WHY TRUSTS DON'T WORK

The Truth About One of the Nation's Most Popular Tax Scams
by Daniel J. Pilla

Introduction

Who doesn't want to cut income taxes? With tax burdens at an all time high, more people than ever seek ways to reduce the load. As a result, some tax professionals and those holding themselves out to be tax professionals develop innumerable plans, structures and schemes of every description designed to reduce or eliminate income taxes. The plans are accompanied by promises that the program is "perfectly legal" in every way.

One program consistently marketed to America for more than thirty years centers on the idea of a "trust." A trust is a separate legal entity—much like a corporation—used legally for decades in the world of estate planning. Trusts allow assets to be held by an entity other than a natural person. The chief advantage is that trusts do not die. Therefore, assets held in trust can remain in a family's estate for generations, avoiding the ravages of estate and gift taxes.

Numerous contemporary promoters market trust packages for income tax planning and reduction purposes. Promoters allege that they somehow managed to gain access to a "secret area" of trust law used by super-rich families to retain wealth and eliminate income taxes. Promoters claim that their trusts are the same as those used by the Kennedys, Rockefellers, Carnegies, etc., for generations to build astonishing wealth.

The heart of the trust claim is that you can do the same thing with both your own assets and income. The claimed advantage is that by running your income through a trust, you eliminate all or a large part of your income tax burden. In this way, you are allegedly able to build substantial wealth to pass on to your children and grandchildren.

Using this basic idea, there are a variety of trust formulas and titles that have been marketed over the years. Early incarnations were known as "family trusts" but titles also include inter vivos trusts, pure trusts, equity trusts, living trusts, businesses trusts, constitutional trusts, common law trusts and unincorporated business organizations (UBOs).

The common plan generally involves these three steps. First you create a trust using the promoter's trust package and team of trustees. Second, you assign your income to the trust so that your earnings are run through the trust. Third, you become an employee of the trust, i.e., the "trust manager." Here it is alleged that the trust, as employer, can provide numerous non-taxable benefits to its manager—you—such as housing, clothing, food, medical care, etc. The theory is that the payment of these expenses by the trust is deductible as business expenses because they are paid to you as a "trust manager." At the same time, the value of the benefits is alleged to be non-taxable to you because they similar to employee benefits, free of taxation.

Various trust promoters put different twists on this basic trust scheme. For example, some argue that trusts are tax exempt altogether. As such, the income earned by the trust need not be reported to the IRS and the trust can distribute its income however it sees fit. Others argue that a trust can split its income much the way a corporation does. That is to say, after payment of trust expenses, including non-taxable benefits to the "trust manager," the income is split, say five ways—between husband, wife and three children—thereby subjecting the income to the lowest possible tax bracket, now just 10 percent. This prevents the income from being taxed at higher marginal rates, substantially reducing and in many cases, purportedly eliminating income taxes altogether.

To execute the plan, a trust "indenture" or contract is created and sometimes filed with local authorities. The citizen then transfers his home and other assets into the name of the trust. He may then enter into a contract with the trust under which he transfers his personal services and income to the trust. Gross income earned from one's job or business is then deposited to a trust bank account and used to pay all personal living expenses, including the home mortgage or rent, car payments, medical expenses, food, clothing, entertainment and personal items.

If the trust files a tax return, it claims all those expenses as a deduction against the trust's income. The trust may not even file if the promoters allege, as they sometimes do, that trusts are entitled to "tax exempt" status. The trust may then distribute the remaining income to its "beneficiaries," including, perhaps, the person who earned the income in the first place. That person in turn files a tax return reporting only distributions received from the trust as income. Naturally, that income is substantially less than the gross income because deductions for personal living expenses are taken by the trust and what's left is split several ways. Thus, what started out as, say, $60,000 of gross income is reduced to say, $10,000 of taxable income through this process. In many cases, there is no taxable income. The purported tax savings are obvious and attractive.

A more exotic twist on the same concept involves trusts that are domiciled in a foreign country, usually a tax haven nation such as the Bahamas, Cayman Islands or the Turks and Cacaos Islands. The offshore trust concept usually involves layers of trusts, starting with one or more domestic trusts and ending with one or more offshore trusts, accompanied by a bank account in the tax haven nation. The idea is to send the money through enough entities and into a foreign bank account so that the IRS eventually loses the trail and consequently, the ability to tax the income. It helps if the country in which the bank is located has tough bank-privacy laws, thereby keeping the IRS' curious eyes away from the bank's records.

One problem with the offshore arrangement is the fact that people who send their money offshore cannot spend it there. This means they have to somehow get it back into the United States. This is usually accomplished in one of two ways. The first is through a series of "paper loans" that are made by the offshore trust to the individual. Because loans are not considered taxable income, the "loan" proceeds need not be reported on a personal tax return. The second method of repatriating the funds is through a debit or credit card issued against the offshore bank account. The individual uses the credit card for personal living expenses and pays the credit card bill with a check drawn on the offshore bank account. This way, the repatriated income never shows up in the individual's personal domestic bank account.

Whether pitching a domestic or offshore trust structure, the clarion cry of all promoters is that their system is "legal." Promoters use a variety of documents to "prove" the validity of their claims. Chief among them are legal opinions citing IRS rules, statutes and court opinions that purport to evidence the promoter's claims. A key part of the package is testimonial letters from clients who claim to have succeeded using the promoter's strategy.

The fact of the matter is that trusts, both domestic and offshore, have been marketed to taxpayers as valid income tax reduction vehicles for more than three decades. They have a long litigation history and that history is marred by repeated failures in the courts. The courts routinely reject the chief legal theories that form the cornerstones of the trust promoters' claims.

Because of the extensive marketing and elaborate promises of trust promoters, trust plans are widely available and millions of citizens have subscribed to the various plans. The IRS currently estimates that between two to three million citizens are involved in some kind of domestic trust program and one to two million citizens are utilizing some form of offshore trust/credit card program. Because of this, the IRS has made this issue a primary enforcement initiative. Later in this report, I examine the current enforcement programs the IRS is undertaking to deal with these scams.

