

ABUSIVE TRUST SCHEMES

Abstract:

This material defines the basic format of trusts. It also discusses why some trusts are abusive and why IRS has targeted them with audits.

INTRODUCTION

According to the *Journal of Accountancy*, more than \$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. Trust and estate matters are the third highest areas of growth among top CPA firms. Domestic trusts filed 3.4 million Forms 1041, U.S. Income Tax Return for Estates and Trusts, returns in 1998 making it the third most frequently filed income tax return behind individual and corporate returns.

In the last few years there has been a proliferation of abusive trust tax evasion schemes. Abusive trust arrangements are typically promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. The promised benefits may include reduction or elimination of income subject to tax, deductions for personal expenses paid by the trust, depreciation deductions of an owner's personal residence and furnishings, a stepped-up basis for property transferred to the trust, the reduction or elimination of self-employment taxes, and the reduction or elimination of gift and estate taxes.

The trusts involved in the schemes are vertically layered, with each trust distributing income to the next layer. The result of this layered distribution of income is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, assets in these schemes are in fact controlled and directed by the taxpayer.

A network of promoters and subpromoters, who may charge anywhere from \$5,000 to \$70,000 for a package, often sponsor such schemes. The fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees as offered by promoters, and to use foreign bank accounts and corporations.

BASIC TRUST TAXATION

A trust is a form of ownership that is controlled and managed by a designated independent trustee so as to completely separate the responsibility and control of assets from the benefits of ownership. There are numerous types of legal trust arrangements, and they are commonly used for estate planning, charitable

purposes, and holding assets for beneficiaries. An independent trustee manages the trust, holds legal title to trust assets, and exercises independent control.

All income that a trust receives, whether from foreign or domestic sources, is taxable to the trust, the beneficiary, or the taxpayers unless specifically exempted by the Internal Revenue Code (IRC).

Distributions. A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate income by making distributions to other trusts or to other entities as long as they are named as beneficiaries. This distribution of income is key to understanding the fraudulent nature of the abusive schemes. **In fraudulent schemes, bogus expenses are charged against trust income at each trust layer.** After the deduction of these expenses, the remaining income is distributed to another trust, and the process is repeated. The result of the distributions and fraudulent deductions is to reduce the amount of income ultimately reported to the IRS.

Forms to File. A domestic trust must file a Form 1041 for each taxable year. If the trust is classified as Domestic Grantor Trust, it is not generally required to file a Form 1041, provided the individual taxpayer reports all items of income on his or her Form 1040, U.S. Individual Income Tax Return. Thus, the individual pays the total tax liability upon the filing of his or her return for the taxable year. All income received by a trust, whether from foreign or domestic sources, is taxable to the trust, beneficiary, or taxpayer unless specifically exempted by the Internal Revenue Code.

Foreign trusts are subject to special filing requirements. If a trust has income that is effectively connected with a U.S. trade or business, it must file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Foreign Gifts, must be filed on the creation of or transfer of property to certain foreign trusts. Form 3520-A, Annual Information Return of Foreign Trusts With U.S. Owner, must also be filed annually.

Foreign trusts may be required to file other forms as well. Foreign trusts to which a U.S. taxpayer has transferred property are treated as grantor trusts as long as the trust has at least one U.S. beneficiary. The income the trust earns is taxable to the transferor under the grantor trust rules. Grantor trusts are not recognized as separate taxable entities because, under the terms of the trust, the grantor retains one or more powers and remains the owner of the trust income. In such a case, the trust income is taxed to the grantor.

In addition to filing trust returns as just described, a taxpayer may be required to file U.S. Treasury Form TD 90-22.1, Foreign Bank and Financial Accounts Report, if the taxpayer has an interest of over \$10,000 in foreign bank accounts, securities, or other financial accounts. Also, a taxpayer may be required to

acknowledge an interest in a foreign bank account, security account, or foreign trust on Schedule B, Interest and Dividend Income, which is attached to Form 1040.

ABUSIVE DOMESTIC TRUST SCHEMES

As stated above, trust schemes are usually offered in a series of trusts that are layered upon one another. They are typically promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. These trusts can include the following:

1. Asset Management Company. In many promotions, taxpayers are advised to create an **Asset Management Company (AMC)**. The AMC, which lists the taxpayer as the director, is formed as a domestic trust. An individual on the promoter's staff is usually the trustee of the AMC, but the taxpayer quickly replaces this individual. The purpose of the AMC is to give the appearance that the taxpayer is not managing his or her business and to start the layering process.

