Abusive Trust Tax Schemes

Presenter's Name
Contact Information
Date

Background

- $4.8 trillion or more in wealth will be transferred from one generation to the next by the year 2015, with much of it expected to be transferred through a variety of trusts, according to USA Today.

- Trust and estate matters are the third highest areas of growth among top CPA firms.

- Domestic trusts are the third most frequently filed income tax return behind individual and corporate returns (4.1 million Forms 1041 filed for tax year 2000).

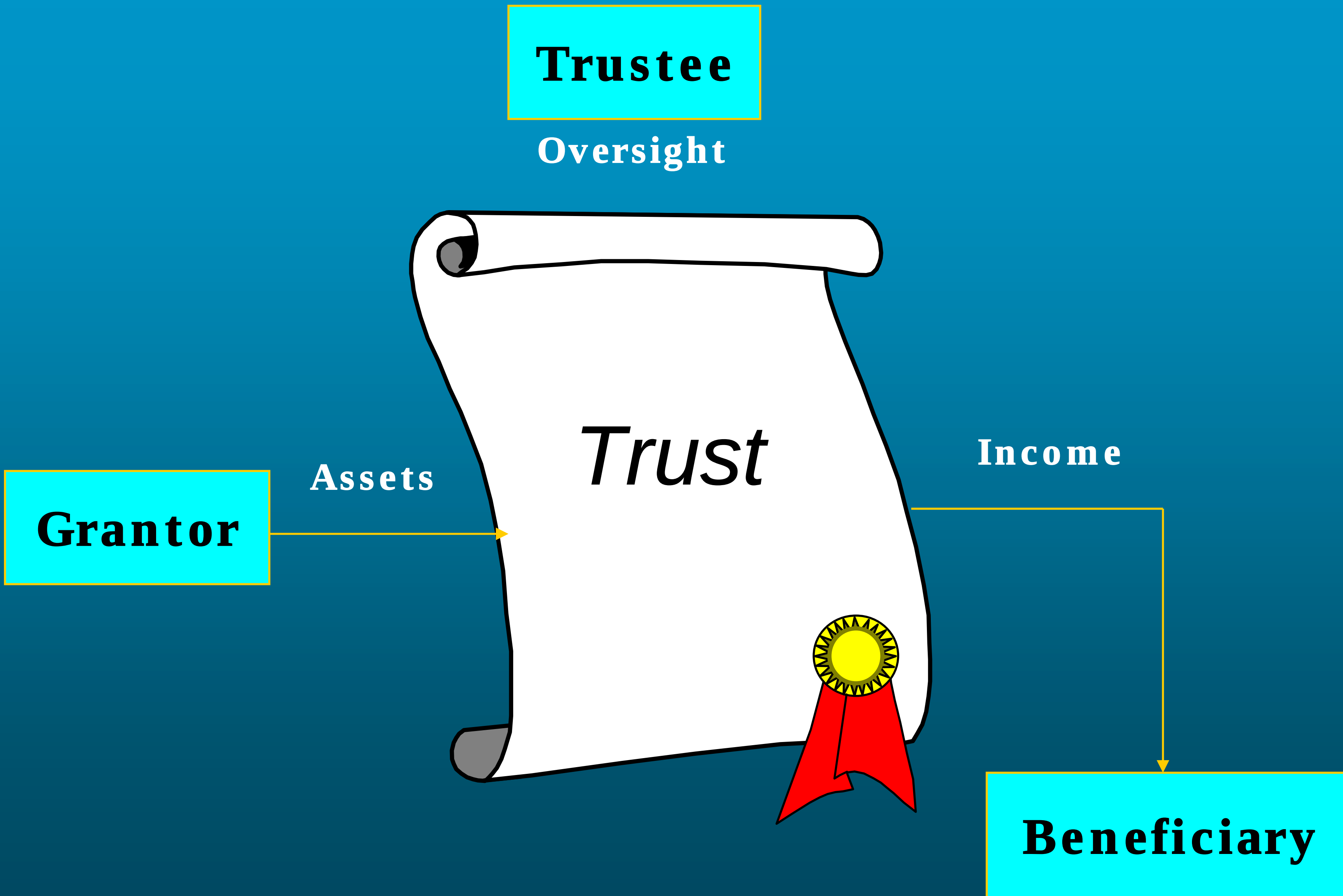
What is a Trust?