The purpose of this report is to expose the truth about why trusts fail as income tax reduction vehicles. Please note that I do not address trusts in the context of estate planning vehicles in this report. Keep in mind, however, that when used properly in this narrow context, trusts are often quite effective at minimizing and in some cases, eliminating estate tax and probate problems.

In the following sections of this report, I analyze five reasons why trusts don't work to achieve the tax reduction goals promised by the promoters. If you are currently considering the use of a trust for that purpose, you must read this report carefully, then seek experienced counsel independent of the promoter for advice on the merits of the specific proposal.

If you are already involved in either a domestic or offshore trust, I layout the considerations you must entertain for developing an exit strategy. This too involves seeking counsel experienced with trust issues and independent of the promoter who sold you the program.

Five Reasons Why Trusts Don't Work

1. "He who earns the income pays the tax." The "assignment of income" doctrine

The federal income tax law creates a tax on income. The level of taxation is determined by a number of factors, including the amount of the income, the nature of the income (whether capital gains, business income, etc.) and the calculation of a variety of deductions, credits, exclusions and exemptions. Once the tax is determined, the person who earns the income pays the tax. This concept is as old as the tax laws themselves.

In addressing the question of who is responsible to pay a tax, the Supreme Court in 1930 used a "tree and fruit" analogy that has stood the test of time. Court decisions by the hundreds, including those

involving trusts, resort to the "tree and fruit" analogy first articulated seven decades ago. The seminal case is Lucas v. Earl, 281 U.S. 111 (1930).

Guy Earl was a California attorney who earned income by rendering personal legal services. Earl created a contract with his wife under which all property received by either of them, whether by gift, inheritance or "earnings (including salaries, fees, etc.)," would be considered their joint property and NOT the separate property of the person who earned or received it.

Under the terms of the contract, Earl argued that the income he earned from his law practice was not taxable solely to him but rather, was the joint income of both he and his wife. The validity of the contract was not questioned. In fact, the Supreme Court stated, "we assume it to be unquestionable under the law of the State of California." If Lucas were correct, his tax liability would be greatly reduced since the income would be split equally between he and his wife and taxed accordingly.

Unfortunately for Earl, the question did not turn on the validity of the contract. The question turned on the application of the federal tax code and more specifically, on the question of who earned the income. Under the relevant provision of the tax code, now section 61, the law taxes wages, salaries, compensation for personal services, etc., to those who earn them. Since Earl earned the income through the performance of his personal legal services, the income belonged to him for federal income tax purposes.

The Court declared that the full measure of the tax "could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." Because Earl earned the income, he was responsible for the tax. Even assuming the validity of the contract, it did not change the fact that he earned the income.

The Court concluded that for federal income tax purposes, no legitimacy would be afforded to an "arrangement by which the fruits are attributed to a different tree from that on which they grew." This is the premise and genesis of the assignment of income doctrine.

Consider the tree to be capital and fruit to be the income produced by the capital. If the tree were, say, a savings account and the fruit the interest from the savings account, the person who owns the savings account (the tree) must pay the tax on the interest (the fruit). Merely assigning the interest to a third party does not relieve the owner of the account (the tree) from the responsibility to pay the tax.

However, if one assigns the account (the tree) to a third party, that third party then becomes the owner of the account. In that case, the interest (the fruit) is taxable to the new owner. However, in order to effectuate that transfer, one must divest himself of full ownership of the asset that produces the income.

The first, most basic failure of the typical trust structure is the fact that if you are to realize the alleged tax benefits of the structure (assuming those benefits are themselves valid), the income must be owned by the trust. To achieve that, you must "assign" your personal income to the trust. Note,

however, that the assignment of income transfers your wages or compensation for personal services—the fruit—and not the asset that produced the fruit.

As we know from the decision in Lucas v. Earl, anticipatory assignments of income are not valid to transfer the incidents of taxation to a tree other than that which produced the fruit. In other words, he who earns the income pays the tax. Even if the trust is valid under state law for other purposes (just as Earl's contract was valid under state law), that trust cannot operate to unravel the federal statutory income tax scheme.

This rule of law is fundamental and was reaffirmed by the Supreme Court in 1949 in the case of Commissioner v. Culbertson, 337 U.S. 733 (1949). There the Court described this rule as "the first principal of taxation: that income must be taxed to him who earns it." The Supreme Court later reiterated the same holding in United States v. Basye, 410 U.S. 441 (1973).

In the late 1970s, the first wave of trust cases began to work their way through the Tax Court and other federal counts. These cases involved what were then referred to as "family trusts." Under this arrangement, a citizen created a trust then entered into a contract under which all "lifetime services" and remuneration from all sources were conveyed to the trust.

Next, all income earned by the citizen was paid into a trust bank account. The citizen then used that income to pay all his family's personal living expenses, signing checks drawn on the trust bank account as a trustee or trust manager of the trust. The trust claimed a deduction for those items, alleging that the expenses were incidental to trust business and therefore tax deductible.

One of the first family trust cases to reach the Tax Court was Horvat v. Commissioner, T.C. Memo. 1977-104 (April 11, 1977). The fact scenario in Horvat was exactly as outlined in the previous paragraph. The Tax Court rejected the tax benefits claimed by the trust, saying that the:

conveyance of the respective lifetime services and the income earned through the performance of those services was simply an assignment of income and ineffective to shift the tax burden from the [taxpayers] to their family trusts. Accordingly, we hold that the amounts paid [to taxpayers] in return for their services was income to them and should have been so reported.

The consequence of this was that all the tax benefits purported to exist were lost. The court simply looked through the trust structure and concluded that because of the assignment of income doctrine, the income and the incidents of taxation belonged to the person who earned it, regardless of whether the trust was valid for other purposes.

This case was a precursor of several others that were to follow. By the early 1980s, several promoters were selling trust packages throughout the nation and citizens ended up in court not long after implementing the promoters' recommendations. IRS used three key Tax Court cases to attack those trusts and the same three cases are used today.