2. Business Trust. The next step is to form a business trust, also a domestic trust. In effect, the client elects to **change the structure of the business from either a sole proprietorship or corporation to a trust**. The AMC is the trustee of the business trust. Administrative expenses may be deducted from the trust as a means of reducing taxable income. The scheme gives the appearance that the taxpayer has given up control of the business to a trust; however, in reality the taxpayer is still running the day-to-day activities of the business and is controlling its income stream.

3. Equipment or Service Trust. An 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.

4. Family Residence Trust. In some instances, taxpayers are being advised to distribute remaining income from the business trust to a family residence trust. Family residences, including furnishings, are transferred to this trust. These trusts sometimes rent the family residence back to the owner. These trusts may attempt to deduct depreciation and such expenses of maintaining and operating the residence as gardening, pool service, and utilities.

5. Charitable Trust. In many promotions, the **last layer** of trust is the charitable trust. 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. After personal and nonallowable expenses are deducted from the charitable

trust, any remaining balance of income, usually a nominal amount, is distributed to the taxpayer.

ABUSIVE FOREIGN TRUST SCHEMES

Similar to the domestic arrangements, foreign packages usually start off with an AMC—a business trust—and distribute income to several trust layers. These foreign promotions, however, also attempt to take funds offshore and outside U.S. jurisdiction. These schemes involve offshore bank accounts, trusts, and International Business Corporations (IBCs) created in “tax haven” countries.

Practitioner Note. An IBC is a corporation set up offshore in a jurisdiction where the tracing of ownership by U.S. authorities is very difficult. Due to the difficulty in tracing the ownership of IBCs, these entities are used quite often in tax evasion schemes.

1. AMC. As with the domestic arrangement, the first step in these schemes is for the taxpayer to form an AMC.

2. Business Trust. The next step is to form the business trust, again very similar to the domestic scheme.

3. Foreign Trust One. Next, a foreign trust is formed in a tax haven country, and the income from the business trust is distributed to this trust. For our purposes, this foreign trust will be referred to as “foreign trust one.” In many cases, the AMC will be the trustee of foreign trust one. Due to the fact that the source of the income is U.S. based, and there is a U.S. trustee, this foreign trust has filing requirements as discussed above.

4. Foreign Trust Two. The next step is to form a second foreign trust or “foreign trust two.” All the income of foreign trust one is distributed to foreign trust two. Either foreign trust one or a foreign member of the promoter's staff becomes the trustee of foreign trust two. (If the trustee is foreign trust one, the taxpayer still controls foreign trust two by the fact that he or she is in control of foreign trust one's trustee, through the directorship of the AMC.) If a foreigner is the trustee of foreign trust two, the taxpayer is empowered by the promoter to overrule any decisions by this trustee. In either case, the taxpayer is in control of foreign trust two.

Promoters will claim to taxpayers that since the trustee and the source of income are now foreign, there are no U.S. filing requirements. Promoters also advise taxpayers that since the trusts are formed in tax haven countries it is impossible for the IRS to determine who is in control of the trusts. In actuality, the taxpayer has never relinquished control of his or her business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.

SUBSTANCE—NOT FORM—CONTROLS TAXATION

The Supreme Court of the United States has consistently stated that the substance, rather than the form, of the transaction is controlling for tax purposes. See, for example, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Clifford*, 309 U.S. 331 (1940). Under this doctrine, **abusive trust arrangements may be viewed as sham transactions**, and the IRS may ignore the trust and its transactions for federal tax purposes.

In *Markosian v. Commissioner*, 73 T.C. 1235 (1980), the court held that the trust was a **sham** because the parties did not comply with the terms of the trust, and the supporting documents and the relationship of the grantors to the property transferred did not differ in any material aspect after the creation of the trust.

In *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984), the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the foreign trust were all being treated as belonging directly to the owner.

IRS ENFORCEMENT STRATEGY

Individuals involved in abusive trust schemes that seek to evade tax are still liable for taxes, interest, and civil penalties. Violations of the Internal Revenue Code with the intent to evade income taxes may result in a civil fraud penalty or criminal prosecutions. Civil fraud can include a penalty of up to 75% of the underpayment of tax attributable to fraud, in addition to the taxes owed. Criminal convictions of promoters and investors may result in fines up to \$250,000 and up to five years in prison.

The IRS has recently undertaken a national, coordinated strategy to address fraudulent trust schemes. The enforcement strategy for combating these schemes is to focus primarily on promoters and on clients who have willfully used the promotion to egregiously evade tax.

