

**APPEALS
TECHNICAL GUIDANCE PROGRAM
APPEALS SETTLEMENT GUIDELINES**

ISSUE: Domestic Abusive Trust Schemes

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SETTLEMENT POSITION
DOMESTIC ABUSIVE TRUST SCHEMES

ISSUES:

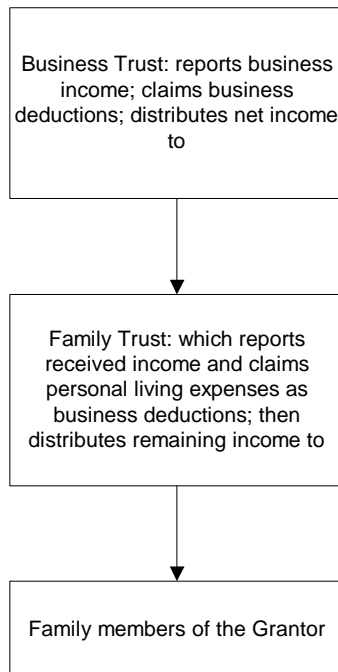
1. Whether income ostensibly earned by the trust is taxable to the individual taxpayer because the trust arrangement is a sham.
2. Whether income ostensibly earned by the trust is taxable to the individual taxpayer because the trust arrangement is a grantor trust.
3. Whether income ostensibly earned by the trust is taxable to the individual taxpayer because the trust arrangement is an anticipatory assignment of income.
4. Whether income ostensibly earned by the trust is taxable to the individual taxpayer because the trust arrangement is a simple trust.
5. Whether the income distribution deduction from the business trust (for income ostensibly passed through to the family trust tier) is not allowable because the business trust tier is a complex trust.
6. Whether claimed business expenses should be allowed at the business trust level.
7. Whether claimed business deductions (for personal living expenses of the grantor and his family) should be allowed at the family trust level.
8. Whether a deduction should be allowed for amounts paid to the promoter of the abusive trust arrangement.
9. Whether taxpayers are liable for self-employment tax or employment taxes because (1) the trust arrangement is a sham; (2) the trust, if valid, paid an inadequate amount to the taxpayer performing services on behalf of the trust; and (3) the trust and/or the taxpayer incorrectly determined employment taxes with regard to employees or independent contractors performing services for the business.
10. Whether the Service should assert (a) the failure-to-file and failure-to-pay penalties of I.R.C. § 6651; (b) the estimated tax penalty of I.R.C. § 6654; or (c) the negligence or intentional disregard of rules or regulations and/or the substantial understatement of income tax portions of I.R.C. §6662 against a taxpayer for engaging in an abusive trust arrangement.

OVERVIEW OF COMPLIANCE'S POSITION

Abusive trust arrangements typically are promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over, or benefit from, the taxpayer's income or assets. The promised benefits may include reduction or elimination of income subject to reporting and tax; deductions for personal expenses paid by the trust; depreciation deductions of an owner's personal expenses paid by the trust; depreciation deductions for an owner's personal residence and furnishings; a stepped-up basis (without a corresponding taxable event) for property transferred to the trust; the reduction or elimination of self-employment taxes; and the reduction or elimination of gift and estate taxes. These promised benefits are inconsistent with the tax laws.