The cases are:
· Wesenberg v. Commissioner, 69 T.C. 1005 (1978)
· Vnuk v. Commissioner, T.C. Memo. 1979-164 (1979)
· Vercio v. Commissioner, 73 T.C. 1246 (1980)

All three cases involved trusts in which the creators assigned personal income to the trust. All three cases failed for the same reasons stated in Horvat. These cases have since become the centerpiece of the IRS' anti-trust legal arsenal.

2. "With the privilege of control comes the burden of taxation." The "grantor trust" doctrine

The "grantor" is the person who creates a trust. Once created, trustees control the trust and are responsible to administer trust assets for the benefit of its beneficiaries. Trustees function much like a corporation's board of directors, directing the day-to-day affairs of the organization. Beneficiaries have a relationship to a trust much like shareholders have to a corporation. Beneficiaries receive distributions of income or assets under the trust indenture as intended by the grantor, whose wishes are to be carried out by the trustees.

An incestuous economic relationship exists when a trust's grantor is also both a trustee and a beneficiary. In such a case, though income and assets are placed in trust—theoretically no longer owned by the grantor—the grantor nevertheless has substantive control over those assets by virtue of his standing as a trustee. Moreover, he may use that control to his own benefit by virtue of his simultaneous standing as a beneficiary.

There is a body of law on the books that addresses the tax treatment of trusts structured in this fashion. The law is known as the grantor trust rules and derives chiefly from the 1940 Supreme Court decision of Helvering v. Clifford, 309 U.S. 331 (1940). In that case, George Clifford created a trust into which he placed income-producing securities. He named himself trustee and his wife the sole beneficiary. He retained full control over the assets and the distribution of trust income. He provided that upon termination of the trust, the assets would revert to his sole ownership but the accumulated income would belong to his wife.

The IRS asserted that Clifford should be treated as the owner of the asset and therefore taxed on the income since his control over the securities was omnipotent. The case worked its way to the Supreme Court. After considering the nature of Clifford's control over the trust and the assets, the Court noted that the creation of the trust "did not effect any substantial change" in his right to control the assets. More specifically, the Court stated that,

In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have.

In practical effect, under the terms of the trust and the intimacy of his continuing relationship with his wife, Clifford retained the full enjoyment of all the property rights he held prior to creating the trust.

The Court ruled that Clifford's powers under the trust blended "imperceptibly with the normal concepts of full ownership." Therefore, he was the true owner of the property and thus subject to the tax on the income. The Court cautioned that,

To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

The grantor trust rules are presently codified in sections 671 to 677 of the Internal Revenue code. Taken together, these code sections and the legions of court decisions applying them hold that the grantor of a trust is considered the owner of trust assets and hence subject to income tax on trust income when:

· The grantor retains the right to return trust assets to himself;
· The grantor retains the right—either personally or through a non-adverse; trustee—to control the distribution of trust income or assets;
· The grantor retains administrative powers that can be exercised to his own benefit;
· The grantor retains the right—either personally or through a non-adverse trustee—to terminate the trust; and
· The grantor retains the right—either personally or through a non-adverse trustee—to distribute income to himself for his benefit or to his wife.

The Tax Court case of Wesenberg v. Commissioner, (cited earlier) in addition to addressing the assignment of income issue, speaks to the grantor trust rules. Richard and Nancy Wesenberg created a trust and between them, comprised a majority of the board of trustees. The trust provided them with a rent-free residence, a monthly "consultant fee" for managing the trust that they themselves determined. The trust paid all health care, vacation expenses and "any other personal expenses which they agreed were in the 'best interests' of the trust." Moreover, the trust agreement gave Richard "complete control over the disposition of the trust's assets" through a provision allowing him to adopt resolutions to "cover contingencies." This power was utilized to provide for Richard and Nancy's medical care, life insurance and housing expenses.

Applying the grantor trust laws under code sections 674 and 677, the court ruled:

Because there were no restrictions in the trust on the use of its income or [assets] to satisfy these obligations, we conclude Richard should be treated as the "owner" of the entire trust under section 677(a).

The Tax Court disallowed all the purported tax benefits claimed by Wesenberg.

Even if you can get by the fact that personal income is assigned to the trust in violation of the assignment doctrine, the grantor trust laws operate to vest the tax liability in the hands of the income earner when the grantor retains substantial control. To divest yourself of the tax liability attributable to

an asset, you must divest yourself of ownership. But as I said earlier, this is virtually impossible when the trust's alleged income is actually derived from your own personal services.

In any event, divesting yourself of ownership implies more than merely changing mere title to property. A critical element of ownership is that of control. And one key selling point of all trust promoters is the idea that one continues to enjoy full control over his assets even after the trust is established, just as Richard Wesenberg retained control over his assets. But if that is in fact the case, with the privilege of control comes the burden of taxation.

3. "Exalting artifice above reality." The "form over substance" doctrine

Nearly every trust promoter points to the 1935 Supreme Court decision of Gregory v. Helvering, 293 U.S. 465 (1935), in making the case for his trust package. That decision stands for the proposition that no citizen has any patriotic duty to pay more taxes than the law requires. The court noted that "the legal right" of a taxpayer to minimize his taxes or "altogether avoid them, by means which the law permits, cannot be doubted." If in fact this is the law, then certainly one must have the right to enter into a trust arrangement, the sole purpose of which is to reduce or eliminate taxes.

Like most claims of trust promoters, this is only half the story. Though the courts accept the general notion of the right to structure one's affairs in a manner that best suits his needs, the courts likewise impose the requirement that such structure carry a legitimate, non-tax business purpose. It is worthwhile to review the facts of the Gregory case because the holding forms the basis of why the courts routinely reject trust structures.

Evelyn Gregory owned shares of her own corporation that she wished to sell at a profit. Rather than simply sell the stock, incur the profit and pay the full tax, she opted to execute a corporate "reorganization" under which she created a new corporation. Three days later, she transferred the shares to the new corporation under a "plan of reorganization." Six days after that, the new corporation liquidated its assets (the stock) and paid a dividend to its shareholder, Evelyn. Through this clever planning device, Evelyn appeared to substantially cut the capital gains tax on her stock.

