the trust

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CRAT Transactions Fail to Achieve Promised Tax Magic

…[T]he CRAT instrument required the trustee to pay to the beneficiaries for a five-year period an "Annuity Amount" "equal to the greater of: (1) ten percent of the initial net fair market value of all property transferred to [the CRAT] . . . or **(2) the payments received . . . from one . . . or more Single Premium Immediate Annuities [(SPIAs)] purchased by the Trustee."** Stipulation of Facts Ex. 13-J, at 23.

The CRAT instrument listed Albert and Gladys Gerhardt as the beneficiaries of the Annuity Amount. **But the CRAT instrument also provided that "[n]either the Recipients nor the Recipients' Children shall have any right title, interest, or incident of ownership in or to any [SPIA] transferred to or purchased by the Trustee." Id. at 22.** The CRAT instrument defined the term "Recipients" as those "entitled to receive the current annuity payment" and identified Albert and Gladys as the Recipients. Id. at 15.

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CRAT Transactions Fail to Achieve Promised Tax Magic

Using the proceeds from the sales, the Albert and Gladys CRAT purchased a SPIA from Symetra Life Insurance Co. (Symetra) for $1,537,822 on March 7, 2016. The SPIA contract identified the Albert and Gladys CRAT as the "Owner" of the SPIA, but listed Albert as the annuitant and Gladys as the joint annuitant. **Under the SPIA contract, Symetra was required to pay an annuity of $311,708 to Albert and Gladys beginning on April 6, 2016, and on each April 6 thereafter until five total payments were made.**

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CRAT Transactions Fail to Achieve Promised Tax Magic

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- *Gerhardt v. Commissioner*, 160 TC No. 9, 4/20/23
  - Although there was a $1,500,000+ capital gain layer, taxpayer did not treat any of the payment as coming from that
  - Rather it was treated as a minor amount of "interest" (the amount shown as taxable on the Form 1099-R) and the remainder as a return of basis
  - IRS argued the entire distribution was taxable - that the $1,500,000 layer had to be taken into account

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CRAT Transactions Fail to Achieve Promised Tax Magic

Congress has established specific ordering rules that govern the characterization and reporting of annuity amounts distributed by a CRAT to its income beneficiaries. See I.R.C. §664(b). Under this regime, distributions from a CRAT to income beneficiaries are deemed to have the following character and to be distributed in the following order:

(1) as ordinary income, to the extent of the CRAT's current and previously undistributed ordinary income;

(2) as capital gain, to the extent of the CRAT's current and previously undistributed capital gain;

(3) as other income, to the extent of the CRAT's current and previously undistributed other income; and

(4) as a nontaxable distribution of trust corpus.

I.R.C. §664(b)(1)–(4); Fox, supra, ¶ 25.50.

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CRAT Transactions Fail to Achieve Promised Tax Magic

The Gerhardts resist the straightforward analysis set out above. In their telling, the Code does a lot more than exempt the CRATs from paying tax on built-in gains realized when contributed property is sold. According to the Gerhardts, the Code also relieves them from paying tax on the distributions that were made possible by the CRATs' realization of the built-in gains. *As they put it, "all taxable gains (on the sale of the asset[s contributed to the CRATs]) disappear and the full amount of the proceeds [is] converted to principal to be invested by the CRAT." Pet'rs' Opening Br. 6-7 (emphasis added). In the Gerhardts' view, "[i]t becomes obvious that Congress intended [this treatment] to promote charitable giving while offering large tax benefits as incentives." Id. at 7.*

KAPLAN

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CRAT Transactions Fail to Achieve Promised Tax Magic

The gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. ***But it finds no support in the Code, regulations, or caselaw.***

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CRAT Transactions Fail to Achieve Promised Tax Magic

