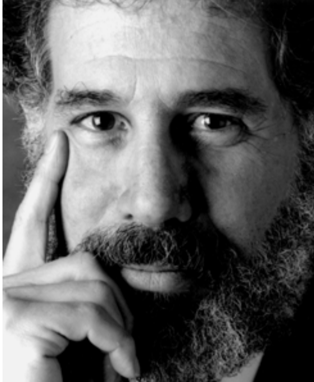

Leimberg's Think About It

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Abusive Trusts, Frauds, Tax Fantasies, and Scams

I recently received a call from my family doctor. He's a very bright guy, financially successful, and pretty sophisticated. So I was surprised when he asked – rather indignantly – why I hadn't told him about the trust that would eliminate income taxes and/or enable him to deduct his personal living expenses.

Of course, there is no such trust. It's a con.

Unfortunately, there are many cruel hoaxes and greedy con artists who really get folks from EVERY social and economic level to buy (literally) into these abusive (also known as scam or sham) trusts.

Here are some of the most notorious tax scams (they don't work now and never did) and a more detailed rundown on those schemes involving trusts:

1. **Zero Wages.** In this scam, a taxpayer claims he has no taxable wages and attaches to his or her return either a Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 that shows zero or little wages or other income. The taxpayer may include a statement indicating the taxpayer is rebutting information submitted to the IRS by the payer.

2. **Zero Return.** Promoters instruct taxpayers to enter all zeros on their federal income tax filings. In a twist on this scheme, filers enter zero income, report their withholding and then write "nunc pro tunc" – Latin for "now for then" – on the return. They often also do this with

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amended returns in the hope the IRS will disregard the original return in which they reported wages and other income.

3. **No Gain Deduction.** Filers attempt to eliminate their entire adjusted gross income (AGI) by deducting it on Schedule A. The filer lists his or her AGI under the Schedule A section labeled "Other Miscellaneous Deductions," and attaches a statement to the return that refers to court documents and includes the words "No Gain Realized."

4. **Form 843 Tax Abatement.** This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns, and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83 – Property Transferred in Connection with Performance of Service."

5. **Frivolous Arguments.** Promoters of tax schemes have been known to make outlandish claims such as: "The Sixteenth Amendment concerning congressional power to levy and collect income taxes was never ratified"; "Wages are not income"; "Filing a return and paying taxes are merely voluntary"; and "Being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to Privacy".

   These arguments have no legal basis and have been consistently thrown (laughed) out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law.

6. **Improper Home-Based Business.** This scheme purports to offer tax "relief" but in reality is illegal tax avoidance. The promoters claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. But the tax law makes it clear that a business purpose and profit motive must exist in order to generate and justify deductible business expenses.

7. **Employment Tax Evasion.** The IRS has seen a number of illegal schemes that instruct employers how not to withhold federal income tax or other employment taxes from wages paid to their employees. This erroneous and misleading advice is based on an incorrect interpretation of Code Section 861 and other parts of the tax law and has been constantly refuted in court.

   Lately, the IRS has seen an increase in activity in the area of "double-dip" parking and medical reimbursement issues. In recent years, the courts have issued injunctions against more than a dozen persons ordering them to stop promoting the scheme. During fiscal year 2005, more than 50 individuals were sentenced to an average of 30 months in prison for employment tax evasion. Employer participants can also be held responsible for back

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payments of employment taxes, plus penalties and interest. Employees who have nothing withheld from their wages are still responsible for payment of their personal taxes.

8. **Phishing.** Phishing is a technique used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards, or apply for loans in their names. These Internet-based criminals often pose as representatives of financial institutions and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing confidential information.

   Sometimes scammers even pose as agents of the IRS! In recent months, some taxpayers have received e-mails that appear to come from the IRS. A typical e-mail notifies a taxpayer of an outstanding refund, and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits his or her social security and credit card numbers. In a variation of this "impersonate the IRS" scheme, criminals have used e-mail to announce to unsuspecting taxpayers they are "under IRS audit" and could make things right by divulging selected private financial information.

   NOTE: The IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1-800-829-1040 to confirm it.

9. **Return Preparer Fraud.** Dishonest tax return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers derive financial gain by skimming a portion of their clients' refunds and charging inflated fees for their return preparation services. They attract new clients by promising large refunds. When choosing or hiring a tax return preparer, remember the old saying, "If it sounds too good to be true, it probably is." Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2005, more than 110 tax return preparers were convicted of tax crimes.