- Generally, a trust is a form of ownership that separates *responsibility* and *control* of assets from the *benefits* of ownership

- Legitimate reasons to create a trust include
  - Estate planning
  - Charitable transfer of property
  - Holding assets for minors and incompetents

Requirements of a Trust

- Grantor
- Trustee
- Corpus
- Beneficiaries


Trustee
Oversight
Trust
Assets
Grantor
Income
Beneficiary

Federal Taxation

- Federal tax is due on trust income

- Taxation may occur at one, two, or all three levels:

  1. The trust level
  2. The beneficiary level (for distributions received)
  3. The grantor level

Tax Ramifications

- Placing assets in “Trust” is basically an income tax neutral transaction
- Pre-trust – Income was taxed to the owner of the assets (the Grantor)
- Post-trust – Income is taxed to:
  - The Trust
  - The Beneficiary (to the extent distributed)
  - Still to the Grantor (if a Grantor Trust)

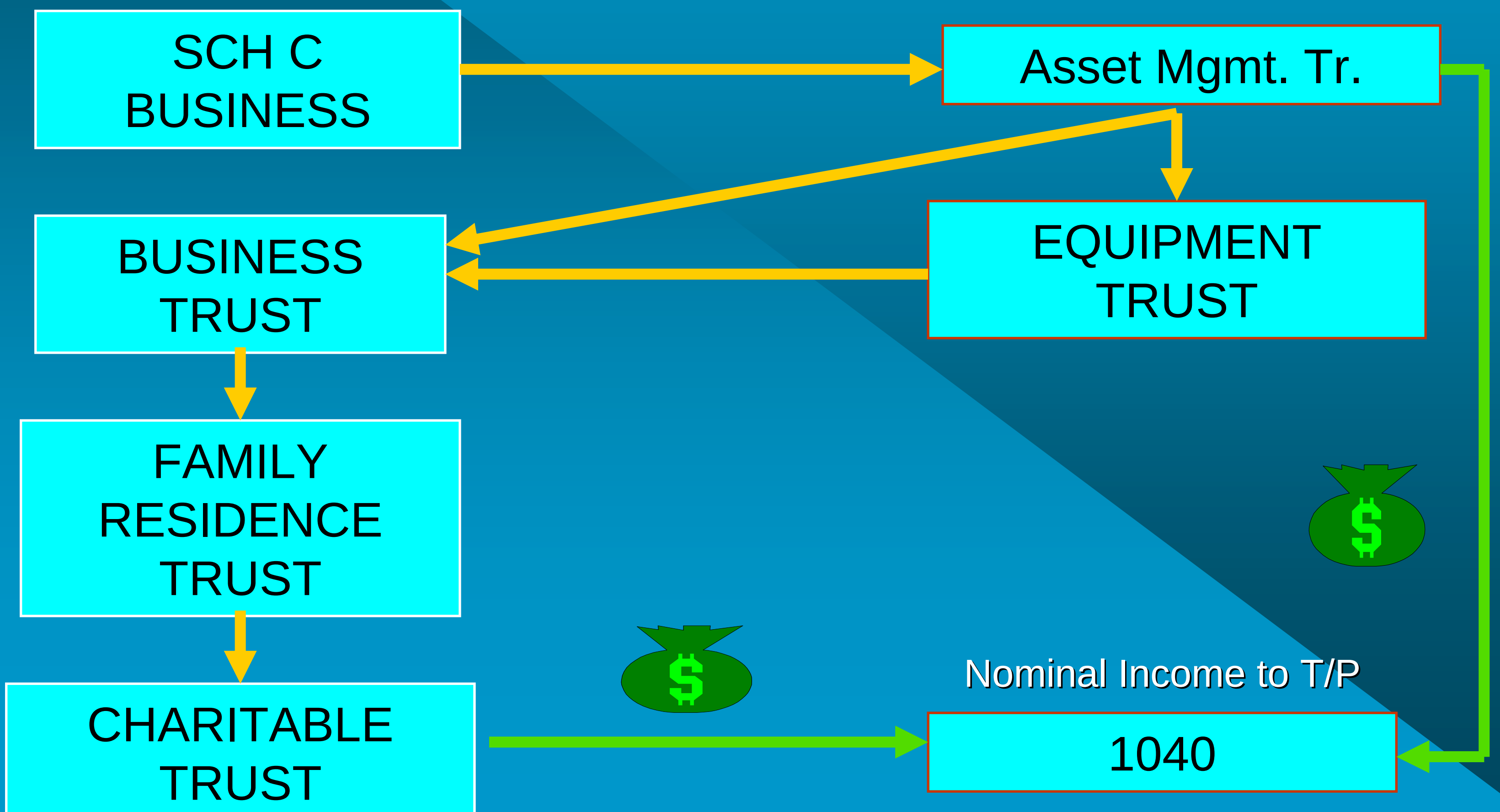
What makes a trust abusive?