As best we can tell, the Gerhardts maintain that the bases of assets donated to a CRAT are equal to their fair market values. See Pet'rs' Reply to Resp't's Opening Br. 10-11 ("Utilizing CRATs, the assets are donated to a CRAT and book at the fair market value of the asset at that time. The donor's basis is a moot point as the controlling fair market value is the price at the time the asset is donated to the CRAT."); id. at 13 ("The trustee of the CRAT has no way to know the cost basis of any asset donated to it, nor is it required to obtain such information since that is not required by the Internal Revenue Code."). **Section 1015 flatly contradicts their position.** Section 1015(a) governs transfers by gift, and section 1015(b) governs transfers in trust (other than transfers in trust by gift). Under either provision, the basis in the property "shall be the same as it would be in the hands of the donor" under section 1015(a) or "in the hands of the grantor" under section 1015(b).37 **And the Gerhardts' claim that section 1015 does not govern transfers to CRATs because it does not specifically mention them is meritless. Nothing in the text of the provision excludes CRATs from its scope.**

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CRAT Transactions Fail to Achieve Promised Tax Magic

The Gerhardts also seek shelter in the rules governing the taxation of annuities in section 72. **But, if one respects the form of the transactions the Gerhardts chose, the Gerhardts did not buy any annuities from Symetra.** The CRATs did so and directed how payments under the annuities were to be made. **Thus, any amounts paid by Symetra as directed by the CRATs constitute amounts distributed by the CRATs for purposes of section 664(b). Contrary to the Gerhardts' view, nothing in section 72 overrides their obligation to comply with the rules of section 664(b) with respect to those amounts.**

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CRAT Transactions Fail to Achieve Promised Tax Magic

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- *Gerhardt v. Commissioner*, 160 TC No. 9, 4/20/23
  - The IRS had written a memo about this type of transaction we discussed back in 2020
  - The marketing materials confused the issue - it only sounds convincing to those that know nothing about CRTs
  - Do not be intimidated by documents, or accept them because you are unfamiliar with the area

https://www.currentfederaltaxdevelopments.com/blog/2023/4/21/crat-transactions-fail-to-achieve-promised-tax-magic

Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

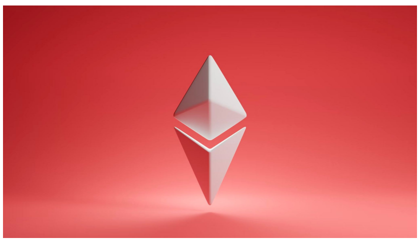

Photo by Shubham Dhage on Unsplash

- Chief Counsel Advice 202316008, 4/21/2023
  - Question if a change from proof of work to proof of stake creates a taxable event.
  - Seen moves to proof of stake for various reasons
    - Concern about cost of mining (economic issue)
    - Also concern about power consumed
  - But is this an exchange of one type of currency for another

https://www.currentfederaltaxdevelopments.com/blog/2023/4/22/change-of-protocol-from-proof-of-work-to-proof-of-stake-does-not-create-taxable-income-to-holder-of-cryptocurrency#_ftnref1

Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

FACTS:

K is a blockchain that uses distributed ledger technology to record transactions involving cryptocurrency pursuant to K's underlying protocol. The K blockchain protocol is a set of rules that includes a consensus mechanism for adding new blocks of transactions to K, including those involving units of C. Participants that successfully add new blocks of transactions to K receive a block reward in accordance with K's underlying protocol.

On Date 1, T purchases 10 units of C and stores the private keys in an unhosted wallet. **On Date 2, K changes its consensus mechanism used to select who may validate transactions and add blocks of transactions to the K blockchain from proof-of-work ("PoW") to proof-of-stake ("PoS") (the "protocol upgrade").**

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Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

FACTS:

After the protocol upgrade on Date 2, K's protocol requires that transactions be validated and that new blocks be added to K's blockchain exclusively through the PoS consensus mechanism. **The protocol upgrade does not affect or otherwise change the transaction history of any blocks prior to Date 2, and new blocks will be added to K pursuant to the changed protocol. Units of C remain unchanged following the protocol upgrade, and T continues to hold the same 10 units of C. T does not receive any cash, services, or property (including additional units of C) as a result of the protocol upgrade.**

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Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

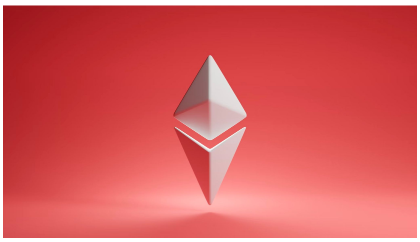

Photo by Shubham Dhage on Unsplash

- Chief Counsel Advice 202316008, 4/21/2023
  - Two potential theories on why it could be taxable:
    - Is it an exchange of one type of asset for a different asset (Section 1001)
    - Some other form of income under Section 61

https://www.currentfederaltaxdevelopments.com/blog/2023/4/22/change-of-protocol-from-proof-of-work-to-proof-of-stake-does-not-create-taxable-income-to-holder-of-cryptocurrency#_ftnref1

Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

The protocol upgrade affects the consensus mechanism by which future transactions are validated and blocks are added to K after Date 2. The protocol upgrade does not alter past transactions or blocks previously validated and added to K, including T's 10 units of C. Furthermore, the existing units of C remain unchanged by the protocol change and there is not an exchange of the units of C under section 1001. **Accordingly, T continues to own the same 10 units of C before and after the upgrade and the protocol upgrade does not result in a realization event from which T realizes gain or loss on T's existing 10 units of C.**

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Change of Protocol from Proof of Work to Proof of Stake Does Not Create Taxable Income to Holder of Cryptocurrency

Similarly, T derives no accession to wealth from the upgrade. T's 10 units of C remain unchanged after the upgrade, and T does not derive any separable economic benefits, in the form of cash, services, or other property (including other cryptocurrencies) from it. **In the absence of an accession to wealth to T, the protocol upgrade does not result in T having an income inclusion within the meaning of section 61(a).**

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IRS Still Takes the Position Bitcoin is Property, Not Currency, Despite Some Countries Recognizing the Cryptocurrency as Legal Tender

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- Notice 2023-34, 4/24/23
  - Revision to Notice 2014-21 that treated Bitcoin as property rather than foreign currency
  - Since Notice 2014-21 was issued, certain countries (El Salvador and the Central African Republic) have recognized it as legal tender
  - Does this change the IRS position?

KAPLAN

https://www.currentfederaltaxdevelopments.com/blog/2023/4/25/irs-still-takes-the-position-bitcoin-is-property-not-currency-despite-some-countries-recognizing-the-cryptocurrency-as-legal-tender

IRS Still Takes the Position Bitcoin is Property, Not Currency, Despite Some Countries Recognizing the Cryptocurrency as Legal Tender

The Department of the Treasury and the Internal Revenue Service are aware that certain foreign jurisdictions have enacted laws that characterize Bitcoin as legal tender. T**hus, the sentence in the Background section of Notice 2014-21 stating that virtual currency does not have legal tender status in any jurisdiction is no longer accurate as to Bitcoin.**

In addition, the Background section of Notice 2014-21 **may be misinterpreted as overstating the similarity between convertible virtual currency and "real" currency because the use of convertible virtual currency, including Bitcoin, to perform "real" currency functions is limited.**

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IRS Still Takes the Position Bitcoin is Property, Not Currency, Despite Some Countries Recognizing the Cryptocurrency as Legal Tender

In certain contexts, virtual currency may serve one or more of the functions of “real” currency — i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance — **but the use of virtual currency to perform “real” currency functions is limited.**

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IRS Still Takes the Position Bitcoin is Property, Not Currency, Despite Some Countries Recognizing the Cryptocurrency as Legal Tender

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- Notice 2023-34, 4/24/23
  - IRS changes some details but continues taking the same underlying position on the taxation of virtual currencies
  - Specifically Q&A 2 is not changed by the revision

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IRS Still Takes the Position Bitcoin is Property, Not Currency, Despite Some Countries Recognizing the Cryptocurrency as Legal Tender

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year


Photo by David Veksler on Unsplash

- *Gage v. Commissioner*, TC Memo 2023-47, 4/12/23
  - Looking at the year a cash basis taxpayer can deduct a payment
  - This case involved settling a legal claim
  - Transferred funds to counsel to pay for a settlement proposal likely to be accepted

https://www.currentfederaltaxdevelopments.com/blog/2023/4/25/taxpayers-delivery-of-cashiers-check-to-pay-settlement-to-their-attorney-before-year-end-did-not-count-as-payment-in-that-year

Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

The United States, on behalf of the Department of Housing and Urban Development (HUD), filed a complaint against Edwin and Elaine Gage. **The Gages tentatively settled in December 2012 and gave their lawyer a cashier's check for the agreed amount before the end of the year.** The government sometimes works slowly, and the tentative settlement didn't become final until March 2013. Shortly after, the Gages' lawyer delivered the check.