   A preparer who makes a client "famous" isn't a friend! No matter who prepares the return, the taxpayer is ultimately responsible for its accuracy!

10. **Credit Counseling Agencies.** Beware of credit counseling organizations that claim they can fix credit ratings, push debt payment plans, or impose high set-up fees or monthly service charges that may add to existing debt.

    The IRS Tax Exempt and Government Entities Division is in the process of revoking the tax-exempt status of numerous credit counseling organizations that operated under the guise of educating financially distressed consumers with debt problems, while charging debtors large fees and providing little or no counseling.

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11. **Abuse of Charitable Organizations and Deductions.** The IRS has observed increased use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur, for example, when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund, but maintains control over the assets or income, thereby obtaining a tax deduction without transferring a commensurate benefit to charity. The Pension Protection Act of 2006 contains a provision which applies an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that, with respect to such fund, is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person.

12. **Offshore Transactions.** Despite a crackdown by the IRS and state tax agencies, individuals continue to try to avoid U.S. taxes through various offshore transactions. One way they do so is by illegally hiding income in offshore bank and brokerage accounts, or using offshore credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities or life insurance.

    The IRS and the tax agencies of states and U.S. possessions continue to aggressively pursue taxpayers and promoters involved in such abusive transactions. During fiscal year 2005, 68 individuals were convicted on charges of promotion and use of abusive tax schemes designed to evade taxes.

FAMOUS LAST (CON) WORDS AND PITCHES

"I DON'T FILE RETURNS OR PAY TAXES – WHY SHOULD YOU?"

The pitch is: I'll share my "secret" for a fee. Of course, even though they will not admit it, most con artists know better and, in fact, typically do file their own returns and pay taxes.

"UNTAX YOURSELF - FOR $49.95"

This scam is based on the patently false premise that paying taxes is "voluntary" and "un-American". Hundreds of individuals have purchased these so-called "Un-Tax" packages and then found – after they paid for, relied on and acted upon the "kit" – that they are faced with civil and/or criminal tax penalties.

"I CAN GET YOU A SOCIAL SECURITY REFUND"

The scammer offers to obtain for the victim refunds of all the Social Security taxes paid during his or her lifetime. The victim pays an up front "paperwork" fee of say $100, plus a percentage of any refund received, to file a refund claim with the IRS. Of course, there is no law allowing such a refund and the promoter is long gone when refund time comes.

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"PUT YOUR MONEY IN TRUST - NEVER PAY TAXES AGAIN!"

Promoters of abusive trust schemes are charging $2,000 to $70,000 for "trust" packages. The 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. Although these schemes give the appearance that the taxpayer has given up use and control of the property transferred to the trust, in fact, he or she never gives up either. Instead, the taxpayer continues to enjoy the "gifted" property to the same extent as before the transfer. So the taxpayer, of course, is taxed the same way he or she would have been had the trust not been set up.

The IRS IS sending these folks (both promoters and the tax evaders) to jail!

ABUSIVE TRUSTS VS. TRUTH AND CONSEQUENCES

For the balance of this commentary, we will look at some of the most egregious abusive uses of otherwise legitimate trusts. Included in the discussion are:

- How trusts are used fraudulently.
- The difference between tax avoidance and tax evasion.
- The truth about "Constitutional" or "Pure" trusts.
- Why transfer of future wages, salaries, or other earnings to a trust does not eliminate income taxes.
- How family residence trusts, business trusts, charitable trusts, and offshore trusts can be fraudulent or abusive.
- The extravagant claims promoters make about their trusts and their blatant disregard for tax laws.
- The tax principles and consequences vis-à-vis abusive or fraudulent trusts.
- Warning signs of "trust mills" or abusive trust promoters.
- Why things that sound too good to be true usually aren't!

HOW ARE TRUSTS USED AS PART OF A FRAUD?

Legitimate trusts are among the most important and useful of all estate and financial planning tools. In THE BOOK OF TRUSTS-4th Edition, Attorneys Charles Plotnick, Dan Evans, and I explain the many benefits of legitimate trusts, those that are fully supported by federal and state tax rules and other laws.

The federal tax benefits of trusts exist because of specific provisions in the Internal Revenue Code or specific rulings of courts or the Internal Revenue Service. The non-tax benefits of trusts are firmly established by decisions handed down in state and federal courts throughout the United States over many years. (Some aspects of trust law were established by court decisions in England before the American Revolution.) The benefits of some legitimate trusts can often seem

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almost magical. But even these trusts, with legitimately available advantages, have limitations, downsides, and costs.