Unfortunately, the IRS challenged the transaction. It claimed that while in form, Evelyn met the terms of the reorganization statute, in substance, there was no reorganization at all. Rather, Evelyn carried out a ruse under the guise of a reorganization designed to accomplish nothing more than tax reduction on the sale of her stock. The Supreme Court settled the dispute and in the process, established a doctrine known as the "form over substance" rule.

To answer the question whether the transaction was to be afforded merit for tax purposes, the Supreme Court stripped away all of the technicalities and focused squarely upon the character of what actually occurred. What happened?

Simply an operation having no business or corporate purpose--a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business

or any part of a business, but to transfer a parcel of corporate shares to [Evelyn]. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In rejecting the tax benefits of the reorganization, the Court said, "to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

When the form of the transaction suggests one thing but the substance reflects something entirely different, courts reject the form and govern on the basis of the substance. The underlying question is whether the transaction has economic substance. That is to say, is there any bona fide business purpose to the transaction, other than the reduction of taxes? If there is no objective economic substance to the transaction and no subjective business motivation behind it, the transaction is disregarded for tax purposes. The Supreme Court later reaffirmed this rule in Knetsch v. United States, 364 U.S. 361 (1960).

The form over substance test is a key element in all court battles involving trusts. Courts carefully consider the economic effects of the transaction by comparing the facts as they exist both before and after the trust is created. A good example of this is found in the case of Markosian v. Commissioner, 73 T.C. 1235 (1980).

Louis and Joan Markosian formed a trust, deeded their property to the trust and transferred to it all personal services through an assignment. Once the trust was created, Louis continued to operate his business in precisely the same manner as before the trust existed. He continued his dental practice in the same office using the same equipment. He lived with his wife in the same house with the same furnishings and paid no rent to the trust. All funds used to pay personal living expenses, including so-called trust expenses, were derived from Louis' dental practice. Finally, Louis and Joan had unlimited power to deal with trust assets in any way they saw fit just as they did before there was a trust.

On the basis of these facts, the Tax Court ruled that there was no economic reality or substance to the transaction creating the trust. The court further observed that even if the form of the trust was valid, "it was not administered like a trust." The court's conclusion is a leading reason why similar trusts repeatedly fail:

In our opinion, the above factors, together with the lack of any valid purpose other than the avoidance of tax, are enough to deprive the trust of all trappings of economic reality and mandate that we disregard this attempt to shift income by creation of this paper entity.

The form over substance doctrine is used routinely to negate promoters' efforts to defeat the grantor trust rules. Promoters routinely recommend the use of third parties as trustees, such as a friend or relative, but not a spouse, son or daughter. However, promoters also suggest that these people sign undated resignation forms in advance that you hold, sign blank, undated checks in advance that you hold, not participate in trust meetings and not make any substantive decisions on trust affairs. In other

words, the third-party trustees exist in name only to create the appearance of independent trustees though they do not act in any true, independent fashion.

The Tax Court routinely rejects the validity of trusts using the economic reality test. Some of the chief case authorities for the Tax Court's actions are:

· Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1970)
· Clawson v. Commissioner, T.C. Memo. 1982-321 (1982)
· Dahlstrom v. Commissioner, T.C. Memo. 1991-264, aff'd without published opinion 999 F.2d 1579 (5th Cir. 1993)
· Muhich v. Commissioner, T.C. Memo. 1999-192, aff'd 238 F.3d 860 (7th Cir. 2001)
· Castro v. Commissioner, T.C. Memo. 2001-115 (2001) (This case presents an excellent discussion of all the elements comprising the form over substance analysis in trust cases.)

So even though it is true that you have the right to create a trust, its mere creation does not carry automatic tax benefits. The trust must be more than a paper artifice designed solely to reduce or eliminate taxes. There must be economic substance to the structure that was created for bona fide business purposes other than simply tax reduction. Moreover, independent trustees must act in a fiduciary manner with the best interests of the beneficiaries in mind. Lacking these attributes, the trust is considered a sham.

4. "You earn the money and use it for your own benefit. "The "step-transaction" doctrine and offshore trusts

Not long after the courts began shooting down the idea of using domestic trusts for income tax planning purposes, promoters began adapting their trust schemes. The most notable change in marketing and structural strategy was the creation of the offshore trust. Under the offshore trust scheme, promoters create a series of entities and orchestrate a series of transactions that channel income outside the United States, into a tax haven country such as the Bahamas, Cayman Islands, the Turks and Cacaos Islands, etc. While different promoters put various twists on the process, the following is a loose illustration of the steps:

1. The promoters create a domestic corporation or limited liability company (LLC) and a domestic trust. You own a minority of shares in the corporation, perhaps 10 percent, and the trust owns a majority of the shares. Your income is assigned to the corporation. Net profits after deductions for business expenses are paid to the shareholders. Because you are a minority shareholder, you show little income on your personal tax return. You are employed by the domestic trust as a trust manager or secretary. (The first problem with this structure is the assignment of income.)

2. Two foreign trusts are created and domiciled in a tax haven nation. The first owns and receives 100 percent of the beneficial interest in the above domestic trust. Funds are channeled offshore into this trust. The trust may or may not file a federal income tax return, but if it does,

it shows substantially all of its income as being expensed to the second offshore trust. You are employed by both offshore trusts as manager or secretary.

3. The second offshore trust (the third trust in the string and fourth entity, including the corporation or LLC) accumulates the income as the last entity in the pipeline. As a foreign entity allegedly conducting no business in the United States, it has no obligation to file a tax return. Hence, its income is not taxable. Its income is deposited to a foreign bank account controlled by the trust manager or secretary—you. In fact, you are the only person with check-writing authority for any of the entities involved in the transactions, even though you may not be a trustee or beneficiary.

4. Funds are repatriated to the United States and to your personal use through either a credit card in the name of the trust or through loans from the trust to you or perhaps to still another domestic trust or corporation. The last trust also owns offshore investment and brokerage accounts.