When the Gages filed their return for 2012, they claimed a business-loss deduction for the amount of the settlement.

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

Negotiations ensued, and by August 2012 it looked like the case would settle. The Gages, RMG's other owners, and counsel for the United States tentatively agreed to settle for $1.75 million, of which the Gages would pay $875,000. **The deal was expressly conditioned on final approval by the Department of Justice,** but it must have looked pretty likely that the deal would work out — **the magistrate judge who supervised the settlement talks entered an order in which he noted that a settlement conference was held and that the settlement was contingent upon acceptance and approval by the DOJ.** The district court then entered an administrative closing order, which terminated the suit without prejudice.

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

On December 27, 2012, the Gages purchased a cashier's check in the amount of $875,000 and delivered it to their lawyer. Their lawyer emailed the Assistant U.S. Attorney who represented the government to inform him that the check would soon be delivered. The Assistant U.S. Attorney, however, explained that the United States did not have authority to receive the cashier's check before the settlement was finally approved. **The Gages' lawyer held onto the check.**

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

The DOJ reviewed the settlement agreement and finally signed it in March 2013. …

The Gages' attorney then finally delivered the cashier's check, dated December 27, 2012, to the United States on March 18, 2013.

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

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- *Gage v. Commissioner*, TC Memo 2023-47, 4/12/23
  - So can the Gage's deduct the payment in 2012 (assuming its deductible)?
  - Or, if deductible, must the Gages wait until 2013

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

The Gages are cash-method taxpayers. What this means is that they can take deductions only for expenses that they actually paid, not that they merely incurred, during a particular tax year. See *Saviano v. Commissioner,* 80 T.C. 955, 964 (1983) ("It is clear that a cash basis taxpayer cannot deduct an expense incurred unless it has been paid during the taxable year") (citing Treas. Reg. § 1.461-1(a)(1)), aff'd, 765 F.2d 643 (7th Cir. 1985); see also §446(a); Treas. Reg. § 1.446-1(c)(1)(i) ("Expenditures [by cash-method taxpayers] are to be deducted for the taxable year in which actually made.") **<u>There's a rule for payments by check as well — tax law treats a payment by check as made when the check is delivered.</u>** See *Guy v. Commissioner,* 105 T.C.M. (CCH) 1626, 1628 (2013). If a check is dated in one year but cashed in the next year, the deduction will not be allowed absent proof of delivery in the year of the deduction. See *Reynolds v. Commissioner*, 79 T.C.M. (CCH) 1376, 1383 (2000), aff'd, 296 F.3d 607 (7th Cir. 2002).

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

The Gages did not themselves deliver the check to the government at the end of 2012. **They instead gave it to their lawyer to deliver to the government when the settlement was finally approved.** (And one might, though the parties don't, question whether the Gages owed anything under the settlement at all before it was finally approved.) Their lawyer delivered the check to the United States only on March 18, 2013. A copy of the United States's payment record confirms that this is the date that the check was received. That check was not cashed by the United States (i.e., actually paid) until March 22, 2013 — after the DOJ reviewed and approved the agreement. The record includes a copy of the check, dated December 27, 2012, and a copy of the United States's payment record, showing that the United States received the Gages' cashier's check on March 18, 2013, and cashed it on March 22, 2013. **The payment record proves that the delivery was made in 2013, not in 2012.**

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

That would seem to end the matter. **But the Gages argue that under Oklahoma law a payment is made when there is a tender of payment.** They purchased a cashier's check and delivered it to their attorney in the case who then offered to give it to the Assistant U.S. Attorney who worked the case. He said that he could not hold the check since the settlement agreement had not been approved. **The Gages argue that under Oklahoma law, this uncontested sequence of events is a tender of payment.**

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Taxpayer's Delivery of Cashier's Check to Pay Settlement to Their Attorney Before Year End Did Not Count as Payment In That Year

We don't need to review Oklahoma law because what constitutes delivery of a check made in settlement of a federal lawsuit brought by the federal government is, we hold, a matter of federal, not state, law.

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