Unfortunately, as good as the lawful benefits of most trusts are, that's not good enough for some people. For them, it's only a small step from a valid application and reasonable interpretation of trust and tax law to a fantasy with no basis or support in law whatsoever. Even more unfortunate is that there are charlatans and con artists who would like to make a profit by selling their fantastic schemes at outrageous prices to a sometimes unsophisticated and usually unsuspecting public.

The principles of legitimate trust law and tax law are at times complex. Con artists can use that complexity (and not a small dash of the prospective purchaser's subconscious greed or unrealistic hope) the same way that a street hustler can use rapid hand motions to hide the pea under the shell. By talking fast, making a lot of motions, telling people what they wish to hear, and adding pounds of paper "documentation," a hustler can make both the pea and the purchaser's money quickly disappear, along with the truth.

And dishonest people can use trusts to obscure their financial dealings. We have all read about "shell corporations" and "dummy corporations" that are used to hide assets, create phony expenses, or create confusion regarding the true ownership of assets. Trusts can be "shams" and used the same way.

These outrageous frauds are, unfortunately, so prevalent that the Internal Revenue Service has launched a national program to recognize, address, and attack abusive trust practices, including criminal prosecutions in appropriate cases. The invalid or fraudulent trust arrangements described below comprise the types of trusts identified by the IRS as abusive. (The complete text of the IRS Notice and much more on scam, sham, abusive, and fraudulent trusts can be found at www.leimbergservices.com).

Courts often observe (and are often quoted to say) that everyone has the right to arrange his or her affairs to reduce his or her taxes to as little as possible. And that's true. Tax minimization is good tax planning - IF it's done in accordance with the letter and the spirit of the law.

Tax evasion, on the other hand, is based on deception and is a crime. The difference is more than semantics; it can mean a difference of up to $100,000 of a client's money and up to 5 years of his or her life. At the least, anyone pulled into these schemes may face repayment of taxes plus interest and penalties and sizeable legal and accounting fees.

Make no mistake: charges can be levied not only against the promoters of trust schemes, but also against those who underreport income or assets based on such abusive trusts. A person will not be excused by a claim that he or she was "taken in."

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What's the worst that can happen?

The IRS has reported that it is investigating about 200,000 cases of potentially abusive trusts, affecting about $1 billion in assets held in those trusts. That may be just the tip of the iceberg.

The following statistics represent IRS Criminal Investigation's investigative efforts involving promoters, clients and other individuals involved in abusive trust schemes.	FY 2005	FY 2004	FY 2003
Investigations Initiated	197	131	79
Prosecution Recommendations	126	127	80
Indictments/Informations	70	82	73
Sentenced	70	45	43
Incarceration Rate*	82.9%	73.3%	79.1%
Average Months to Serve	38	36	47

*Incarceration includes confinement to federal prison, halfway house, home detention, or some combination thereof.

Data Source: IRS Criminal Investigation Management Information System.

What is a "Constitutional" or "Pure" Trust and Will it Save Taxes?

If a promoter calls the trust he/she is selling a "Constitutional" trust or "Pure" trust (or some other patriotic name), the odds are it is a slickly promoted scheme with no legal or factual basis. In fact, anyone "selling" trusts should be suspect!

The appeal of the "Constitutional" trust seems to be that, because the words "common law" appear in the U.S. Constitution, and because the law of trusts began in English common law (that is, the law that comes from the decisions of judges and not the enactments of legislatures), such a trust may be entitled to some sort of Constitutional protection that makes it immune from the taxes that everyone else must pay. Its promoters also claim that, because a trust is a form of contract and the Constitution forbids the "impairment" of contracts, a trust cannot be taxed or otherwise "impaired."

Of course, there is no valid legal basis for either theory. When presented to courts, these arguments have been described by judges as "ridiculous" and "frivolous." Anti-tax zealots who have insisted on raising these arguments have been heavily (and repeatedly) fined by the courts for wasting judicial time and public resources with their ridiculous claims.

The fact of the matter is that the taxing powers of Congress under the Constitution are incredibly broad. A trust (or its grantor or beneficiary) will be subject to federal income tax unless a specific provision of the Internal Revenue Code can be found that exempts the trust.