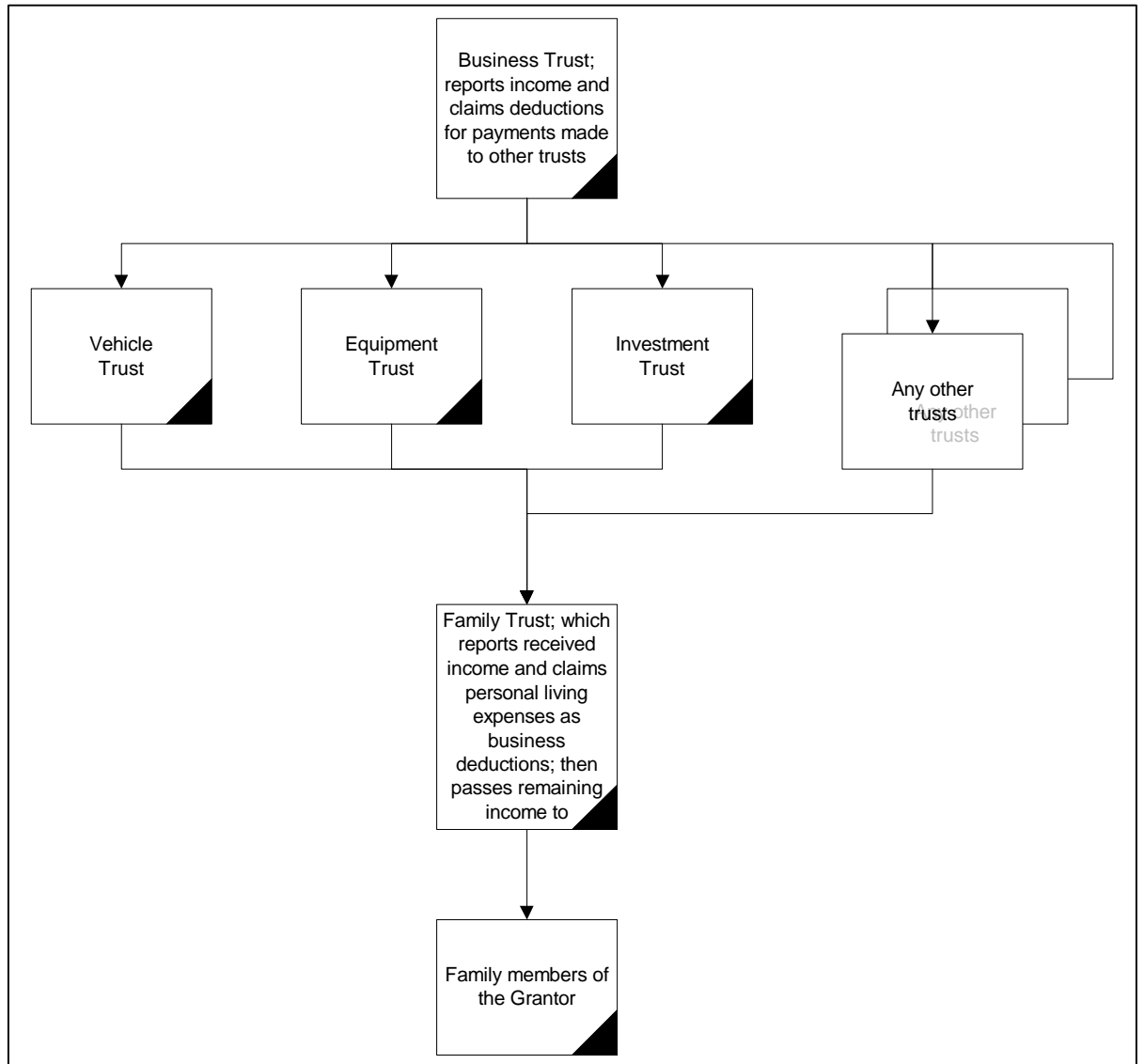
Abusive trust arrangements often use trusts to hide the true ownership of assets and income or to disguise the substance of transactions. These arrangements frequently involve more than one trust, each holding different assets of the taxpayer (for example, the taxpayer's business, business equipment, home, automobile, etc.), as well as interests in other trusts. Funds may flow from one trust to another trust by way of rental agreements, fees for "management" or other services, purchase and sale agreements, distributions, "charitable" contributions, and the like. In some situations, one or more foreign trusts also may be part of the arrangement; however, for purposes of this memorandum, foreign trusts are excluded. Similarly, charitable trusts are excluded unless the alleged charitable trust is simply non-existent.

The typical domestic abusive trust scheme outlined in this memorandum looks like the following diagram:



Note that the business trust generally accurately reports its income; the typical tax scheme involves the second tier, where the family trust deducts the family living expenses, claiming that they are “business expenses” of the trust. If any net income is left after the deductions at the family trust level, it is supposedly distributed to family members in amounts small enough to ostensibly not trigger filing requirements or tax liability on the part of the beneficiaries.

A more complicated scheme, but with the same basic format, would look like the following diagram:



OVERVIEW OF TAXPAYERS' POSITION

Taxpayers generally argue that their trust arrangement is valid for federal tax purposes because the grantor has given up control of income and assets. They argue that control has passed from their hands to an independent trustee who manages the trust, holds legal title to trust assets and exercises independent control.