Through these devices, promoters craft a long and circuitous conduit through which money is routed from the taxpayer who earns it, ultimately back to the taxpayer, who spends it. The question is whether the courts will find and determine that the income is non-taxable given the extensive pipeline through which it is channeled.

The answer lies in a one-sentence observation by the Supreme Court in the 1938 case of Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938), whereupon analyzing a particularly twisted series of corporate transactions designed to avoid capital gains tax on a stock sale, the Supreme Court stated, "A given result at the end of a straight path is not made a different result because reached by following a devious path."

The "straight path" is this: the taxpayer earns the income and spends it. That renders the income taxable to him—period. This result is the same even after following the "devious path" through several entities, bank accounts and foreign countries. The principle of law the courts rely to reach this conclusion derives from the form over substance doctrine discussed above. As we know, the courts look to the substance of a transaction to determine its validity, not merely its form.

When a series of complicated transactions are involved, the courts apply what is known as the "step-transaction" doctrine to determine the substance of what occurred. The step-transaction doctrine requires that the transaction be treated as a "unified whole" as opposed to independently considering each distinct, individual step. Commissioner v. Clark, 489 U.S. 726 (1989). Said another way, the courts look at the "straight path" rather the "devious path." The result is that even though the individual steps—taken in isolation from one another—may lead to a non-taxable transaction, the outcome will not be countenanced where it represents a result clearly not intended by Congress.

The Supreme Court, in the 1945 case of Commissioner v. Court Holding Co., 324 U.S. 331 (1945), described the step-transaction doctrine in these words:

The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Even assuming you can get past the assignment of income doctrine, the grantor trust laws and the form over substance doctrines operate to vest ownership of trust assets in the hands of the person who controls the trust. Certainly, there is no less control of the money under a foreign trust scheme than there is under a domestic trust. Remember, the fact that you retain control of the money and may use it for your own benefit is a key selling point all trust promoters trumpet. Even though you add layers of entities through which money is funneled, you never lose control of the money. As shown above, the trust manager or secretary—you—is the only person authorized to sign on any of the bank accounts. Taken as a whole, the substance of the transactions can be boiled down to this simple truth: you earn the money and use it for your own benefit.

Since the early 1980s, the Tax Court and other federal courts have held that offshore trust schemes such as those described here constitute "shams, lacked economic substance, and were to be disregarded for Federal income tax purposes." Zmuda v. Commissioner, 79 T.C. 714 (1982), aff'd 731 F.2d 1417 (9th Cir. 1984). Some of the key cases include:

· Akland v. Commissioner, 767 F.2d 618 (9th Cir. 1985), aff'g T.C. Memo. 1983-249
· Professional Services v. Commissioner, 79 T.C. 888 (1982)
· Dahlstrom v. Commissioner, T.C. Memo. 1991-265, aff'd without published opinion 999 F.2d 1579 (5th Cir. 1993)
· Able Co. v. Commissioner, T.C. Memo. 1990-500 (1990)
· Waegemann v. Commissioner, T.C. Memo. 1993-632 (1993) [extensive discussion of the validity of "loans" orchestrated to repatriate funds]

A representative example of how courts treat these cases is Rendel v. Commissioner, T.C. Memo. 1995-593, aff'd 129 F.3d 127 (9th Cir. 1997). David and Rachel Rendel formed a corporation in 1980 to handle their sales business and after it began earning substantial income, they consulted with trust promoters who sold them on the purported tax benefits of offshore trusts.

In 1982, the Rendels established five trusts located in the British West Indies. Bank accounts were opened under the name of four of the trusts. An investment account was opened under the name of the fifth trust. During 1982 and early 1983, $174,300 of profits were transferred through the string of offshore trusts and into the investment account. The Rendels repatriated the money through sham loan transactions and used the money to purchase real estate, which was held in one of the trusts.

Later, the Rendels were indicted for conspiracy to defraud the United States and income tax evasion. They each pleaded guilty to one count of evasion. In addition to extracting guilty pleas, the IRS obtained a tax assessment for $87,231 against the Rendels, which included the civil fraud penalty.

5. "Moving assets from the left pocket to the right pocket." The "alter ego" and "nominee" doctrines

Another key marketing claim of trust promoters is that trusts provide "bullet proof" asset protection against potential IRS enforcement action. Promoters argue that you are able to keep your property out of the IRS' reach in the event of future tax problems. Many promoters even go so far as to claim that those with existing IRS problems can avoid the ravages of enforced collection (wage levies, bank levies and property seizures) by placing assets in a trust. it is asserted that since the assets are "not in your name," they cannot be seized by the IRS to pay your delinquent taxes.

It is certainly true that the IRS cannot seize property belonging to one person to satisfy the tax debt of other. It is not true, however, that merely placing property in the name of a trust that you control prevents the IRS from seizing that property. Two principles of law come into play here that the IRS has used for decades to reach through the trust veil to seize property that is titled in the name of a trust. I speak of the "alter ego" and "nominee" doctrines.

Under the doctrine of alter ego, when the facts establish a unity of interest in ownership and property between an individual and an entity, such as a trust, the courts view the entity as merely an extension of the individual. As a result, the entity is accorded no legal distinction apart from the individual vis-à-vis the rights of third parties. Once an alter ego relationship is established, third party creditors, including the IRS, can collect from the assets of the entity (i.e., the trust) just as though the assets were held by the individual. Towe Antique Ford Foundation v. I.R.S., 999 F.2d 1387 (9th Cir. 1993); Neely v. United States, 775 F.2d 1092 (9th Cir. 1985).

Think of the alter ego situation as moving money from the left pocket to the right pocket. Just because you title the left pocket differently from the right pocket, you still control every element of the left pocket. The left pocket is therefore the alter ego of the right pocket.

