Internal Revenue Service
United States Department of the Treasury

Abusive Trust Tax Evasion Schemes - Facts (Section I)

Facts

I. Background

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) 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.

In the last few years, the Internal Revenue Service has detected a proliferation of abusive trust tax evasion schemes. These promotions are targeted towards wealthy individuals, small business owners, and professionals such as doctors and lawyers.

Abusive trust arrangements typically are promoted by the promise of such benefits as:

- Reduction or elimination of income subject to tax.
- Deductions for personal expenses paid by the trust.
- Depreciation deductions of an owner's 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.
- The reduction or elimination of gift and estate taxes.

Abusive trust arrangements often use trusts to hide the true ownership of assets and income or to disguise the substance of transactions. Although these schemes give the appearance of separating responsibility and control from the benefits of ownership, as would be the case with legitimate trusts, the taxpayer in fact controls them.

These arrangements frequently involve more than one trust, each holding different assets of the taxpayer (the taxpayer's business, equipment, home, automobile, etc.), as well as interests in other trusts. The trusts are vertically layered, with each trust distributing income to the next layer. Funds may flow from one trust to another trust by way of rental agreements, fees for services, purchase and sale agreements, and distributions. The goal is to use inflated or nonexistent deductions to reduce taxable income to nominal amounts.

Although the individual abusive promotions vary, two basic schemes have been identified:

- The domestic package, and
- The foreign package.

These schemes are often promoted by a network of promoters and sub-promoters who have charged $5,000 to $70,000 for their packages. This 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. In some instances, tax return preparer services are also made available.

Taxpayers should be aware that abusive trust arrangements will not produce the tax benefits advertised by their promoters and that the IRS is actively examining these types of trust arrangements. Furthermore, in appropriate circumstances, taxpayers and/or the promoters of these trust arrangements may be subject to civil and/or criminal penalties.

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