Price & Farrington's Estate and Tax Planning *Fast* Faxts May, 2003

Estate, Tax and Wealth Planning for Advisors and Clients

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Top *Tax Scams* Part II: Abusive Trusts

This month's FastFaxts is a follow-up to our March, 2003 edition, "Top Tax Scams: The Dirty Dozen". Read on...

IRS Publication 2193 is titled "Too Good to Be True: Should Your Financial Portfolio Include Trusts". It is a very good warning to clients about schemes and pipe dreams involving trusts.

Facts: This IRS publication starts with a definition of fraudulent trusts. Abusive trusts – unlike legitimate trusts – are specifically designed and created to hide the true ownership of assets and income or to disguise the substance of financial transactions. The IRS makes it clear that if you violate the tax law, you may face serious civil penalties and/or criminal prosecution.

Civil Penalties: The IRS assesses a fraud penalty of up to 75% of the underpayment of tax attributable to the fraud, in addition to payment of the proper taxes and interest owed.

Criminal Sanctions: Fines of up to $250,000 and/or up to five years in prison can be imposed for each offense. The IRS publication states in no uncertain terms that "taxpayers are responsible for payment of their taxes regardless of who prepares their return." In other words, you can't hide behind your accountant as a defense from prosecution.

If a promoter makes any of the following *false* statements, you have a good indication that the trust involved is likely to be fraudulent:

False: Set up this trust and you can eliminate income or self-employment taxes.

Truth: Someone must pay tax on the income produced by trust assets. That may fall to either the trust, the beneficiary or the transferor (grantor) of the trust assets.

False: You can retain complete control over your income and assets and still save income and estate tax.

Truth: Sorry. You can't have both at the same time. You can retain complete control over your income and your assets in a revocable trust but you save no income or estate taxes through the use of such a trust. You can save income and estate taxes by using an irrevocable trust as long as you give up control over the income and the assets you place into the trust.

False: You can deduct personal expenses paid by the trust on your personal tax return.

Truth: You can't transform nondeductible personal living expenses into deductible expense by assigning assets or income to a trust.

False: You can depreciate your home and furnishings and take them as deductions on your income tax return.

Truth: Depreciation of your residence and furnishings used solely for personal use is not deductible even if you transfer your home to a trust.

Trust: Can You? Trusts are legitimate, powerful tools to achieve both tax and non-tax objectives. But don't be misled by the word "trust." The name "trust" does not make a document legitimate – nor does it offer any assurance of accomplishing the tax objectives it purports to accomplish.

Classic Trust Scams and Schemes: Don't walk away from any of the following cons and scams. *RUN FAST!*:

Business Trust: Also often called (or combined with) a "pure" trust or a "constitutional" trust, this scheme suggests that you transfer your business or practice to a trust in order to make it appear that you have divested yourself of control. But the promoter tells you that, in reality, through someone or some entity you in fact control – or through a "paper trustee" – even after the transfer of your business to a supposedly irrevocable trust, you still run day-to-day activities and control the business's (or practice's) income stream and can still treat the capital as your own. The truth is, these arrangements provide no tax savings.

Equipment or Service Trust: The

"You can't do this! I married him for his money!"

BRAND NEW MEDICAID RULES IN WASHINGTON

BE AWARE AND BEWARE!

NEW RULES EFFECTIVE APRIL 1,2003 WHICH APPEAR AT FIRST TO MERELY CHANGE THE MATHEMATICAL FORMULA TO DETERMINE ELEGIBILITY FOR MEDICAID WILL RESULT IN A MUCH LONGER PENALTY PERIOD IF GIFTS ARE NOT STRUCTURED PROPERLY.

LEARN MORE AT OUR JUNE 5 SEMINAR (SEE NEXT PAGE)

"He that won't be counselled, can't be helped."

-Benjamin Franklin

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promoter forms a trust which is designed to hold equipment that is rented or leased to the business trust, often at highly inflated rates. The business trust attempts to reduce its income by claiming deductions for payments to the equipment trust. In reality, this type of arrangement, like the business trust, provides no tax savings.

Family Residence Trust: Here, you are told to transfer your home, including furnishings, to a trust. In some cases, the trust will rent the residence back to you. The trust deducts depreciation and the expenses of maintaining and operating the residence including pool service and utilities. Of course, these expenses are not deductible.

Charitable Trust*:* The promoter suggests you transfer assets or income to a trust which you call a charitable organization. The trust or organization pays for personal, educational, and recreational expenses on your behalf (or on behalf of a family member). The trust then claims the payments as charitable deductions on its tax returns. Typically, these alleged charitable organizations are not "qualified", i.e., they do not meet certain tests for tax exempt status and have no IRS exemption letter. Therefore, contributions are not deductible and money growing inside them is not tax exempt.

Foreign Trust: You are told the promoter will set up a trust for you in a foreign country that imposes little or no tax on trusts. You are also assured that the entire transaction will be free from creditors and never subject to scrutiny by the IRS. Typically, these abusive foreign trust arrangements are touted to enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to you. The trust promoter claims that this distribution is tax-free. In fact, the income from these arrangements is fully taxable. It's a transparent sham.

Signs: If you hear any of the following, you or your client may be the victim of unscrupulous trust promotion:

- ☞ "We can eliminate your income and self-employment tax."
- ☞ "We can get you deductions for your personal expenses."
- ☞ "We can get you depreciation deductions on your home and furnishings."
- ☞ "Our high trust fees are quickly offset by incredible tax benefits."
- ☞ "We'll just back-date these papers."
- ☞ "You can replace the trustee anytime you want with anyone you want with no tax consequence."
- ☞ "We've got a post office box we can use as the trust's address."
- ☞ "This is a pure trust, a constitutional trust, a sovereign trust, a patriot's trust." Run! Hide!

Diversionary Tactics: Promoters of sham trusts often distract you from asking the right questions by using more tactics: (1) supplying an attorney letter that says the trust is legal; (2) Referring to the U.S. Constitution to support the trust; (3) Citing court cases as proof the trust is legal and/or (4) using wealthy family examples.

These diversions supposedly prove their trust is legal or has been used successfully by the wealthy. Usually the attorney letter is technically accurate, but these references are a smokescreen. The real issue is not the trust itself but the way it is used. A "legal" trust is meaningless when you commit tax fraud or operate it in a manner inconsistent with trust and property laws. And it will rarely be the attorney who wrote the letter that gets you involved in the illegal activities. It will be some non-licensed, non-certified "professional" playing lawyer, financial planner or "estate planner". Neither the Constitution nor any court citations will support you when you operate outside the law or the tax system. The result? No asset protection. A collapsed trust. A quagmire that costs a fortune to unravel, not counting back taxes, penalties and interest. And in some cases, jail.

Bottom Line: If it looks too good to be true, it probably is! ■

As always, please let us know how we can best help you help your clients accomplish important goals through proper planning.

Glen D. Price

In Our Next Issue:

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An 85 year old retired nurse has taken an *extraordinary measure* to ensure that her doctors do not prolong her life against her wishes. This takes "Do Not Resuscitate" to a very unexpected place!