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Claims to the contrary are nothing but fantasies. Someone or an entity, such as the trust, the grantor, or its beneficiaries (or some combination) is ALWAYS taxable on trust income!

Think about it: why should some citizens be taxed when others – who purchase the "Patriots' Trust" – should not? Just the thought of one class of individuals evading the duty that the rest of us have – that is, to pay for the services of the government we elected – is, on its face, just the opposite of patriotic.

Can future wages, salary, or other earnings BE TRANSFERRED to a trust?

One can transfer almost any property (or property interest) he or she owns to a trust. But that transfer might not have any positive tax consequences. Numerous decisions of the U.S. Supreme Court and other federal courts have made it clear that wages, salaries, and other forms of earned income are always taxed to the person who earns the income. Such an attempt to shift taxation (i.e., an "assignment of income") will be ignored for federal income tax purposes. Any attempt to assign the income tax on income one has earned to a trust is a complete waste of time. Anyone who makes any claim to the contrary is either incredibly ignorant, or is not being honest.

Similarly, the income from a property is taxed to the party who or which owns the property at the time the income is earned. This is sometimes known as the "fruit of the tree" doctrine – the analogy being that the income from property is like the fruit of a tree. The income belongs to the owner of the property, just like the fruit belongs to the owner of the tree. One can make a gift of property either outright or in trust. After the gift is made, income earned by the property will be taxed to the new owner. But the property owner must really give away the right to enjoy and control the property in order to shift the tax on its income to some other party.

Many of the abusive trust arrangements described below are attempts to disguise or hide the true ownership of property, and transfer the title to property without actually transferring the control or use of the property or its "fruit." Don't bother trying to assign income without making a true, irrevocable assignment of property. It just will not work (and the attempt may subject the owner/transferor to potential interest, penalty, and possibly criminal charges)!

Can a family residence trust reduce taxable income by allowing the grantor to deduct MAINTENANCE expenses?

A grantor retained interest trust (GRIT) or a qualified personal residence trust (QPRT) is well known to planners as a legitimate estate-planning tool. The tax benefit that a GRIT or QPRT can provide is specifically authorized by the Internal Revenue Code. Used properly, it can enable the grantor to make a gift of a personal residence in trust with the title to the property to be transferred to children, grandchildren, or other beneficiary at a specified date in the future, that is, at the end of the trust term (e.g., 10 or 15 years). Yet the grantor can continue to live in the home until that date.

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The residence can be transferred at a very significant gift tax "discount" because the gift tax is based, not on today's value or on the potentially appreciated value of the house when the trust ends, but on the much reduced present value of the beneficiary's right to the residence at the end of the trust term. In other words, the gift is only the gift of a remainder interest in the residence.

If the grantor lives beyond the date when the title passes to the ultimate beneficiaries, the home will be out of his or her estate. That can save hundreds of thousands of dollars in transfer taxes. (For more information about this device see The Tools and Techniques of Estate Planning or The Cutting Edge.)

Not content with the incredibly generous gift tax benefits allowed by this law, some people have tried to claim they can spin straw into gold and create income tax benefits others can't get by transferring a personal residence to a trust (other than a GRIT or QPRT). They then claim otherwise unavailable income tax reductions or deductions as a result of the transfer.

A common claim is that the residence generates deductible expenses after it has been transferred to the trust; as though it were a rental property and the expenses were incurred for the maintenance of the property. Some promoters have the gall to make this outrageous claim even though the residence actually generates no rental income, and is still used as the personal home of the grantor. Sometimes the promoter of a trust scam will claim that the tax basis of the residence can be increased when the residence is transferred to the trust (even though no taxable gain or loss was reported by the transferor). This, the unscrupulous promoter will say, results in additional depreciation deductions.

A basic principle of tax law is that food, shelter, clothing, and other personal living expenses are NOT deductible. Period! Scam artists will tell an unsuspecting potential purchaser of an abusive trust that by transferring a personal residence to a trust, he or she can convert the dozens of non-deductible personal expenses associated with a house into deductible expenses. "Imagine the insurance, gardening, and upkeep expenses of our home all tax deductible." As is the case with each of the tactics mentioned in this commentary, this straw-into-gold claim is just plain fraudulent.

Can a business trust avoid income taxes?

A trust can be a valid alternative to a partnership or corporation for the operation of a business. In fact, there are many valid business uses for trusts. However, unethical promoters often use the transfer of a business to a trust as part of a scheme to evade taxes.