FACTS

An abusive trust arrangement may involve some or all of the trusts described below. The type of trust arrangement selected is dependent on the particular tax benefit the arrangement purports to achieve. The typical abusive trust arrangement will consist of **at least** (1) a business trust (which supposedly earns the income and deducts business expenses, then passes the net distributable income to the next tier of the scheme), (2) a family trust or asset protection trust (which supposedly receives the net income from the business trust, deducts as business expenses all the family's personal living expenses, and then passes any remaining on to. . .), and (3) the individuals for whose benefit the trust arrangement is established (i.e., the grantor, spouse, and children of the grantor, who receive either supposedly non-taxable distributions or use and control of the income through another means, such as credit cards). More complicated schemes will have more entities and tiers.

In each of the trusts described below, the original owner of the assets that are nominally subject to the trust effectively retains authority to cause the financial benefits of the trust to be directly or indirectly returned or made available to the owner. For example, the trustee may be the promoter, or a relative or friend of the owner who simply carries out the directions of the owner whether or not permitted by the terms of the trust. Often, the trustee gives the owner checks that are pre-signed by the trustee, checks that are accompanied by a rubber stamp of the trustee's signature, or a credit card or a debit card with the intention of permitting the owner to obtain cash from the trust or otherwise to use the assets of the trust for the owner's benefit.

1. The Business Trust

The owner of a business allegedly transfers the business to a trust (sometimes described as an unincorporated business trust) in exchange for units or certificates of beneficial interest, sometimes described as units of beneficial interest or UBI's (trust units). The business trust makes payments or distributions to the trust unit holders or to other trusts created by the owner (characterized either as deductible business expenses, charitable contributions, or distributions) that purport to reduce the taxable income of the business trust to the point where little or no tax is due from the business trust. In addition, the owner typically claims the arrangement reduces or eliminates the owner's self-employment taxes on the theory that the owner is receiving reduced or no income from the operation of the business because the business "is owned by the trust."

Some individuals who transfer their business to a business trust also establish a second trust known as an employee leasing trust. An employee leasing trust has no function other than leasing employees to the business trust. Although, the employee leasing trust may be a valid trust, it may also be an arrangement used to reduce or eliminate (1) an individual's self-employment taxes on the theory that the individual is not receiving income from carrying on the business or (2) the business's Federal Insurance Contributions Act (FICA) tax or federal income tax withholding liabilities ("employment taxes") on the theory that the employee leasing trust, and not the individual or corporate business, is the employer of the individuals performing services for the business.

2. The Equipment or Service Trust

An equipment trust may be formed to hold equipment that is supposedly rented or leased to the business trust, often at inflated rates. A service trust may be formed to provide services to the business trust, often for inflated fees. In either or both cases, the business trust purports to reduce its income by making allegedly deductible payments to the equipment or service trust. Further, as to the equipment trust, the equipment owner may claim that the transfer of equipment to the equipment trust in exchange for the trust units is a taxable exchange. The trust takes the position that the trust has "purchased" the equipment with a known value (its fair market value) and that the value is the tax basis of the equipment for purposes of claiming depreciation deductions. The owner, on the other hand, takes the inconsistent position that the value of the trust units received cannot be determined, resulting in no taxable gain to the owner on the exchange. The equipment or service trust also may attempt to reduce or eliminate its income by distributions to other trusts.

3. The Family Residence Trust

The owner of the family residence transfers the residence, including its furnishings, to a trust. The parties claim inconsistent tax treatment for the trust and the owner (similar to the equipment trust), in that the trust claims the exchange results in a stepped-up basis for the property, while the owner reports no gain. The trust claims to be in the rental business and purports to rent the residence back to the owner; however, in most such cases, little or no rent is actually paid. Rather, the owner contends that the owner and family members are caretakers or provide services to the trust and, therefore, live in the residence for the benefit of the trust. Under some arrangements, the family residence trust receives funds from other trusts (such as a business trust) which are treated as the income of the trust. In order to reduce the tax which might be due with respect to such income (and any income from rent actually paid by the owner), the trust may attempt to deduct depreciation and the expenses of maintaining and operating the residence.

4. The Automobile Trust

The automobile trust functions in essentially the identical manner as the residence trust described above.

5. The Asset Protection Trust (sometimes called the Final Trust or the Holding Trust)

The grantor of one or more abusive trusts establishes a trust (the “final trust”) that holds trust units of the owner’s other trusts and is the final distributee of their income. The purpose of the final trust is to make it difficult for creditors to encumber the assets of the individual taxpayer; nevertheless, the individual always retains control over those assets. (A final trust often is formed in a foreign country that will impose little or no tax on the trust. In some arrangements, more than one foreign trust is used, with the cash flowing from one trust to another until the cash is ultimately distributed or made available to the U.S. owner, purportedly tax free. Such foreign trust schemes are not included in this memorandum.)