FALSE CLAIMS USED BY PROMOTERS

1. False Claim. Establishing a trust will reduce or eliminate income taxes or self-employment taxes.

1.

Truth. Taxes must be paid on the income or assets held in trust, including the income generated by property held in trust. The responsibility to pay taxes may fall to the trust, the beneficiary, or the transferor.

2. False Claim. Individuals will retain complete control over income and assets with the establishment of a trust.

Truth. Under legal trust arrangements, individuals must give up significant 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.

3. False Claim. Taxpayers may deduct personal expenses paid by the trust on their tax return.

Truth. Nondeductible personal living expenses cannot be transformed into deductible expenses by virtue of assigning assets and income to a trust.

4. False Claim. Taxpayers can depreciate their personal residence and furnishings and take them as deductions on their tax return.

Truth. Depreciation of a taxpayer's residence and furnishings used solely for personal use does not become deductible by virtue of assigning the residence to a trust.

RECENT CRIMINAL CONVICTIONS

1. CHAPPELL, ET AL. INVESTIGATION

In May 1999, Ronald Chappell, a former CPA from Roseville, California, was sentenced to **87 months imprisonment** for defrauding the IRS by promoting bogus trusts. In addition to Chappell, Todd Gaskill, an attorney, Martin Goodrich, and Lloyd Winburn, a former legislative aide in Sacramento, were sentenced to 58, 37, and 63 months of imprisonment, respectively, 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. On their tax returns, clients claimed various personal expenses related to the bogus trusts, including depreciation of personal residences, lawn care, house cleaning, and scholarships for their children.

In another scheme directed at high-income taxpayers, Chappell, Gaskill, and Goodrich instructed clients to conceal income from the IRS through a series of bank accounts in the U.S. and the Caribbean. The judge in the case found that the trust scheme deprived the federal and state governments of more than \$2.5 million in tax revenue.

2. BRADLEY INVESTIGATION

In June 1999, Edgar Bradley and his sons, Edgar Bradley II and Roy Bradley were sentenced to 60, 57, and 46 months of imprisonment, respectively, followed by three years supervised release, for conspiracy to defraud the IRS and for failing to file tax returns.

In an attempt to conceal income, the Bradleys, who were found guilty by a federal jury, assigned their income to several nominees and purported irrevocable trusts that had no economic substance. As part of the conspiracy, the Bradleys used several bank accounts opened in trust and other names to conceal insurance commission receipts and proceeds from the sale of certificates of deposit and coins.

The Bradleys 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 the Bradleys to pay fines of \$413,500 and restitution in excess of \$636,000 to the IRS.**

3. RIVERA INVESTIGATION

In January 1999, Pedro Ivan Rivera, a physician in Carrollton, Texas, was sentenced to 37 months of imprisonment, followed by three years supervised release, and was ordered to pay \$414,819 in restitution to the IRS for **tax evasion** for the years 1992 through 1996. Rivera created trusts, including one for his family residence, that he controlled and used to conceal his income.

In addition, Rivera transferred funds among trusts, offshore corporations, and their corresponding bank accounts located in the U.S., the Bahamas, and the Channel Islands, in order to conceal taxable income.

4. MORRIS INVESTIGATION

In July 1999, James C. Morris of Cincinnati, Ohio, was sentenced to 24 months of imprisonment followed by three years supervised release for **tax evasion** and for attempting to interfere with the administration of the IRS. Morris, who pleaded guilty, admitted that he did not file a Federal income tax return or pay substantial tax due for 1992 on the sale of certificates of deposit.

As part of his scheme, Morris used nominee trusts to conceal his income and assets from the IRS. Morris admitted that he impeded the IRS by **selling sham** trusts that were used to conceal assets and income from the IRS and others. Morris also admitted that he was a member of the Liberty Foundation, an organization that sold “untaxing packages” and assisted its members in circumventing the filing of Federal income tax returns and payment of Federal income tax. Morris sold these “untaxing packages” and sham trusts through his business, Excellence in Planning Associates. In addition to imprisonment, the

judge ordered Morris to pay a \$5,000 fine and restitution to the IRS in the amount of \$41,686.

ADDITIONAL INFORMATION

More information about trusts can be found on the IRS Web site at www.irs.gov. Information on the IRS policy regarding fraudulent trusts can be found in Public Announcement Notice 97-24 and Publication 2193, *Too Good to Be True Trusts*, contains information on **abusive trust schemes** that advertise bogus benefits. Both of these documents are also available on the IRS Web site.

<p>Practitioner Note. To report abusive trust tax evasion schemes call (800) 829-0433.</p>