The nominee doctrine is only slightly different. Under this theory, the IRS might recognize that a transfer indeed occurred between you and a trust. However, when there continues to be a unity of interest between you and the trust, the nominee theory considers that the entity has not assumed full and lawful ownership of the asset but rather, is merely holding it on your behalf, the true owner. G.M. Leasing Corp. v. United States, 429 U.S. 338 (1977); United States v. Reed, 168 F. Supp. 2nd 1266 (D. Utah 2001).

Think of the nominee situation as handing money to your brother with clear instructions to hold it for you until you ask for its return. Just because your brother holds money for you does not mean the money belongs to your brother. You still own and in essence, control the money though it is in the hands of another. Therefore, creditors—including the IRS—can reach the money to satisfy your debts.

Most often, the IRS asserts both the alter ego and nominee theories in breaking trusts to reach property.

To determine that an alter ego relationship exists, the courts point to, among others, these five key factors:

- · Although property was transferred to a trust, the taxpayer continues to treat the property as if it belongs to him. F.P.P. Enterprises v. United States, 830 F.2d 114, 116 (8th Cir. 1987). That is to say, you continue to reside on the property yet pay no rent. You pay all utilities, taxes, up keep and maintenance costs after the property was transferred to the trust.

- · Little or no consideration was paid by the trust in exchange for the property. In the vast majority of cases, there is no exchange of value for placing the property into the trust and yet, the individual continues to pay the expenses associated with the property and continues to use and enjoy the property free of any interference from the trust.

- · The taxpayer maintains "active" or "substantial control" over the operation of and decisions with respect to the property after it was conveyed the trust. In this regard, the courts carefully examine the role of alleged trustees other than the taxpayer, including the duties of the trustees; whether other property is controlled by the trustees; the nature, scope and extent of meetings of the trustees and their participation; the performance of trust activity by trustees other than the taxpayers.

- · Whether a family or close relationship exists between the taxpayer and the trust. Shades Ridge Holding Co. v. United States, 888 F.2d 725, (11th Cir. 1989). Trustees that are family members or have a close relationship to the taxpayer are often considered as being subject to the control of the taxpayer.

- · Whether the taxpayer expressed an intent to shelter personal assets using the trust structure. The courts examine all the background facts concerning the trust's creation, including the representations of the promoter concerning the alleged effectiveness or desirability for sheltering assets under a trust umbrella. Expect a court to carefully scrutinize promotional documents regarding claims in this area.

The case of United States v. Powell, Docket No. CV 99-224-TUC-RCC, District Court, Arizona (February 20, 2001); (aff'd Ninth Circuit, unpublished per curium opinion, Docket No. 01-16162, February 22, 2002), is an excellent study for determining the true effectiveness of trusts for sheltering assets. The Powells had a long running dispute with the IRS and eventually created a trust closely following the factual outline of trusts addressed here. When the IRS attempted to break the trust and sell the Powells' home to pay their delinquent taxes, the case ended up before a federal judge in Arizona.

The Powells asserted that the trust was the true owner of the property and hence, the IRS could not reach it to pay their tax debt. After considering all the facts, the court disagreed, stating that the case record,

supports a finding that the Powells retain active and substantial control over the Trust: (1) the Powells continue to treat the transferred property as if it still belongs to them; (2) the Trust paid minimal or no consideration for transfer of the property title; (3) the Powells retain control over transferred property; (4) the Powells have established a family relationship in the Trust; and (5) facts indicate that the Trust may have been established to shelter the Powells' assets from tax liability.

The property was ordered sold to pay the Powells' delinquent tax debts.

In determining nominee status, the courts view factors similar to those expressed above. Guidance is provided by the case of United States v. Bannister, Docket No. 02-C-075-S, (D. Wis., August 7, 2002). That case involved William and Joyce Bannister who had long running IRS disputes. They created a trust to protect their home from the IRS. The fact pattern surrounding the trust itself is not unlike any of those already set forth above.

Just as in the Powell case, the IRS sought an order from a federal judge breaking the trust and allowing the IRS to sell the home. The court obliged and in breaking the trust, ruled that Bannister,

exercises dominion and control over the property. He continues to reside at the property, and the River Trust does not interfere with his use of the property. The River Trust did not pay any consideration for the property. Defendant William R. Bannister is the trustee and beneficiary of the trust and continues to enjoy the benefits of the property. Further, the transfer of the trust in 1992 occurred after said defendant had failed to file federal income tax returns for three years. Considering all these factors the Court finds that the Rice Lake property is held by a nominee of defendant William R. Bannister and the federal tax liens may be foreclosed against the property.

The above cases are just a small, and frankly, random sampling of federal cases where the IRS successfully pierced the trust veil to force a sale of property allegedly owned by a trust. The reality is, because the overwhelming majority of trust cases follow the fact pattern discussed here, you must assume that the IRS will always be successful in breaking the trust and selling your property.

Keep in mind that some of the chief claims that trust promoters make to sell trusts is that you continue to enjoy full control over the property—you continue to be able to use and benefit from it as though it were legally yours—even after establishing the trust. But understand that that is the very factor that spells the kiss of death for your trust. As illustrated here, merely moving assets from the left pocket to the right pocket does not shelter them from the IRS.

Tax Law Enforcement in Trust Cases

Another key marketing claim of trust promoters is that by adopting a trust and moving income into the trust, you enjoy maximum privacy and freedom from contact by the IRS. It is alleged that you no longer have to worry about meddling IRS agents or crippling collection effects. Apart from the obvious concerns about this claim as outlined in the preceding sections, the fact is, trust involvement is likely to cause more problems with the IRS—not fewer.

The chief reason for this is the level of enforcement resources the IRS is directing against what it calls abusive trusts. An abusive trust is a "sham trust," or one that falls into the factual pattern of those described throughout this treatise. The IRS is so active in enforcing the tax laws against abusive trusts that the National Taxpayer Advocate, in her 2002 Annual Report to Congress, listed "abusive trusts" as one of the most litigated tax issues in the United States during 2002.

Specifically, the Taxpayer Advocate states,

The IRS estimates that in tax year 2000 alone, there were 570,000 abusive domestic trust returns and offshore trust schemes. …The estimated tax revenue loss is between $20 billion and $40 billion. With the increase of IRS resources targeting abusive trusts, it is certain that more of these cases will reach the courts in the coming years.