ISSUE 1

Compliance’s Position

Sham transaction.

Abusive trust arrangements typically follow the form of creating a valid trust (including preparing a trust document, obtaining TINs, opening checking accounts, etc.), but the individual(s) engaged in the arrangement always retain complete control over the business, the residence, the automobiles, etc. The so-called “trusts” should be treated as nullities for tax purposes. The trust arrangement should be collapsed and income ostensibly earned by the trust taxed to the individual taxpayer because the trust arrangement is a sham.

Taxpayer’s Position

Taxpayers generally argue that they have complied in substance as well as in form to create trust arrangement valid for federal tax purposes. They contend that the person named as trustee exercises independent control over the business or assets placed in trust.

Discussion

When trusts are used for legitimate purposes, either the trust, the trust beneficiary, or the transferor to the trust, as appropriate under the tax laws, will pay the tax on the income generated by the trust property. When used in accordance with the tax laws, trusts will not transform a taxpayer’s personal, living or educational expenses into deductible items, and will not seek to avoid tax liability by ignoring either the true ownership of income and assets or the true substance of transactions. Accordingly, the tax results that are promised by the promoters of abusive trust arrangements are not allowable under federal tax law. Contrary to promises made in promotional materials, several well-established tax principles control the proper tax treatment of these abusive trust arrangements.

If the trust is not a sham and is not a grantor trust, the trust would be taxable on its income, reduced by amounts distributed to beneficiaries. The trust must obtain a taxpayer identification number and file annual returns reporting its income. The trust must report distributions to beneficiaries on a Form K-1, and the beneficiary must include the distributed income on the beneficiary's tax return. (I.R.C. §§ 641, 651, 652, 661 and 662.)

Substance, not form, controls taxation. As the Court summarized in Patterson, T.C. Memo. 1984-339, a case involving a family estate trust;

An entity whose existence, everyday functioning, and ultimate demise are controlled by its creators and which produces no material changes in the status quo, except to reduce income taxes, can only be characterized as a sham, devoid of economic reality.

The Supreme Court of the United States has consistently stated that the substance rather than the form of the transaction is controlling for tax purposes. See, e.g., Helvering v. Clifford, 309 U.S. 331 (1940); Gregory v. Helvering, 293 U.S. 465 (1935). Under this doctrine, the abusive trust arrangements may be viewed as sham transactions, and the IRS may ignore the trust and its transactions for federal tax purposes. See Markosian v. Commissioner, 73 T.C. 1235 (1980) (holding that the trust was a sham because the parties did not comply with the terms of the trust and the supporting documents and the relationship of the grantors to the property transferred did not differ in any material aspect after the creation of the trust); Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984). Accordingly, the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the other trusts would all be treated as belonging directly to the owner.

Note that whether the trust exists for state purposes is irrelevant for purposes of determining federal income (and employment) tax liability; the tax liability is determined under federal statutes (the Internal Revenue Code), regardless of what the law of a given state, or the common law, may say. Helvering v. Clifford supra.

ISSUE 2

Compliance's Position

Grantor trust.

The individual taxpayer retains control over the trust, and therefore, should be treated for income tax purposes as the owner of the trust property. All transactions by the trust should be treated as transactions of the owner.

Taxpayer's Position

Taxpayers generally argue that the person named as trustee exercises independent control over business or assets placed in trust, therefore they are not grantor trusts.

Discussion

I.R.C. § 674(a) provides:

[T]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

I.R.C. § 672(a) defines "adverse party" as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."

The grantor trust rules (I.R.C. §§ 671-679, 684(b)) provide that if the owner of property transferred to a trust retains an economic interest in, or control over, the trust, the owner is treated for income tax purposes as the owner of the trust property, and all transactions by the trust are treated as transactions of the owner. This means that all expenses and income of the trust would belong to and must be reported by the owner, and tax deductions and losses arising from transactions between the owner and the trust would be ignored. Furthermore, there would be no taxable "exchange" of property with the trust, and the tax basis of property transferred to the trust would not be stepped-up for depreciation purposes. See, Rev. Rul. 85-13, 1985-1 C.B. 184.

ISSUE 3

Compliance's Position

Anticipatory assignment of income.

