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Internal Revenue Service
Criminal Investigation Division
Summary of Abusive Trust Schemes

Introduction

In the last few years the Internal Revenue Service Criminal Investigation (CI) has detected a proliferation of abusive trust tax evasion schemes. Currently, there are two prevalent fraudulent schemes being promoted: the “domestic scheme” and the “foreign scheme.” The domestic scheme involves a series of trusts that are formed in the U.S., while the foreign trust scheme is formed offshore and outside the jurisdiction of the U.S. The trusts involved in the schemes, either foreign or domestic, 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, these schemes are in fact controlled and directed by the taxpayer.

These schemes are often promoted by a network of promoters and sub-promoters that may charge $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.

Basic Trust Taxation

To understand fully the trust schemes offered today, it is important to focus on some basic trust taxation rules.

A trust is a form of ownership, which is controlled and managed by a designated independent trustee, that completely separates responsibility and control of assets from the benefits of ownership. The IRS recognizes numerous types of legal trust arrangements, and they are commonly used for estate planning, charitable purposes, and holding assets for beneficiaries. The independent trustee manages the trust, holds legal title to trust assets, and exercises independent control.

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

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 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.

A domestic trust must file a Form 1041*, U.S. Income Tax Return for Estates and Trusts*, for each taxable year. If the trust is classified as a Domestic Grantor Trust, it is not generally required to file a Form 1041, provided that all items of income are reported by the individual taxpayer on his own Form 1040, *U.S. Individual Income Tax Return.* Thus, the individual pays the total tax liability upon the filing of his return for that 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. [1]

In addition to filing trust returns as just described, a taxpayer may be required to file U.S. Treasury Form TD F 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 account. 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, the domestic trust schemes are usually offered in a series of trusts that are layered upon one another. These trusts can include the following:

[1] A grantor is the individual placing assets into a trust.

- **Asset Management Company –** In many promotions, taxpayers are advised to create Asset Management Companies (AMC's). 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 this individual is quickly replaced by the taxpayer. 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.

- **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 their business from either a sole proprietorship or corporation to a trust. The AMC is the trustee of the business trust. False administrative expenses may be deducted from the trust as a means to reduce taxable income. The scheme gives the appearance that the taxpayer has given up control of their business to a trust; however, in reality the taxpayer is still running the day-to-day activities of their business and is controlling its income stream.

  - **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.

  - **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 non-allowable depreciation and the expenses of maintaining and operating the residence such as gardening, pool service, and utilities.

- **Charitable Trust –** In many promotions, the last layer of trusts 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 falsely claimed as "charitable" deductions on the trust tax returns. After the personal and non-allowable expenses are deducted from the charitable trust, any remaining balance of income, usually nominal amounts, 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. However, these foreign promotions also attempt to take funds offshore and outside U.S.

jurisdiction. These schemes involve offshore bank accounts, trusts, and International Business Corporations (IBC's)[2] created in "tax haven" countries.

A typical offshore trust scheme may have the following steps:

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

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

- **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.

- **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/she is in control of foreign trust one's trustee, by 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 is 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 their business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.

How do taxpayers involved in these schemes enjoy the fruits of their evasive scheme since their funds are offshore? There are several methods to repatriate the taxpayer's funds to the U.S. All of these methods, at some point, involve the opening of foreign bank accounts.

- One method is to open a foreign bank account in a tax haven country and then issue the taxpayer either a debit or credit card from the account. These debit or credit cards are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses, like groceries, medical bills, gasoline, and

[2] An IBC is a corporation set up offshore in jurisdictions where the tracing of ownership by U.S. authorities of such an entity is very difficult. Due to the difficulty in tracing the ownership of IBC's, these entities are used quite often in tax evasion schemes.

other miscellaneous expenses. Since these cards are issued from banks located in tax haven countries, it is very difficult for the IRS to trace these transactions back to the taxpayer.

- Another method is to set up an International Business Corporation (IBC) and transfer the funds from the foreign trusts to the IBC via foreign bank accounts. Fraudulent loans are set up from the IBC to taxpayers and funds are wired back to the taxpayers in the U.S. Because purported loans are claimed non-taxable, the repatriation of funds is not reported on a U.S. tax return. In addition, because the ownership of IBC's is documented with bearer shares and IBC's are located in tax haven countries, it very difficult for the IRS to prove that fraudulent loans are actually the taxpayer's income.

CI's Efforts in Combating Abusive Trusts

CI's enforcement strategy to combat these schemes is to focus primarily on promoters and on clients who have willfully used the promotion to egregiously evade tax. Further, fraudulent trust issues are addressed through a national strategy that includes CI, the IRS Examination and Collection Divisions, IRS Chief Counsel's Office, and the Department of Justice. As part of this strategy, emphasis is placed on multi-function coordination, the identification of fraudulent offshore promotions, and the use of civil and criminal enforcement actions.

