TAX NEWS - IRS TAX PRACTITIONER NEWSLETTER
April 17, 2000, Volume 2000, Issue 7

To Trust or Not To Trust? That is the Question!

A[n irrevocable [1]] trust is a form of ownership, which completely separates responsibility and control of assets from all the benefits of ownership. Trusts are used in such matters as estate planning; to facilitate the genuine charitable transfer of assets; and to hold assets for minors and those unable to handle their financial affairs. [Emphasis Added.]

Under a[n irrevocable] trust arrangement, you must give up control over income and assets. An independent trustee is designated to hold legal title to the trust assets, to exercise independent control over the trust, and to manage the trust. Taxes [2] must be paid on the income received by the trust, including the income generated by property held in trust. The responsibility to pay taxes may fall to the trust, the beneficiary, or the grantor. [Emphasis Added.]

A trustee is designated to hold legal title to the trust property, to exercise independent control over it, and is responsible for its management.

All trusts must comply with the tax laws as set forth by the Congress in the Internal Revenue Code, Section 641-683. Trusts established to hide the true ownership [3] of assets and income or to disguise the substance of financial transactions are considered Fraudulent/Abusive Trusts.

Too Good to be True...

Promoters of **<u>fraudulent trust arrangements</u>** use a variety of methods to advertise their schemes. They may include seminars, flyers, and even the Internet. The main selling point of fraudulent trust arrangements is that the paperwork will look like you are giving up control of your assets and money; when in reality you still control how your money and assets are used. [Emphasis Added.]

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[1] A revocable trust does not remove ownership nor personal responsibility from the Grantor of the assets funding the trust. To accomplish complete divesting of legal and equitable title; the trust must be irrevocable with an independent trustee ... one not related to the Grantor by blood, marriage or employment.

[2] An irrevocable trust must file an IRS Form 1041 - Fiduciary Income Tax Report.

[3] It is the opinion of most estate planners that all entities (except for sole proprietorships and joint tenancy) are created to hide the true identity of the owners. This includes corporations, partnerships, etc. yet their creation doesn't necessarily make these statutory (state approved) entities fraudulent or abusive. "Own Nothing ... Control Everything!" - John D. Rockerfeller -

A fraudulent trust only has the appearance of a trust [4]. It is typically promoted by the promise of tax benefits or avoidance [5] with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets.

Using the name "trust" in association with financial arrangements [6] does not make it a legitimate trust. No matter how carefully written the trust documents are, **<u>if the intent is to evade taxes</u>**, the trust will be treated as fraudulent. [Emphasis Added.]

Fraudulent trusts are illegal and are a specific area of concern for IRS Criminal Investigation.

The Jungle of Fraudulent Trust Schemes-

Currently, there are two prevalent fraudulent arrangements that are being promoted: The "domestic package" and the "foreign package." The domestic package involves a series of trusts that are formed in the US, while the foreign trust packages are formed offshore and outside the jurisdiction of the US. Further, trusts involved in the schemes are vertically layered with each trust distributing income to the next layer. The goal of this layered distribution of income is to fraudulently reduce taxable income to nominal amounts.

The Business Trust-

Some trust promoters are advising taxpayers to transfer their on-going business to Business Trusts. This scheme gives the appearance that the taxpayer has given up control of his/her business to a trust; however, in reality the taxpayer is still running the day-to-day activities of

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[4] Not so fast with the name calling! The unicorporated business organization (IRS and State of California terminology ... not ours) is not a trust. It is a common law contract between two or more persons cast in the form of a trust. Bottom line ~ UBOs are not trusts under IRC §§ 671 - 678.

[5] This article uses the words “avoidance” and “evasion” quite often equating them to the same thing - illegal. In northern California; Interstate 80 West abruptly ends at the San Francisco Bay Bridge. Motorists are given three choices: (1) pay [*voluntarily comply*] the $2.00 toll and drive over the bridge, or (2) turn south to San Jose and come back north on Hwy 101 without paying [*avoid*] the tax (toll), or (3) run the toll booth [*evasion*] and try to get over the 7 mile bridge before the CHP nabs you. One and Two are legal - Three is not!