The individual taxpayer is attempting to transfer his income to a trust, which, in turn, will report the income with no self-employment tax due or paid by the trusts. Trust income is also fractionalized to other trust beneficiaries to eliminate employment taxes and (depending upon the scheme) eliminate taxable income or have it taxed to the beneficiaries at lower marginal rates. The trust arrangement should be collapsed and income ostensibly earned by the trust should be taxed to the individual taxpayer because the trust arrangement is an anticipatory assignment of income. SECA tax or employment taxes continue to apply to the net earnings or wages, respectively, without regard to the attempted assignment of income.

Taxpayer's Position

Taxpayers generally argue that it is legal for a trust to operate a business, and therefore, use of the assignment of income doctrine by the Service to challenge the use of a trust in such cases will deprive them of the lawful use of the trust form.

Discussion

Under the anticipatory assignment of income doctrine, gross income from personal services must be included in the income of the person who renders the services. Helvering v. Eubank, 311 U.S. 122 (1940); Lucas v. Earl, 281 U.S. 111 (1930). This is true whether the income is from wages or is income from a sole proprietorship owned and controlled by the taxpayer. Wolfe v. Commissioner, T.C. Memo 1974-238. Even if a taxpayer transfers an interest in that business to another, the income is still included in his gross income if he retains control of the business. Pleason v. Commissioner, 226 F.2d 732 (7th Cir. 1955), aff'd 22 T.C. 361 (1954); Finley v. Commissioner, 27 T.C. 413 (1956), aff'd, 255 F.2d 128 (10th Cir. 1958); Grayson v. Commissioner, T.C. Memo 1954-70. Thus, the mere assignment of business income by a taxpayer who continues to control his sole proprietorship does not result in the exclusion from his gross income-- it remains taxable to him. Wise v. Commissioner, T.C. Memo 1987-113; Tucker v. Commissioner, T.C. Memo 1983-456; Curry v. Commissioner, T.C. Memo 1967-218; Fry v. Commissioner, 4 T.C. 1045 (1944).

A long line of case precedent has cited the anticipatory assignment of income doctrine as authority for including income allegedly earned by that business or family trust in the gross income of the individual taxpayer who established and controlled that business or family trust. See e.g., Hanson v. Commissioner, 696 F.2d 1232 (9th Cir. 1983); Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980); Alsop v. Commissioner, T.C. Memo 1999-172; Stokes v. Commissioner, T.C. Memo. 1999-204; Christal v. Commissioner, T.C. Memo. 1998-255.

The taxpayer is taxable on assigned income even if the taxpayer delivers a payer's check to a third party before cashing it (United States v. Allen, 551 F.2d 208 (8th Cir. 1977)); if the taxpayer causes the check to be issued directly to a third party (Hall v. Commissioner, T.C. Memo 1976-311, aff'd, 595 F.2d 1059 (5th Cir. 1979)); if the taxpayer causes the check to be issued to his corporation (Johnson v. Commissioner, 78 T.C. 882 (1982), aff'd without pub. opinion, 734 F.2d 20 (9th Cir. 1984); Johnson v. United States, 698 F.2d 372 (9th Cir. 1982); Willett v. Commissioner, T.C. Memo 1988-439); if the taxpayer causes the check to be issued to a trust fund established for the benefit of his family (Wheeler v. United States, 768 F.2d 1333 (Fed. Cir. 1985); Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd, 570 F.2d 210 (7th Cir. 1978); Sanders v. Commissioner, 720 F.2d 871 (5th Cir. 1983), aff'd T.C. Memo 1982-655)); or, if the taxpayer assigns to another, an unpaid account receivable or contract right arising from his performance of services (Siegel v. United States, 464 F.2d 891 (9th Cir. 1972)). See also, Rev. Rul. 55-2, 1955-1 C.B. 211.

ISSUES 4 & 5

Compliance's Position

Simple v. Complex trust.

In unagreed cases, Compliance often sets up a whipsaw position between the business, family, and other abusive trust(s) and individual income tax return, maximizing the deficiencies for all entities by disallowing deductions claimed by the trusts and taxing the trust gross income to the individual, without deductions.

As part of the whipsaw, Compliance will treat the business trust as a complex trust and disallow the income distribution deduction (IDD). This will result in the claimed IDD being included in the taxable income of the business trust. Compliance will also consider the family trust to be a simple trust, and will include in the income of the family trust, all of the income which it received, including the disallowed IDD.