It is very difficult to determine precisely the amount of fraud attributable to these schemes because of their design and inherent complexity. However, it can be said that these schemes are directed towards taxpayers with at least six figure incomes, and as evidenced by the individual cases detailed later in this summary, the potential for lost tax revenue could be massive.

Because this is a new area of fraud, CI has been tracking these investigations only since October 1998. The following statistics represent CI's efforts on promoters, clients, and other individuals involved in abusive trust schemes for Fiscal Year 1999.

Criminal Investigations Initiated	67
Prosecution Recommendations	57
Indictments/Informations	35
Incarceration Rate	85.7%
Avg. Months to Serve (w/prison)	35
Avg. Months to Serve (all Sent)	30

The following data on is foreign and domestic trusts investigations as of January 31, 2000.

Open Criminal Investigations	130
Percent of Open Investigations on Foreign Schemes	55%
Percent of Open Investigations on Domestic Schemes	45%

Criminal Convictions

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, 63 months imprisonment respectively, for their involvement in the scam. The men sold packages of bogus trusts to clients and advised them 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. Clients claimed various personal expenses related to the bogus trusts on their tax returns 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.

Mayer Investigation

In June 1998, Louis R. Mayer of Clearwater, Florida, was sentenced to six months imprisonment and six months of home detention after he was convicted in February 1998 of conspiring to impede and impair the IRS from administering the tax laws. Mayer was also convicted of six counts of aiding and assisting in the preparation of false income tax returns.

The indictment charged Mayer, a promoter of foreign and domestic contractual trusts, with employing a series of trusts to generate fraudulent deductions and conceal the income of two of his clients from the IRS. These trusts created the appearance that the clients had relinquished ownership and control of the assets which were placed in the trust, when in fact they still retained control. Mayer also counseled his clients to open a series of foreign bank accounts in the Bahamas

to facilitate the return of the income to his clients. Funds from these fraudulent trusts were transferred through a series of foreign bank accounts to avoid detection and subsequently used by his clients to purchase high-end diamond jewelry, several luxury cars, a 46' boat and an exotic parrot. Mayer's clients concealed hundreds of thousands of dollars in this manner.

Hawley T. Webb, an accountant and return preparer from New Port Richey, Florida, was also sentenced to 30 months imprisonment followed by two years supervised release for his role in the scheme.

Bradley Investigation

In June 1999, Edgar Bradley and his sons, Edgar Bradley II and Roy Bradley, were sentenced to 60, 57, and 46 months imprisonment followed by 3 years supervised release, respectively 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 $635,000 to the IRS.

Rivera Investigation

In January 1999, Pedro Ivan Rivera, a physician in Carrolton, Texas, was sentenced to 37 months imprisonment followed by three years supervised release and ordered to pay $414, 819 in restitution to the IRS for tax evasion for the years 1992 to 1996. Rivera created trusts, including one for his family residence, that he controlled and used to conceal his income. In addition, Rivera transferred funds between trusts, offshore corporations, and their corresponding bank accounts located in the U.S., Bahamas, and the Channel Islands in order to conceal taxable income.

Morris Investigation

In July 1999, James C. Morris of Cincinnati, Ohio was sentenced to 24 months imprisonment followed by 3 years of 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 and owing 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 he impeded the IRS by selling sham trusts that were used

to conceal assets and income from the IRS and others. Morris also admitted he was a member of the Pilot Connection Society and later its successor, the Liberty Foundation, an organization that sold so-called “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.

Foster, et al. Investigation

Karl Foster, of Blaine Minnesota, was convicted of conspiracy to obstruct the IRS, aiding and assisting in the filing of a false tax return and aiding and abetting another person to obstruct and impede the IRS. In May 1998, Foster was sentenced to 78 months imprisonment followed by three years of supervised release.

Foster was a tax consultant, who created and sold trusts designed to conceal income and assets from the IRS. Foster advised his clients that trusts were tax-free because they were sovereign from the U.S. He also advised clients they were citizens of the Republic of Minnesota and therefore did not have to pay taxes.

Two of Foster’s clients were convicted of tax evasion and conspiracy to obstruct and impede the IRS. Darlow Madge, owner of Allied Medical Associates, was sentenced to 41 months imprisonment followed by three years of supervised release for failing to report $741,000 in income between 1990 and 1993. Madge’s son, Brian Madge, was sentenced to 20 months imprisonment followed by two years supervised release for failing to report approximately $80,000 in income over a two year period.

Civil and Criminal Penalties

Investors of abusive trust 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. Criminal statutes that maybe applicable are as follows:

- Title 18 USC 371, Conspiracy to Defraud the IRS
- Title 26 USC 7201, Tax Evasion

- Title 26 USC 7206 (1), Subscription to a False Tax Return
- Title 26 USC 7206(2), Aiding or Assisting in a False Tax Return
- Title 26 USC 7212(a), Corrupt or Forcible Interference with the Administration of Internal Revenue Laws
- Title 31 USC 5314, Records and Reports on Foreign Financial Agency Transactions