



Internal Revenue Service Criminal Investigation Tax Fraud Alert

Abusive Tax Schemes

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Overview

Since the mid-1990s, the IRS has witnessed a proliferation of abusive tax schemes, particularly those with offshore components. Originally those schemes took the structure of abusive domestic and foreign trust arrangements. However, abusive schemes are evolving into sophisticated arrangements that take advantage of the financial secrecy laws of some foreign jurisdictions and the availability of credit/debit cards issued from offshore financial institutions.

IRS Criminal Investigation (CI) has developed a nationally coordinated program to combat these abusive tax schemes. CI's primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme (e.g., accountants, lawyers). Secondly, but equally important, is the investigation of investors who knowingly participate in abusive tax schemes.

What is an Abusive Tax Scheme?

The Abusive Tax Schemes program encompasses violations of the Internal Revenue Code (IRC) and related statutes where multiple flow-through entities are used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of trusts, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), Inter-

national Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

Form over substance are the most important words to remember before buying into any arrangements that promise to "eliminate" or "substantially reduce" your tax liability. The promoters of abusive tax schemes often employ financial instruments such as trusts in their schemes. However, the instruments are used for improper purposes including the facilitation of tax evasion.

What are some of the Most Common Abusive Tax Schemes?

Tax evasion using foreign jurisdictions is accomplished using many different methods. Some can be as simple as taking unreported cash receipts and personally traveling to a tax haven country and depositing the cash into a bank account. Others are more elaborate involving numerous domestic and foreign trusts, partnerships, nominees, etc. The following schemes are not all-inclusive, but just a sample of abusive tax schemes.

Abusive Foreign Trust Schemes: The foreign trust schemes usually start off as a series of domestic trusts layered upon one another. This set up is used to give

the appearance that the taxpayer has turned his/her business and assets over to a trust and is no longer in control of the business or its assets. Once transferred to the domestic trust, the income and expenses are passed to one or more foreign trusts, typically in tax haven countries.

As an example, a taxpayer's business is split into two trusts. One trust would be the business trust that is in charge of the daily operations. The other trust is an equipment trust formed to hold the business's equipment that is leased back to the business trust at inflated rates to nullify any income reported on the business trust tax return (Form 1041). Next the income from the equipment trust is distributed to foreign trust-one, again, which nullifies any tax due on the equipment trust tax return. Foreign trust-one then distributes all or most of its income to foreign trust-two. Since all of foreign trust-two's income is foreign based there is no filing requirement.

Once the assets are in foreign trust-two, a bank account is opened either under the trust name or an International Business Corporation (IBC). The trust documentation and business records of this scheme all make it appear that the taxpayer is no longer in control of his/her business or its assets. The reality is that nothing ever changed. The taxpayer still exercises full control over his/her business and assets. There can be many different variations to the scheme.

Where Do You Report Suspected Tax Fraud Activity?

If you suspect tax fraud or know of an abusive return preparer, you should report this activity to your nearest Internal Revenue Service office. This information can be communicated by phone or in writing to your local IRS office.

You can contact the IRS by phone at 1-800-829-0433.

International Business Corporations (IBC): The taxpayer establishes an IBC with the exact name as that of his/her business. The IBC also has a bank account in the foreign country. As the taxpayer receives checks from customers, he sends them to the bank in the foreign country. The foreign bank then uses its correspondent account in the to process the checks so that it never would appear to the customer, upon reviewing the canceled check that the payment was sent offshore. Once the checks clear, the taxpayer's IBC account is credited for the check payments. Here the taxpayer has, again, transferred the unreported income offshore to a tax haven jurisdiction.

False Billing Schemes: A taxpayer sets up an International Business Corporation (IBC) in a tax haven country with a nominee as the owner (usually the promoter). A bank account is then opened under the IBC. On the bank's records the taxpayer would be listed as a signatory on the account. The promoter then issues invoices to the taxpayer's business for goods allegedly purchased by the taxpayer. The taxpayer then sends payment to the IBC that gets deposited into the joint account held by the IBC and taxpayer. The taxpayer takes a business deduction for the payment to the IBC thereby reducing his/her taxable income and has safely placed the unreported income into the foreign bank account.

How Does the Taxpayer Access the Funds in Offshore Accounts?

Although the unreported funds sitting in the offshore bank account are earning interest or being used for investment purposes, most of the time the taxpayer wants to have access to the money. There are several methods used to get the funds back to the taxpayer, but the following are the most common.

Fraudulent Loans: The taxpayer's International Business Corporation (IBC) will make a loan to the taxpayer. The funds are wire transferred back to the taxpayer's

U.S. bank account. Since these wired funds are allegedly loans they are not taxable. Many times ownership of the IBC is through bearer shares so it is very difficult to prove that the loan is a complete sham. Further adding to the difficulty is the fact that the promoters provide their clients with loan documents to make the transaction appear legitimate.

Credit/Debit Card: One of the most popular methods in recent years has been use of the bankcard to access offshore funds. Once the foreign bank account is established, the taxpayer is issued a bank card. The taxpayer can use the bankcard in the to withdraw cash and to pay for everyday expenses.