In an abusive business trust, the business owner transfers a business to a trust in exchange for "certificates of beneficial interest," and then lists on his or her trust's tax return "deductible business expenses for distributions to certificate holders or other trusts;" as a result, the trust shows little or no taxable income. The business owner may then claim to owe neither employment (Social Security) tax nor self-employment tax, because no wages were paid and the trust had no income.

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In a legitimate business trust, income may be generated through the personal services of the original owner. Yet in an abusive trust, the income produced by that individual is distributed to the "beneficiaries" of the trust (e.g., the children of the business owner) and considered to be their income taxable at their (much or relatively) lower rates, even though they own no part of the business. But of course, this trick can't work either. Remember, basic principles of tax law require that income be taxed to the person (or business) who (which) earns it (the person who does the work or the real owner of the business/property).

A related scheme is to transfer equipment to a trust, which then rents the equipment to the business trust, often at highly inflated rates. There are legitimate ways to transfer equipment to a trust and then lease the equipment back to the original owner. But these legitimate gift-leaseback or sale-leaseback arrangements are based on objectively appraised fair market values, and properly documented arm's length leases. In a proper lease transaction, the lessor and lessee take consistent and reasonable positions on their tax returns.

But when equipment is transferred to an abusive trust, the trust might claim a new (higher) basis in the equipment and an increased depreciation deduction, even though the original owner of the equipment does not report any taxable gain on the transfer to the trust. This violates the basic principle that an increase in the tax basis of an asset only occurs when the asset is sold, or otherwise disposed of in a taxable transaction (or at the owner's death).

A taxable transaction must be a taxable transaction with respect to both parties (not just one). In the abusive trust arrangement, there may be other inconsistent tax treatments as well, so that tax deductions are claimed for payments upon which no one else reports any income.

How can a charitable trust be fraudulent or abusive?

Charitable trusts are powerful devices that can legitimately provide significant benefits for both the charity (and charities) and the donor(s). They are truly "Gifts that Give and Gifts that Give Back". But there are very specific and highly stringent requirements for charitable deductions and charitable trusts. (See Tools and Techniques of Charitable Planning). In order for a trust to be tax-exempt and for contributions to a trust to be deductible for federal income tax purposes, the trust must be operated EXCUSIVELY for charitable purposes and must serve public (and not private) interests (with the exception of the narrowly circumscribed Internal Revenue Code limits of charitable remainder and charitable lead trusts (CRTs and CLTs).

Despite these rules, some grantors create trusts that do not meet Code requirements for which they claim charitable deductions. However, the abusive charitable trust does not (and is never intended to) serve any public or charitable purpose. Instead, it is intended to pay the personal living expenses of the grantor and the grantor's family and to make those expenses appear to be charitable contributions. For example, the grantor might pay a child's college tuition from a "charitable trust" he or she has created, and then claim that the check to the college represented a deductible charitable donation and not a non-deductible personal expense. Again, this is thinly disguised but very real tax fraud.

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Can "offshore" (foreign) trusts be used to avoid income taxes?

Offshore trusts have legitimate uses.

In order to prevent abuse, Congress has enacted a number of measures making the taxation of foreign trusts harsh and unattractive.

If a United States citizen or resident alien creates a foreign trust, the trust is considered to be a "grantor trust." That means the grantor is taxable on all of the income earned by the trust – anywhere in the world – if any of the income of the trust is or might be distributed to a citizen or resident of the United States. We want to be very clear on this: The grantor will not realize any income tax savings from an offshore trust!

The transfer of appreciated property to a foreign trust can result in an excise tax equal to 35 percent of the previously untaxed capital gain. However, if the transferor of the property is considered to be the owner of the trust under the grantor trust rule described above, that tax may be deferred until the grantor is no longer considered to be the owner, such as upon death. If that's the case, then the capital gain at the owner's death will be added to federal and state death taxes, and may create a crushing tax and liquidity burden on the owner's estate.

There is also a requirement that the creation of a foreign trust, the transfer of any property to a foreign trust, or the death of the grantor of a foreign trust be reported to the Internal Revenue Service. The failure to report a transfer can result in a penalty tax of 35 percent of the assets involved.

If the income of the foreign trust is not taxed to the grantor, the distributions to his or her children (or other beneficiaries) may be taxed very harshly. For example, foreign capital gains will be considered to be part of distributable net income, but will be taxed as ordinary income to the beneficiaries. Furthermore, any accumulations of income or delays in the distribution of income can result in nondeductible interest charges on the taxes deferred.