Taxpayer's Position

The taxpayer argues that the trusts are valid for federal tax purposes, for any or all of the reasons discussed under Issues 1, 2 and 3; therefore the IDD's claimed by the trust returns should be respected.

Discussion

The statutory and regulatory scheme for taxing trust income is relatively straightforward. Other than trusts specifically treated under the Code (such as REITs, REMICS, I.R.C. § 468B Settlement Funds, etc., none of which are covered in this Appeals Settlement Guideline), trusts are classified as either "simple" or "complex" and taxed accordingly.

Simple trusts are treated as strictly pass-through entities: all of the trust's income is deemed to be distributed and taxed to the beneficiaries of the trust, whether or not any actual distribution takes place. The income distribution deduction (IDD) is the entire net distributable income of the trust; there is, therefore, no tax at the trust level. See, I.R.C. §§ 651, et seq.

Complex trusts, on the other hand, are allowed an IDD only for the amount distributed to the beneficiaries; the remaining income (which may be retained at the trust level) is not allowed as an IDD, but is taxed at the trust level at the generally higher trust rates. Thus, a complex trust will generally be taxed on the income which exceeds the allowable IDD. See I.R.C. §§ 661, et seq.

I.R.C. § 651(a) states that a deduction will be allowed for simple trusts for the amount of the income which is required to be distributed currently; however, the corollary requirement set out in I.R.C. § 652(a) is that “the amount of income for the taxable year required to be distributed currently by a trust . . . shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not” and the deduction is limited by section 651(b) to the amount of the distributable net income. Inclusion in income is not a condition precedent for a deduction; however, it is also clear that inclusion of the trust’s distribution in the income of the beneficiary-taxpayer is required in order to calculate the tax liability of that beneficiary-taxpayer. And since the liability of the beneficiary-taxpayer may be assessed as a mathematical adjustment, it is absolutely necessary that the trust return properly and completely identify the beneficiary.

Similarly, I.R.C. § 661(a) states that a deduction will be allowed for complex trusts for the amount of the income which is required to be distributed currently (and which is actually paid out of income for that taxable year), plus any other amounts properly paid or credited or required to be distributed. Again, however, the corollary requirement set out in I.R.C. § 662(a) is that the amount of income included in the beneficiary’s income for the taxable year is that amount which is “required to be distributed currently to such beneficiary, whether distributed or not” plus the other amounts properly paid or credited or required to be distributed. Thus, again, inclusion in income is not a condition precedent for a deduction, but inclusion in income of the beneficiary-taxpayer is required in order to calculate the tax liability of the beneficiary-taxpayer; thus, proper identification of the beneficiary is necessary.

ISSUE 6

Compliance’s Position

Business expense deductions.

Compliance’s position is to allow properly verified business expense deductions. However, inasmuch as the trust scheme is generally collapsed and the trust is generally disregarded, the substantiated business expenses will not be allowed to the business trust, but will generally be allowed on the individual’s Form 1040, Schedule C. If the business had previously operated in corporate form or as a partnership, then the business expenses would be allowed on a corporate or partnership return.

Taxpayer’s Position

The taxpayer contends that all deductions claimed at the business trust level are allowable.

Discussion

Taxpayers are required to substantiate their claimed deductions by I.R.C. § 6001, and the regulations promulgated thereunder.

. . . any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax information.

Treas. Reg. § 1.6001-1. See also I.R.C. § 162.

Deductions are a matter of legislative grace and taxpayers must prove their entitlement to those deductions. Welch v. Helvering, 290 U.S. 111 (1933); T.C. Rul. 142. If substantiated as to amount, business purpose, timing, etc., as per the specific provision of the Code under which the expense is claimed, the expense should be allowed by Compliance.

However, since the trust scheme is collapsed in settlement, the substantiated business expenses will generally be allowed at the individual level, on the individual's Form 1040, Schedule C. If the business had previously operated in corporate form or as a partnership, then the allowable expenses would be allowed on the corporate or partnership return.

ISSUE 7

Compliance's Position

Deductions for personal living expenses of the grantor and his family.

Compliance's position is that the claimed "business" deductions for personal living expenses of the grantor and his family should not be allowed at any level of the scheme.

Taxpayer's Position

Taxpayers defend their "business" deductions according to the guise in which they were claimed on the return. For example, in some schemes the taxpayer contends that deductions associated with his personal residence are from a rental activity (business).