[6] "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands." Judge Learned Hand in Helvering v. Gregory, 69F.2d 809.

business [7] and is controlling its income stream. This is accomplished through trustees or other entities **<u>controlled by the taxpayer</u>**. [Emphasis Added.]

The Equipment or Service Trust-
The Equipment or Service trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust.

The Family Residence Trust-
Taxpayers are being advised to transfer family residences, including furnishings, to trusts. These trusts sometimes rent the residence back to the taxpayer. They also deduct depreciation and the expenses of maintaining and operating the residence, such as gardening, pool service, and utilities.

The Charitable Trust-
Taxpayers are receiving advice to transfer assets or income to trusts claiming to be charitable organizations. These trusts or "charitable organizations" pay for personal, educational, or recreational expenses on behalf of the taxpayer or family members. The payments are then claimed as "charitable" deductions on the trust tax return.

Foreign Trusts-
These trusts are often domiciled in a foreign country that imposes little or no tax on trusts and also provide financial secrecy. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to the original owner, purportedly tax-free. These trusts are usually used in combination with a foreign corporation and foreign bank account.

Buyer Beware! Recognizing a Fraudulent Trust. Common Warning Signs:

- A promise to reduce or eliminate income and self-employment tax;

- Deductions for personal expenses paid by the trust;

- Depreciation deductions on an owner's personal residence and furnishings;

- High fees for trust packages, to be offset by promised tax benefits;

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[7] If the trust is not controlled by an independent trustee ... the trust is truly fraudulent. However, independent trustees are not [*yet*] prohibited by law from hiring whoever they want to manage the day-to-day activities, sell the products, stock the shelves, sweep floors, write checks, etc. provided they don’t discriminate based on race, color, creed, religion, or national origin.

- Use of back-dated documents and post office boxes for trust addresses;

- Unjustified replacement of trustee;

- Lack of an independent trustee;

- Use of terms such as pure trust, constitutional trust, sovereign trust, or unincorporated business organization.

Just the Facts

It is estimated that $4.8 trillion in wealth will be inherited or transferred from one generation to the next by 2015, with much of it transferred through a variety of trusts. Filings of trust returns (Form 1041's) are now the third most frequently filed income tax return behind individual and corporate returns. Although the vast majority of these transfers are legal, there is widespread potential for fraud [8].

In Fiscal Year 1999, Criminal Investigation elevated abusive foreign and domestic trusts from an emerging issue to a program area. This elevation was due to the proliferation of abusive promotions in the US. These promotions are targeted towards wealthy individuals, small business owners, and professionals such as doctors, lawyers, and dentists. The promotions, which are in some instances distributed by a national network of promoters, promise taxpayers substantial tax reduction and asset protection. In reality, these promotions are nothing more than complex tax evasion schemes [9].

The IRS takes fraudulent trust arrangements seriously. It is a matter of maintaining public confidence in the fairness of the tax laws. Recommending prosecution of those who violate the tax laws demonstrate the IRS' commitment to ensuring all taxpayers pay their fair share of taxes.

Civil and Criminal Outcomes

If a taxpayer chooses to participate in a trust that improperly avoids [10] or evades income tax, that

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[8] Endron, World Com, etc. were not business trusts. In fact the first is a corporation with many smaller limited partnerships and the latter a corporation. No one suspects that all partnerships and corporations are abusive or fraudulent. Business trusts are the “ugly duckling” of the IRS.

[9] Extremely subjective statement. Even the IRS states that business trusts with economic reality and business objectives are legal. Remember, 1041 returns are the third ranking form of corporate filings in US. They can’t all be “shams”.