While the loss of revenue to the Treasury is substantial, there are also economic and social effects on the taxpayers who become involved in these types of trust schemes. Once a court determines a trust is abusive, the taxpayer faces not only an income tax deficiency, but also interest, penalties and possible criminal sanctions. IRS, "National Taxpayer Advocate, 2002 Annual Report to Congress," December 31, 2002, p. 338.

In 2002 alone, the various federal courts decided thirty-eight trust cases, including cases against three trust promoters. Of those, five involved the seizure of property, such as a home or business. Four involved criminal prosecutions and jail time, either of a promoter or participant in a trust program. The IRS won every single case. Perhaps most notably, one court even sanctioned an attorney by assessing court costs and fees against him for even raising what are now considered patently frivolous trust defenses. See Johnson v. Commissioner, 289 F. 3d 452 (7th Cir. 2002).

With regard to offshore trust schemes, the IRS is engaged in an aggressive investigation calculated to unearth the users of credit and debit cards drawn on foreign bank accounts. To aid this investigation, the IRS has been obtaining court authorization to issue "John Doe" summons against credit card companies such as Visa and MasterCard, American Express, and wide variety of other providers of products and services. A "John Doe" summons, issued under the authority of code sections 7602(c) and 7609(f) and allows the IRS to obtain information from third parties when it is shown that "such person or group or class of persons may fail or may have failed to comply with any provision" of the tax code. Most notably, the IRS is serving these summons on airlines, travel agencies, hotel and resort chairs, exclusive jewelers such as Tiffany and Company, auto dealers, Internet providers, furniture retailers, etc.

The investigation is designed to generate a list of the names of American citizens who use credit or debt cards drawn on banks in foreign countries to make purchases. With the information obtained from these companies, the IRS follows up with full-scale audits, potential criminal investigations and possible prosecutions.

The following is a summary of the recent court cases associated with the investigation:

· In Re Tax Liabilities of John Does, Docket No. CV 02-0049 Misc. (N.D. Cal., March 27, 2002); summons to VISA for account information on US citizens with credit/debit accounts in any of thirty counties, including Switzerland, Liechtenstein and numerous Caribbean nations.

· In Re Tax Liabilities of John Does, Docket No. 1:02-MI-0254 (N.D. Ga., August 30 2002); summons to MasterCard for account information on US citizens with credit/debit accounts in any of thirty counties, including Switzerland, Liechtenstein and numerous Caribbean nations.

· In Re Tax Liabilities of John Does, Docket No. 3:02-CV-1854-L (N.D Texas, September 30, 2002); eleven companies summonsed.

· In Re Tax Liabilities of John Does, Docket No. M-18-304 (S.D. NY, October 16, 2002); seventeen companies summonsed.

· In Re Tax Liabilities of John Does, Docket No. 6:02-MC-100-ORL-22JGG (M.D. Fla., October 17, 2002); seven companies summonsed.

· In Re Tax Liabilities of John Does, Docket No. 3:-02-CV-1854-L (N.D. Texas, October 25, 2002); eleven companies summonsed.

· In Re Tax Liabilities of John Does, Docket No. C-1-02-738 (S. D. Ohio, January 21, 2003); seventy companies summonsed.

The information gathered through these investigations is leading to the names of thousands of people who have used credit or debit cards drawn on offshore banks. With increasing intensity, the IRS is targeting for enforcement action each person it finds.

You might ask, "Why does the IRS let promoters get away with selling these schemes?" The answer is, the IRS doesn't.

For years, the agency has used code section 6700 as a means of obtaining injunctions against promoters, preventing them from marketing the trust packages. That code section gives federal judges the authority to enjoin the marketing and sale of abusive tax schemes.

There are innumerable examples of trust promoters whose activities have been shut down under section 6700. The problem is, every time the IRS closes down one operation, more pop up. And with the ubiquity of the Internet, promoters are able to reach more people faster than the IRS can shut them down.

Still, the IRS has approximately 300 audits pending of promoters of offshore and domestic schemes of this nature. Under the IRS' new commissioner, Mark Everson, you can expect more of this activity since

he promised the Senate Finance Committee that "enforcement will be a principle responsibility of the IRS" under his leadership.

Building an Exit Strategy

If you are involved in either a domestic or offshore trust along the lines of the fact patterns described in this report, you must give very serious and immediate consideration to developing an exit strategy. Here are the major considerations you must weigh.

1. Cease the activity. You cannot allow the pattern of conduct to continue over a protracted period. A pattern of conduct is an important factor the IRS evaluates in determining whether to pursue criminal charges. A continuing pattern of illegal conduct makes prosecution more likely. Such a prosecution is more likely to be successful than one involving a person who committed a "one-time" act. Generally speaking, the IRS looks for at least a three-year pattern of conduct to support its allegation that your actions were deliberate, intentional and knowing, as opposed to being attributable to some good faith reason such as inadvertence, misunderstanding, mistake, etc.

Even if you are not prosecuted, interest and penalties accumulate, even during the period prior to an adverse audit or court determination on your trust. These additions can easily double or triple a tax bill. Therefore, it is clear that the sooner you cease the activity, the better off you are.

2. Consider amending trust returns. The question always arises whether to amend trust returns to eliminate the purported tax benefits of the trust structure. Amended returns would assume the traditional stance of reporting income and expenses on a Schedule C, Form 1040 for a self-employed person. However, filing amended returns creates an immediate tax liability that you are obligated to pay. Ideally, if the returns are amended, the tax should be paid at the time of filing the returns. I discuss this in more detail later.

But you must realize that filing amended returns raises the so-called Fifth Amendment dilemma. On the one hand, if you fail to amend the returns, the IRS may view that as a deliberate refusal to correct a mistake you knew you made, thus tarnishing your claim of good faith and lack of criminal intent. On the other hand, if you amend the returns, the IRS may take that as an admission of an outstanding tax liability for the amendment years, reducing the government’s burden of proof in a potential criminal trial. You also open the door to allow the IRS to argue that filing the amended returns is a de facto admission by you that your original returns were erroneous and that you knew them to be, otherwise you would have not have amended them.