In Partnership - IRS Criminal and Civil Enforcement and Department of Justice

The IRS criminal and civil enforcement divisions work with the Department of Justice, Tax Division to shut down these abusive schemes as quickly as possible in an effort to protect taxpayers from potential additional financial harm. Parallel civil and criminal investigations are an effective and aggressive IRS approach that halts these schemes quickly and permanently. A civil injunction against the promoter stops the scheme and prevents additional 'clients' from investing. In addition, CI shares abusive tax scheme investor lists with the civil operating divisions to ensure investor tax returns are considered for examination (audit).

Civil and Criminal Penalties

Investors of abusive tax schemes that improperly 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 prosecution. 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.

Should your Financial Portfolio include Too Good to be True Trusts?

Recognizing a problem trust. Taxpayers should look for the following common warning signs that may reveal an unscrupulous trust promotion:

- A promise to reduce or eliminate income and selfemployment 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.
- Use of back-dated documents.
- Unjustified replacement of trustee.
- Lack of an independent trustee.
- Use of post office boxes for trust addresses.
- Use of terms such as *pure trust*, *constitutional trust*, *sovereign trust* or *unincorporated business organization*.

"Taxes are what we pay for a civilized society."

Oliver Wendell Holmes

There have always been groups and/or individuals who, for a variety of reasons, have tried to circumvent the tax system. And there have always been groups and/or individuals who have made legitimate efforts to seek reform of our tax system and to simplify our tax laws. But those who participate in or assist taxpayers in structuring transactions, specifically for the purpose of evading taxes, are engaging in criminal activity.

Following false, misleading, or unorthodox tax advice is seldom free. Upfront 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.

"If it sounds too good to be true, it probably is!" Seek expert advice before you subscribe to any scheme that offers instant wealth or exemption from your obligation as a United States Citizen to pay taxes. Buying into a tax evasion scheme can be very costly.

See criminal cases United States v. Scott and United States v. Noske for what the Federal courts really say about fraudulent trusts (www.findlaw.com).

The Facts About Trusts

■ A 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.

■ All trusts must comply with the tax laws as set forth by the Congress in the Internal Revenue Code, Sections 641-683.

■ 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.

■ Taxpayers are responsible for payment of their taxes as set forth by Congress regardless of who prepares their return.

Trusts established to hide the true ownership of assets and income or to disguise the substance of financial transactions are considered Fraudulent Trusts.

False Claims Concerning Fraudulent Trust Arrangements

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

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 either the trust, the beneficiary or the transferor.

False Claim: You will retain complete control over your income and assets with the establishment of a trust.

Truth: Under legal trust arrangements, you 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.

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 residence and furnishings used solely for personal use is not deductible by virtue of assigning the residence to a trust.

Taxpayers must take responsibility for their own actions. Should a taxpayer choose to participate in a fraudulent trust scheme, the taxpayer will not be shielded from potential civil and criminal sanctions.

Don't be misled by the word "trust." Just because the name "trust" is associated with financial arrangements does not make it a legitimate trust. The following arrangements have been used to promote fraudulent trust schemes:

1. Business Trust: This involves the transfer of an on going business to a trust. Also called an unincorporated business organization, a pure trust or a constitutional trust, it makes it appear that the taxpayer has given up control of his or her business. In reality, however, through trustees or other entities controlled by the taxpayer, he or she still runs day-to-day activities and controls the business's stream of income. Such arrangements provide no tax relief.

2. Equipment or Service Trust: This 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. This type of arrangement has the same pitfalls as the business trust. It provides no tax relief.

3. Family Residence Trust: Taxpayers transfer family residence, including furnishings, to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence including, pool service and utilities. These expenses are not deductible and the IRS will disallow them.

4. Charitable Trust: Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, educational, and recreational expenses on behalf of the taxpayer or family member. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter. Therefore, contributions are not deductible.

5. Foreign Trust: These trusts often are located in foreign countries that impose 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. The trust promoter claims that this distribution is tax-free. In fact, the income from these arrangements is fully taxable.

For more details about the IRS policy regarding fraudulent trusts, read IRS Public Announcement Notice 97-24 which warns taxpayers to avoid fraudulent trust schemes that advertise bogus tax benefits.

FY 2003 Archive Significant Case Summaries

The following case summaries are excerpts from public record documents on file in the courts in the judicial district in which the cases were prosecuted.

Member of Institute of Global Prosperity (IGP) Sentenced to Tax Charges

On September 19, 2003, in Portland, Maine, Margo E. Jordan was sentenced to five years probation. Jordan pleaded guilty on February 28, 2003, to tax charges. According to the charging document filed in court, Jordan was a member of the Institute of Global Prosperity (IGP), an organization that hosted offshore seminars for promoters of abusive trusts and anti-tax schemes. Jordan marketed and sold various IGP products, including an "education course" named "Global 1" priced at \$1,250; a ticket to a three-day offshore seminar named "Global 2" priced at \$6,250; and a ticket to a five-day offshore seminar named "Global 3" priced at \$18,750. The offshore seminars included presentations by individuals and organizations involved in the sale and operation of foreign trusts designed in part to conceal income from the IRS. Documents filed in court stated that Jordan personally purchased a foreign trust and opened two bank accounts using a false tax identification number, which she used to conceal the profits she earned from the sale of IGP products.