[10] Again, we do not know what it is to “improperly avoid” income tax. This commentator had the opportunity to accept a great job paying $135,000 per year plus perks but turned it down because

person will not be shielded from payment of taxes, interest, and penalties due. Evasion of income taxes may result in a civil fraud penalty or criminal prosecution:

- Civil fraud can include a penalty up to 75 percent of the underpayment of tax attributable to the fraud in addition to the taxes owed.

- Criminal conviction may result in fines up to $250,000 and/or up to five years in prison for such offenses.

Since the 1990's there has been a substantial increase in both civil examinations and criminal investigations. The tax court has consistently found against abusive schemes, deeming them shams [11] or simply grantor trusts that do not deliver the promised tax benefits.

Following false, misleading, or unorthodox tax advice is seldom free. Up front you pay fees or commissions to subscribe to fraudulent trust schemes and in the end; unfortunately, you pay even more in penalties, interest and fines for following bad advice.

Knowingly participating in fraudulent trust arrangements has led to the incarceration and/or financial ruin of many taxpayers.

The bottom line is Don't Buy In!

Too Good - Exhibit A

A physician was sentenced to 37 months imprisonment followed by 3 years supervised release, and ordered to pay $414,819 in restitution to the IRS for tax evasion for the years 1992 through 1996. The physician created trusts, including one for his family residence, that he controlled and used to conceal his taxable income. In addition, he transferred funds between trusts, offshore corporations, and their corresponding bank accounts located in the US, Bahamas, and the Channel Islands in order to conceal taxable income.

Too Good - Exhibit B

A father and his sons were sentenced to 60, 57, and 46 months imprisonment followed by three years of supervised release, respectively, for conspiracy to defraud the IRS and for failing to file tax returns. A Federal jury found them guilty in an attempt to conceal income, assign their

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of the income tax ramifications it would cause. Is this an improper avoidance of income tax?

[11] The fact is the number of prosecutions and imprisonment of abusive trusts taxpayers or promoters is no more than the national average for other fraudulent entities or returns; i.e., 1040s, 1040EZs 1065s, 1120s, non filer, etc.

income to several nominees and purported irrevocable trusts that had no economic substance. As part of the conspiracy, they used several bank accounts opened in trust and other names to conceal insurance commission receipts and proceeds from the sale of certificates of deposits and coins. They also attempted to conceal their assets from the IRS by the conveyance of real property from their names to purported trusts and nominees. In addition to their imprisonment, the judge in the case ordered them to pay fines of $413,500 and restitution in excess of $635,000 to the IRS.

Too Good - Exhibit C

A former CPA was sentenced to 87 months imprisonment for defrauding the IRS by promoting bogus trusts. In addition, an attorney and a former legislative aide were sentenced for their involvement in the scam. The men sold packages of bogus trusts to clients and advised them on how to use trusts to generate fraudulent tax deductions. Clients of these individuals put businesses, homes, and other assets in trusts, but in fact continued to control those assets. Clients claimed various personal expenses related to the bogus trust on their tax returns including depreciation of personal residences, house cleaning, lawn care, and scholarships for their children. The judge in the case found that the trust scheme cost the federal and state government more than $2.5 million in lost tax revenue.

For more information about what the Federal Courts REALLY say about fraudulent trusts...

See Criminal cases United States v. Scott and United States v. Noske at - www.findlaw.com

Criminal Investigations Initiated ._._._._._._._._ 67
Prosecutions Recommended _._._._._._._._._._._ 57
Incarceration Rate _._._._._._._._._._._._._._._._ 85.7
Average Month Sentenced to Serve in prison _._._ 35

Tax News is published by the Public Affairs Office, Southern California District. Please send ideas or comments to IRS, Public Affairs Office, Attn: Tax News Editor, P.O. Box 30210, Laguna Niguel, CA 92607-0210, or e-mail them to socal@irs.gov

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Endnote:

[**Tax evasion is a crime punishable under 26 U.S.C. 7201.** The commentator recommends that all Americans follow the law at all times but warns that one should not be intimidated by false and inflated literature whose only purpose is to intimidate and scare into “voluntary compliance”.]