In light of these conflicting arguments, the question becomes, upon which ground would you rather stand?

Amending the returns clearly is a waiver of your Fifth Amendment rights with regard to the tax liability issue. Amended returns constitute an admission that you owe taxes. The returns then give the government the latitude to argue that you knew the original returns were erroneous and by extension, fraudulent.

However, whether amended returns prove your good faith or lack thereof a fact question for a jury to decide. The court cannot impute bad faith or criminal intent merely because you amended returns. See Heindel v. United States, 150 F.2d 493 (6th Cir. 1945). In the context of a criminal prosecution, however, the government can be expected to argue the point to a jury.

On the other hand, amending the returns provides you with the capacity to argue that good faith is proved by the fact that you corrected mistakes when they became known to you. In fact, numerous courts have pointed to a defendant's failure to correct known errors as evidence of fraudulent intent. For example, in Hill v. United States, 363 F.2d 176 (5th Cir. 1966), the court ruled that it was proper for a jury to consider the defendant's failure to amend returns, pursuant to his accountant's advice, as evidence of the defendant's willfulness as alleged by the government. Likewise, in sustaining a civil fraud penalty against taxpayers who used offshore trusts, the Ninth Circuit in the case of Rendel v. Commissioner, T.C. Memo. 1995-593, aff'd 129 F.3d 127 (9th Cir. 1997) (unpublished) noted that the taxpayers refused to amend returns after their CPA advised them to do so.

One thing is for sure. DO NOT make the decision until after you consult with experienced counsel who understands the full legal implications of amending returns and balances the benefits against the detriments.

3. Paying the taxes. The best possible approach to consummating an exit strategy is to pay all the taxes at the time of filing amended returns. If you do, the chances are better that the IRS will merely process the amendments in the ordinary course of its activities, assuming it has not already commenced an audit or criminal investigation.

However, failure to pay the taxes will likely lead to the case being assigned for collection action. If a revenue officer becomes involved with the collection process, that may (though not certainly) lead to questions regarding the nature of the liability. Admittedly, however, collection officials rarely pose the question, "Why do you owe this?" As a general rule, they do not care. They just want the money.

On the other hand, in the past two years, revenue officers have been instructed to "be on the lookout" for cases that present the potential for criminal prosecution. The IRS has re-built its in-house referral system to feed cases to the criminal investigation and prosecution machines. Specifically, the IRS looks for trust cases to make examples of people. For these reasons, it is best to stay away from a collection situation.

4. The statute of limitations. Another important factor to consider is the impact of the statute of limitations. At some point, the IRS will not be able to audit your returns, assuming you never come under criminal prosecution. The normal period of limitations for a civil audit is three years from the date the return is filed. Code section 6501. Amended returns must be filed within that three-year period. The IRS will not process amended returns filed after that period.

However, there are two important exceptions to this three-year rule. This first is code section 6501(e). It provides that if more than 25 percent of your gross income is omitted from a return, the limitations period grows to six years. The IRS has the burden to prove the omission. The second exception is code

section 6501(c)(1) and (2), the so-called fraud exception. If the IRS can prove that there was a false or fraudulent return or there was an attempt in any manner to evade or defeat payment of the tax, there is no statute of limitations on the right to audit and assess taxes. (This rule does not apply to the IRS' right of criminal prosecution.)

Even assuming there is no criminal investigation or prosecution, a civil audit is likely in trust cases. Given that, can you rely on a three-year statute of limitations? Probably not, given the two exceptions set out above. That means that your exposure to civil tax assessments could linger for several years, increasing the interest and penalties when the IRS finally does make an assessment. Moreover, after three years expire from the date of filing, you cannot amend even if you want to. This leaves you entirely at the mercy of the IRS' capacity to undertake and complete an audit. This must be factored into your exit strategy.

5. What if you cannot pay the taxes owed? Even if you determine that the best approach is to file amended returns, collection of the delinquent tax may pose an entirely different set of problems. As we learned earlier, the IRS can reach trust assets to pay the taxes and wage, bank or other property levies are common in delinquent tax cases. Therefore, your plan must take into account a strategy for handling a collection case if you cannot pay in full.

There are several options available under these circumstances. Which one will work best for you depends upon the specifics of your situation. The alternatives are:

· Installment agreement. If you can make an aggressive payment and do not owe a substantial amount to begin with, an installment agreement can keep enforcement action at bay while you pay off the debt.

· Penalty cancellation. In conjunction with an installment agreement, you can seek cancellation of penalties if you can prove that you acted in good faith and based upon a reasonable cause for your actions. Good faith reliance upon counsel can be a defense to penalties.

· Leveraging or selective liquidation of assets. If you have the equity in assets to pay the tax, you must consider either borrowing against those assets or selectively liquidating them to pay the debt. IRS penalties and interest accumulate at the rate of about 20 percent annually. Therefore, you are almost always better off raising money from third party sources than you are using an installment strategy with the IRS.

· Offer in Compromise. If you do not have the income or the assets to pay in full, an Offer in Compromise may be a solution. This is the process by which the IRS accepts less than full payment of a tax if you prove that the amount offered is the most the IRS can collect from you. In the right case, the IRS settles for five to ten cents on the dollar.

· Bankruptcy. One of the best-kept legal secrets is the fact that tax debts can be discharged in bankruptcy under certain circumstances. When all else fails, you must consider a bankruptcy to resolve your delinquent tax debt.

How to Get Help with Your Situation

We offer a number of ways you can get the experienced, knowledgeable help you need to solve your problem. My two books, *How to Get Tax Amnesty* and *The IRS Problem Solver* are a must to help you figure out your options and develop a strategy to resolve your situation. If you need more personal help, you can get that as a member of my Tax Solutions Network.

For more information or to talk with someone in my office, call 800-346-6829 or email us at Support@taxhelponline.com.