- Two fraudulent arrangements are being promoted:
  - *Domestic Packages* for trusts created in the U.S.
  - *Foreign Packages* for trusts created offshore and outside U.S. jurisdiction
- IRS guidance found in Notice 97-24

Abusive Domestic Trusts

- Asset Management Company
- Business Trust
- Equipment or Service Trust
- Family Residence Trust
- Charitable Trust

Typical Abusive Trust Arrangement



Abusive Foreign Trusts

- Asset Management Company
- Business Trust
- Foreign Trust #1
- Foreign Trust #2

FOREIGN TRUST ARRANGEMENT

SCH C BUSINESS → AMT

AMT → BUSINESS TRUST

BUSINESS TRUST → FOREIGN TRUST 1

FOREIGN TRUST 1 → FOREIGN TRUST 2

FOREIGN TRUST 2 → FOREIGN CORPORATION AND/OR FOREIGN BANK ACCOUNT

FOREIGN CORPORATION AND/OR FOREIGN BANK ACCOUNT →

Wire transfers, Gifts, Loans, Debit/Credit Cards

Abusive Trust Concept

- The basic concept of the abusive trust scheme is to create multiple entities holding different assets of the taxpayer to engage in self-dealing activities where the taxpayer attempts to:

  - **Underreport income**
    - Split income over multiple entities at different layers
    - Wire income offshore and fail to report it

Abusive Trust Concept (Cont'd)

- **Increase deductions**
  - Charge bogus and personal expenses against distributed trust income at each layer
- **Avoid filing returns**
- **Protect transactions through bank secrecy laws in tax haven countries**

Self-Dealing Activities Include:

- “Hiring”
- Transferring
- Deducting
- Selling

Legal Principles Applicable to Abusive Trusts

- Substance, not form, controls taxation
- Grantors may be treated as owners of trusts
- Non-grantor trusts are taxable
- Transfers to trusts may be subject to estate and gift taxes

Legal Principles Applicable to Abusive Trusts (Cont'd)

- Personal expenses are generally not deductible
- A genuine charity must benefit in order to claim a valid charitable deduction
- Special rules apply to foreign trusts

Recognizing a Problem Trust
“Too Good to be True” Tax Benefits

- Reduced or eliminated income
- Deductions created for personal expenses
- Increased depreciation deductions
- Reduced or eliminated self-employment tax
- Reduced or eliminated estate and gift taxes

Recognizing a Problem Trust

Questionable Promises

- Grantor has complete use and control of trust assets
- Concealment of identities of grantor, trustee and beneficiaries
- High fees for trust packages to be offset by promised tax benefits

Recognizing a Problem Trust
Questionable Actions

- Use of back-dated documents
- Unjustified replacement of trustee
  - Trustees executing advance resignations
- Lack of an independent trustee
  - Grantor is trust manager
- Trustee does not exercise any control over trust assets
  - Assets flow in and out of trust for the benefit of the grantor/beneficiary

Recognizing a Problem Trust
Questionable Actions (Cont'd)

- Use of post office boxes for trust addresses
- Use of terms such as pure trust, constitutional trust, asset protection trust, estate preservation trust, sovereign trust or unincorporated business organization

It’s important enough to repeat!

- Placing assets in “Trust” is basically an income tax neutral transaction
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  - The Trust
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Need Additional Information? Contact Phone Number

If you have specific questions on a tax scheme or wish to report possible schemes, call the IRS at:

1-866-775-7474

or email IRS at: irs.tax.shelter.hotline@irs.gov

Need Additional Information? Through the Web

- Visit Criminal Investigation's Tax Fraud Alert page at: www.ustreas.gov/irs/ci/
- Visit IRS’s web site at: www.irs.gov

Need Additional Information? Through IRS Publications

All found on www.irs.gov:

- Pub. 2193, *Should Your Financial Portfolio Include Too Good To Be True Trusts?*
- Pub. 17, *Your Federal Income Tax for Individuals*
- Pub. 334, *Tax Guide for Small Business*
- Notice 97-24

Questions?

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