Discussion

Personal expenses are generally not deductible. Personal expenses such as those for home maintenance, education, and personal travel are not deductible unless expressly authorized by the tax laws. See section 262. The courts have consistently held that non-deductible personal expenses cannot be transformed into deductible expenses by the use of trusts. Furthermore, the costs of creating these trusts are not deductible.

See e.g., Neely v. United States, 775 F.2d 1092 (9th Cir. 1985); and Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984); Schulz v. Commissioner, 686 F.2d 490 (7th Cir. 1982).

ISSUE 8

Promoter fees.

Participants in abusive trust schemes typically claim deductions for fees paid to the promoter for 1) purchase of the trust scheme; 2) fees paid to the promoter (for either one-time or annual “management,” “tax,” or “bookkeeping” fees); and 3) other “fees” ostensibly paid to another entity, but repaid to the individual grantor on a one-time basis (a “circular” flow of funds).

8.a. Fees paid to the promoter for purchase of the abusive trust arrangement.

Compliance’s Position

The taxpayer typically deducts the cost of the trust package as a business expense on the trust return, usually as legal and professional fees or as cost of goods sold on the Schedule C, or elsewhere as a less obvious item on the trust return. Compliance’s position is that no deduction should be allowed for amounts paid to the promoter of the abusive trust arrangement.

Taxpayer’s Position

Taxpayers who deduct the cost of purchasing the abusive trust arrangement as legal and professional fees contend that is allowable under I.R.C. § 212. (Taxpayers discovered to have concealed the deduction under another category of business expense also may argue that the item should be reclassified as an allowable section 212 deduction.)

Discussion

Promoters are in the business of making money by selling a product. This product may consist of a package of “fill-in-the-blank” materials, a package of trust documents prepared by the promoter, or of “educational” services or “seminars” which seek to “train” the participant in “true constitutional or legal principles.” One who wishes to enter into a trust scheme must first purchase this package/training; thereafter, on the first 1040 or 1041 filed under the scheme, the participant will attempt to deduct the costs of the package/training, typically as “educational expense” or “consulting fees.”

The position of the Service on such deductions is clearly set out in Rev. Rul. 79-324, 1979-2 C.B. 119, which provides:

“Family estate trust” package. No deduction is allowed under section 212 of the Code for amounts paid for a trust form instrument and related materials used to create a “family estate trust” to which all the taxpayer’s property and “lifetime services” are transferred and over which the trustees (the taxpayer, the taxpayer’s spouse, and a third party) have complete discretionary control.”

The Revenue Ruling goes on to state that these expenses are personal expenses under I.R.C. § 262 and are, therefore, not deductible.

The courts almost invariably uphold the Service in its determination of deductibility. One of the lead cases was decided by the Tenth Circuit. In Holman v. United States, 728 F.2d 462 (10th Cir. 1984), Dr. Holman challenged summary dismissal of their action for refund of tax overpayments. The taxpayers had set up a family trust, with both as trustees and both of them and their children as beneficiaries. The trust held all personal and real property they owned. The taxpayers kept using their property as they had prior to the trust’s creation, with the trust obligated to pay various living expenses as well as miscellaneous expenses. The United States had informed the taxpayers that it would not recognize the trust. Nevertheless, the trust filed a fiduciary income tax return for the years in question. The taxpayers also filed joint returns for those years and the United States assessed deficiencies on their joint returns. The taxpayers paid the deficiencies and brought suit. The federal district court granted summary judgment in favor of the United States, holding that the income was taxable to the Holmans and the claimed deductions were not allowable under I.R.C. § 162 or 212. The Tenth Circuit affirmed the summary judgment order because the taxpayers were properly treated as the trust’s owners where the beneficial enjoyment of the corpus was subject to their power of disposition and because the trust scheme was merely an anticipatory assignment of income. In regard to the issue of deducting the fees for establishing the trust, the Tenth Circuit said:

The deductions sought by plaintiffs for the cost of the trust materials were properly disallowed. Generally speaking, 26 U.S.C. § 212 provides for the deduction of expenses incurred for the production or collection of income, for the maintenance of property held for the production of income or for tax advice. 26 U.S.C. § 162 provides for the deduction of ordinary and necessary business expenses. Plaintiffs have failed to carry the burden of proving their entitlement to a deduction for the cost of the trust materials under either 26 U.S.C. § 162 or 212. See Welch v. Helvering, 290 U.S. 111(1933). Cases such as Gran v. Commissioner, 664 F.2d 199 (8th Cir. 1981) and Contini v. Commissioner, 76 T.C. 447 (1981) have held that the cost of establishing a family trust of this kind is a nondeductible personal expense under 26 U.S.C. § 262. Plaintiffs have not demonstrated why the reasoning set forth in both Gran and Contini should not apply to the instant case.

