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Abusive Trust Tax Evasion Schemes - Talking Points

Talking Points

- Trust/estate matters are the third highest area of growth among top CPA firms.
- Domestic trusts filed 3.03 million Form 1041 returns for tax year 2008 and 2.9 million Form 1041 returns for tax year 2009; the third most frequently filed income tax return behind individual and corporate returns.
- Since the mid-1970s the number of Form 1041 returns filed has doubled and there has been a proliferation of abusive trust schemes marketed to avoid or evade income taxes.
- Facts about trusts:
  - A trust is a legal entity formed under state law. To create a trust, legal title to property is conveyed to a trustee, who is then charged with the responsibility of using that property for the benefit of another person, called the beneficiary, who really has all the benefits of ownership, except for bare legal title.
  - Legal 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.
  - A trustee is designated to hold legal title to the trust property, to exercise independent control over it, and to be responsible for its management.
  - All trusts must comply with the tax laws as set forth by the Congress in the Internal Revenue Code, Sections 641-683.
  - Trusts established to hide the true ownership of assets and income or to disguise the substance of financial transactions are considered fraudulent trusts.
  - Taxpayers are responsible for payment of their taxes as set forth by Congress regardless of who prepares their return.
- Trusts are also being used to reduce income taxes through a variety of abusive techniques not allowed by the Internal Revenue Code:
  - To depreciate personal assets (such as a home);
  - To deduct personal expenses;
  - To split income over multiple entities, often filed in multiple locations;
  - To underreport income;
  - To avoid filing returns;
  - To wire income overseas and fail to report it; and
  - To attempt to protect transactions through bank secrecy laws in tax haven countries
- Trusts continue to grow in number despite the following:
  - Professional and setup costs can be significant.
  - Increased complexity in filing and reporting of trust and trust-related returns:
    - Form 1041, U.S. Income Tax Return for Estates and Trusts
    - Form 1041A - U.S. Information Return Trust Accumulation of Charitable Amounts
    - Form 3520 - Annual Return to Report Transactions with Foreign Trusts
    - From 3520A, Annual Information Return of Foreign Trust With a U.S. Owner
    - Form 926, Return by a U.S. Transferor to a Foreign Corporation
    - Form 114, FinCEN Report
    - Form 709, U.S. Gift Tax Return
    - Form 5227, Split-Interest Trust Information Return
    - Form 56, Notice Concerning Fiduciary Relationship
    - Form 1040NR, U.S. Nonresident Alien Income Tax Return
    - Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
    - Form 8804, Annual Return for Partnership Withholding Tax (under section 1446)
  - Risk of significant penalties for failure to comply. For example, failure to file penalty for Form 3520 is 35% of the property transferred to a foreign trust.
  - No income tax advantages.
  - Trust tax rates are high compared to 1040 and 1120. (For 2003, the 35% maximum rate is reached by trusts with $9,350 of taxable income. Individuals filing jointly do not reach the 35% rate until they have $311,950 of taxable income.)
  - The Internal Revenue Code generally does not allow trusts to operate a trade or business. The regulations require that trusts operating a trade or business be treated as either a

corporation or partnership if the grantor, beneficiary or fiduciary materially participates in the operations or daily management of the business. If the grantor maintains control of the trust, then grantor trust rules will apply and income and expenses of the business will be attributed directly to the grantor.
    - Grantor is treated as owner, and therefore taxable on income generated by a trust where the grantor is considered the substantial owner or enjoys the benefits of the corpus or income from the trust.
    - Tax courts, federal courts, and bankruptcy courts have been virtually unanimous in finding for the Service where trusts are created to avoid income taxes.
- Currently, there are two abusive trust arrangements being promoted:
    - The "domestic package" and
    - The "foreign package".
- The domestic package involves a series of trusts formed in the U.S., while the foreign trust packages are formed offshore and outside the jurisdiction of the U.S. Trusts involved in both schemes are vertically layered with each trust distributing income to the next layer. The goal of this layered distribution of income is to reduce taxable income to nominal amounts.
- Promoters of abusive trust arrangements use a variety of methods to advertise their schemes including seminars, flyers, and the Internet.
- The main selling point of abusive trust arrangements is they give the appearance a person is giving up control of their assets and money, when in reality they still control how the money and assets are used.
- The public should not be misled by the word "trust". Mere association of the term "trust" with a financial arrangement does not make it a legitimate trust for federal income tax purposes. No matter how carefully written the trust documents are, if the intent is to evade taxes, the trust will be treated as abusive.
- False Claims Used to Promote Abusive Trust Arrangements:
    - **False Claim** - Establishing a trust will reduce or eliminate income taxes or self-employment taxes.
    - **Truth** - The transfer of assets to a trust will give the donor no additional tax benefit. 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.
    - **False Claim** - You can transfer your income into a trust, thus eliminating income taxation on that income.
    - **Truth** - Income remains taxable to the individual who earns it. Lucas v. Earl, 281 U.S. 111 (1930).
    - **False Claim** - You will retain complete control over your income and assets with the establishment of a trust.
    - **Truth** - Under non-grantor trust arrangements, you must give up significant control over income and assets. A trustee is designated to hold legal title to the trust assets, to exercise independent control over the trust, and to manage the trust.
    - **False Claim** - Taxpayers may deduct personal expenses paid by the trust on their tax return.
    - **Truth** - Non-deductible personal living expenses cannot be transformed into deductible expenses by virtue of assigning assets and income to a trust.
    - **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 personal residence and furnishings is not deductible by virtue of assigning the residence to a trust.
- To stop Abusive Trust Promoters, the IRS has recently undertaken a national coordinated strategy to address abusive trust schemes. For more details about the IRS policy regarding abusive trusts, refer to IRS Public Announcement Notice 97-24, which warns taxpayers to avoid abusive trust schemes that advertise bogus tax benefits.
- IRS Service Center personnel are being trained to review, to recognize fraud risk factors, and refer suspicious returns to IRS Compliance for an audit or IRS Criminal Investigation for criminal prosecution.
- Should a taxpayer choose to participate in an abusive trust scheme, the taxpayer will not be shielded from potential civil and criminal sanctions.
- Violations of the Internal Revenue Code may result in civil penalties and/or criminal prosecution.
    - Civil sanctions can include a fraud penalty up to 75% of the underpayment of tax attributable to the fraud in addition to the taxes owed.
    - Criminal convictions may result in fines up to $250,000 and/or up to five years in prison for each offense.
- In conclusion, the IRS takes abusive 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 demonstrates the IRS' commitment to ensure that all taxpayers pay their fair share of taxes.

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