Dentist Sentenced to 30 Months for Tax Evasion

On September 25, 2003, in Columbus, Ohio, Dr. Jon C. Pensyl, a dentist, was sentenced to 30 months in prison followed by three years supervised release. In addition, Pensyl was ordered to pay \$300,000 in restitution to the IRS, \$3,712 for costs of prosecution, a \$300 special assessment, and fined \$60,000. On May 9, 2003, Pensyl was convicted by jury on three counts of tax evasion for the years 1995, 1996, and 1997. Evidence at trial showed from 1995 through 1997, Dr. Pensyl evaded taxes on more than \$750,000 in income. Pensyl created two trust entities, Heritage Trust, Ltd., and Bennington Trust, Ltd., to which he later transferred his Arizona residences, his dental practice, his bank accounts, some of his shares of stock, and other personal assets. According to evidence at trial,

Pensyl attempted to evade his income of taxes by concealing his ownership of assets and business receipts of income through the use of these trusts and failing to file income tax returns.

Anderson's Ark Associate Sentenced to 21 Months

On August 12, 2003, in Boston, MA, Richard Castellini was sentenced to 21 months in federal prison. Castellini was convicted on July 19, 2002, of conspiracy and money laundering charges in connection with an illegal offshore trust program used to move and conceal millions of dollars overseas in an effort to avoid paying U.S. taxes. Castellini was indicted in March 2001, with five individuals connected with Anderson's Ark & Associates Organization.

Brother and Sister Sentenced for Obstruction Of Justice

On August 5, 2003, in Fresno, CA, Terri Yvonne Lewis was sentenced to 10 months in imprisonment followed by three years supervised release. Lewis' brother, Steven Lyle Anderson, was sentenced on March 31, 2003, to 10 months imprisonment. Both were sentenced for obstructing justice related to efforts to shred documents and delete information from a computer in order to avoid revealing information to a grand jury. According to the indictment filed with the court, Anderson and Lewis were members and associates of Anderson's Ark and Associates (AAA), an organization which promotes the use of trusts by individuals to avoid paying taxes. Lewis also pled guilty to the same charges on April 19, 2002. According to the plea agreements, both Lewis and Anderson admitted that, after being served with federal grand jury subpoenas February 28, 2001, requesting AAA-related documents, they deleted and operated a "wipe" program to erase AAA records and information from a computer.

Golf Course Architect Sentenced to 121 Months Imprisonment

On July 31, 2003, in West Palm Beach, Florida, Theodore M. McAnlis, a well-known golf course architect, was sentenced to 121 months imprisonment followed by three years of supervised release. In addition, McAnlis was ordered to pay the costs of prosecution and to cooperate with the IRS to pay back

taxes. On April 9, 2003, McAnlis was convicted on eight counts of income tax evasion. Evidence at trial showed that McAnlis concealed his income and assets from the IRS by using common law trusts, a sham church, false social security numbers, nominee names, and a Bahamian bank account. The estimated loss to the government was over \$1.3 million in federal taxes, penalties and interest.

Contractor Sentenced for Tax Evasion

On July 14, 2003, in Fresno, CA, Michael Gilbert was sentenced to 24 months imprisonment followed by 36 months supervised release. Gilbert pleaded guilty on December 23, 2002, to not paying more than a quarter-million dollars in taxes. By entering his plea to five counts of tax evasion, Gilbert admitted to several elaborate schemes to avoid paying over \$266,000 in federal income taxes. The methods used to hide his assets included transferring assets into trusts, using fraudulent business licenses, conducting cash transactions, using false Social Security numbers, filing inaccurate Currency Transaction Reports (CTR's), providing false taxpayer identification numbers, utilizing a concealed room within his residence to store hundreds of thousands of dollars in cash and using incorrect identifying information when opening up bank accounts and failing to file tax returns.

Promoter of Abusive Trust Scheme Sentenced to 108 Months in Prison

On May 29, 2003, in Chicago, IL, Paul E. Palmer was sentenced to 108 months in prison. In addition, Palmer was ordered to pay a fine of \$150,000, to pay restitution to the IRS in the amount of \$1,369,622, and to cooperate with the IRS to pay all of his own outstanding taxes, as well as interest and penalties. Palmer was convicted in May 2002 of conspiring to defraud the IRS by obstructing the computation, assessment, and collection of income taxes. From 1993 to 1998, Palmer promoted and sold entities he called "trusts," causing the concealment of approximately \$2.1 million in income from the IRS. Clients paid Palmer \$4,200 to \$46,000 to participate in the trust system

For more summaries, visit www.irs.gov and enter IRS Keyword Fraud.