Claims that offshore trusts can save income taxes are almost always founded upon a scheme involving multiple trusts, corporations, and other parties or entities, as well as a series of convoluted and circuitous transactions among them. For instance, an offshore trust arrangement may entail the creation of a Panamanian corporation to create a Bahamian trust, that will invest in Swiss bank accounts for the benefit of a Cayman Islands corporation that will be the beneficiary of the trust, with the stock of the corporation to be held by another trust created by another corporation of which the grantor or his/her family will be the beneficiaries. In other words, it is a shell game. The assumption is that the introduction of enough layers of trusts and corporations, plus multiple circuitous transactions, will keep the IRS from figuring out what is really going on. This is fraud, not tax planning.

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Are revocable living trusts abusive?

No. Revocable living trusts are certainly not abusive – IF they are established, operated and administered properly. They are well recognized and accepted as legitimate tax and personal financial planning tools if they are based on full compliance with the rules and regulations under the Internal Revenue Code. Like the irrevocable life insurance trust, the credit shelter trust, trusts for minors, the QPRT (qualified personal residence trust), the GRAT (grantor retained annuity trust), the CRAT (charitable remainder annuity trust), and the CRUT (charitable remainder unitrust), revocable living trusts are not – per se – abusive.

Although the IRS has announced a program to investigate abusive trusts and to vigorously attack their promoters and participants, the IRS announcement also clearly states that there should no concerns about the legitimate uses of trusts, including the proper use of trusts in estate planning.

The problem is often not the trust itself, but the purpose to which the trust has been put, or the tax treatment claimed for, or implied about, the trust. Even some of the abusive trusts identified by the IRS may be perfectly valid trusts under state law. But they will not produce the tax results claimed for the trust.

Who is promoting these trust abuses and why?

Selling trust packages to consumers has become a big and very profitable business. People are concerned with high tax rates and creditor and other liability. So promoters who advertise "investment seminars" or "tax seminars" that promise to show attendees how to eliminate income, gift, and estate taxes – and at the same time provide complete creditor protection – can draw large crowds. And promises of otherwise impossible, substantial tax savings can lure people into paying large sums of money for trust forms, and instructions on how to create and operate trusts.

There are numerous reported decisions of taxpayers who have paid thousands of dollars for what amounted to nothing more than preprinted forms. The taxpayers who have been foolish enough to pay inflated prices wind up being penalized twice. First, they pay large sums of money for forms and tax advice that is both worthless and dangerous. Then, if they rely and act upon the claims made for such trusts, they are audited by the Internal Revenue Service and are assessed with tax deficiencies, interest on unpaid or underpaid taxes, and penalties for negligence, substantial understatements of tax, and even civil (and possibly criminal) fraud. To add insult to tax injury, the Internal Revenue Service will not allow a tax deduction for the fees paid to the trust promoter, even though fees for tax advice are ordinarily deductible.

So the motivation for trust promoters is often nothing less than pure greed. Some people willingly allow themselves to believe in almost anything to avoid taxes or creditor claims. The trust promoters prey and capitalize on that single-minded willingness by telling taxpayers what they want to hear, and charging them dearly for the privilege.

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Promoters of abusive trust arrangements may be subject to civil and criminal penalties, both for the violation of tax laws relating to abusive tax shelters and for simple consumer fraud. The IRS and the Federal Trade Commission have already prosecuted many promoters of abusive trust arrangements.

How do you recognize an ABUSIVE trust?

There are several common tax principles that are invariably violated by abusive trust arrangements. These principles will help planners and/or their clients recognize whether a trust arrangement is fraudulent or abusive, and not valid.

In an abusive trust arrangement, deductions will be claimed for personal living expenses. In reality, one cannot deduct personal expenses such as home maintenance costs, or depreciate a home or its furnishings.

There is a purported change in the taxation of income from property even though there is no meaningful change in the grantor's control or use of the property placed in the trust. In other words, the trust is used to disguise the true ownership of assets. Be suspicious any time it is claimed that the grantor can have his/her cake and eat it too. In reality, the grantor cannot continue to use and control the assets, yet be exempt from taxes on the income produced by those assets, and eliminate estate taxes on that property at death – and (as often claimed) creditor proof the trust assets.

Another common but false claim is that income is no longer taxed to the person who earns the income, therefore he or she is no longer required to pay Social Security or other employment taxes. In reality the opposite is true. If the grantor earns income, he or she will be subject to tax regardless of how the money is disguised. Likewise, the grantor is subject to Social Security and other taxes on the income earned no matter how many layers of "fact" separate him or her from that income.

A new tax basis (usually higher) is claimed for property even though there was no taxable gain or loss realized when the property was transferred to the trust. In reality, if there is no taxable event at the time of transfer, there will be no increase in basis available to either the transferor (the grantor) or the transferee (the trust or trust beneficiary).

Trust income is received that is not taxed to anyone. In reality a trust's income always must be taxed to one or more persons or parties. It must be taxed to the creator of the trust, the grantor (if the trust is a "grantor trust" because of rights or powers retained by the grantor), the beneficiaries of the trust (if distributed to them), or to the trust itself (or to some combination of the parties). And the trust must file a tax return showing how much income is received by the trust, as well as how and to whom that income will be taxed.

In an abusive arrangement, charitable deductions are claimed for tuition or other payments privately and personally benefiting the grantor/donor and/or family members. In reality only

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gifts to legitimate charities made in a specified manner will result in a charitable income tax deduction.

OTHER WARNING SIGNS OF "TRUST MILLS" OR ABUSIVE TRUST PROMOTERS

Even if a person has difficulty understanding the tax principles and the underlying tax consequences, there are several other "red flags" that should warn them of abusive trust schemes.

Avoid trust promoters who use words like "Constitutional," "Fair," "Pure," "Equity," "Liberty," "Prime", or "Patriot" when describing their trusts. Those words have no legal or tax significance, and are often wrapped around illegal, impure, and fraudulent trusts.

Be wary of any trust promoter who claims "secret" or "insider" information known only to Kennedys, Congressmen, or other wealthy or famous families or individuals. One promoter had promotional materials that go so far as to claim proprietary rights in the will of Jacqueline Kennedy Onassis, implying that he wrote the former First Lady's will. What utter nonsense! Mrs. Onassis's will was actually drafted by a well-known New York law firm.

Contrary to what these promoters would have people believe, there are no "great secrets" or "conspiracies of concealment." The U.S. tax laws are all public documents and accessible information. Anyone can find them on the World Wide Web.

For instance, try: http://www.irs.ustreas.gov/plain/forms_pubs/index.html and there are connections to a wealth of free information on tax law. Many law firms and practitioners have Web Pages that provide useful (and free) information on trusts and related subject matters. For example, see http://evans-legal.com/dan (the home page of one of the authors of THE BOOK OF TRUSTS) and http://www.leimbergservices.com where, if you search the archives for Abusive or Sham Trusts, you'll find many cases where promoters and participants in these schemes have been sentenced to long jail terms as well as sizeable fines.

There are very few legitimate tax techniques that cannot be found in the books and magazines of any law library, or from a legitimate (and often free or inexpensive) public source.

In an abusive arrangement, multiple trusts are often required and they are invariably inter-related, with money or other assets flowing through a labyrinth of funnels from trust to trust to trust. Although it is sometimes necessary or useful to use two or more trusts to benefit different beneficiaries or to serve different estate and financial planning purposes, a number of trusts passing assets (or deductions) from trust to trust may be a sign that it is part of a fraudulent "shell game" instead of legitimate wealth management/transfer planning.

In an abusive arrangement, a promoter almost inevitably sells the trust as a package; and, typically, it's the only product or service sold by the promoter. Tax and financial advisers provide a variety of services and are able to select the planning techniques (or combination) most suitable to the client from a number of possible tax and financial planning techniques. "One size

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fits all" rarely works for clothing, and it certainly doesn't work in estate and financial planning. Someone promoting a specific trust, and only that trust, typically has the answer before the client asks any questions. He or she is probably a scam artist.

In an abusive arrangement, the trust promoter will usually discourage people from consulting a lawyer, accountant, financial planner (CLU, ChFC, or CFP), banker, investment advisor, or calling the IRS. Legitimate tax planners have nothing to fear from a second opinion.

WHAT'S THE BOTTOM LINE?

The harsh reality is that most things that sound too good to be true aren't (true). This includes trusts. You should warn you clients that if they receive promotional materials that claim tax benefits that seem impossibly great, they should check with you before spending their money and risking not only additional taxes, interest, fines, and penalties, but perhaps their financial and personal freedom as well.

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