In so holding, the Tenth Circuit is aligned with the rest of the judicial system. For example, in Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984), the Ninth Circuit

addressed the issue of deductibility of fees paid for “educational seminars” to prepare trust scheme documents, with the following:

The Zmudas claimed deductions for ALA membership and seminar fees under 26 U.S.C. § 212 (1976). This section permits deductions for all ordinary and necessary expenses paid: (1) for the production or collection of income; (2) for management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

The Zmudas stated that they established the trusts: (1) to allow real property investments to continue after death; (2) to limit personal liability; (3) to avoid probate costs; and (4) to minimize taxes. These reasons do not meet the standards of section 212.

The Zmudas simply restructured the form in which they hold their property. The transfer into the trusts did not aid in the production of income nor did it alter management activity. Rearranging title is not related to management or conservation under section 212. Schultz v. Commissioner, 50 T.C. 688 (1968), aff'd per curiam, 420 F.2d 490 (3rd Cir. 1970). Section 212 was not designed to allow tax deductions based on mere preservation of net worth. Woodward v. Commissioner, 410 F.2d 313, 318 (8th Cir.), aff'd, 397 U.S. 572 (1969).

There are a large number of cases to the same effect, holding that claimed deductions for buying into a trust scheme are not allowable; see for example., Professional Services v. Commissioner, 79 T.C. 888, 917-922 (1982).

8.b. Other “fees” paid to the promoter.

Compliance’s Position

Aside from the payment for the abusive trust arrangement, other fees supposedly may have been paid to the promoter. Often, these payments are called fees for management, tax advice, consulting, bookkeeping, or the like. Some of these amounts may be deductible. However, in all such cases, the burden is on the taxpayer to prove both the purpose and the amount of the expenditure. No deduction should be allowed for amounts paid to the promoter of the abusive trust arrangement.

Taxpayer’s Position

Taxpayers argue that these other payments are deductible as trade or business expenses under I.R.C. § 162 or as “ordinary and necessary” expenses under I.R.C. § 212 for the production or collection of income (212(1)); the management, conservation, or maintenance of property held for the production of income (212(2)); or in connection with the determination, collection, or refund of any tax (212(3)).

Discussion

The taxpayer carries a heavy burden (established by precedent cases) in attempting to show any part of these other payments are deductible under I.R.C. § 212.

The court's detailed discussion of the section 212(2) and (3) issues in Professional Services v. Commissioner, 79 T.C. 888, 917-922 (1982) [portions omitted] shows the substantial litigating hazards faced by the taxpayer:

We will initially consider petitioners' argument under section 212(2). Section 212(2) allows a deduction for all ordinary and necessary expenses paid for the management, conservation, or maintenance of property held for the production of income. Petitioners have the burden of proving that the amounts in dispute were both "ordinary and necessary" and were expended for the purposes designated in the statute. T.C. Rul 142(a); Welch v. Helvering, *supra*. Since we think petitioners have failed to establish that the \$11,000 expenditure in any way related to the management, conservation, or maintenance of income producing property, we need not consider whether the expenditure was "ordinary and necessary" within the meaning of section 212(2).

Initially, it is clear that the \$11,000 payment did not relate to the management or conservation of income producing property. The materials and assistance petitioners received in exchange for the \$11,000 purchase price related solely to restructuring the form in which their property was to be held. Petitioners' actual transfers of property to the "business trust organizations" did not, in substance, alter the management or economic ownership of the property. It is well established that expenses paid for advice and assistance which concerns merely rearranging title to property relates neither to the management nor conservation of such property under section 212(2). Epp v. Commissioner, 78 T.C. 801 (1982); Luman v. Commissioner 79 T.C. 846 (1982); Schultz v. Commissioner, 50 T.C. 688, 699-700 (1968), aff'd per curiam 420 F.2d 490 (3d Cir. 1970).

Nor is petitioner's testimony that he was motivated to purchase the tax package materials and create the "business trust organizations" by his desire to minimize probate expenses and isolate his assets from potential malpractice liability sufficient to sustain petitioners' burden of proving that the expenditure related to the maintenance or conservation of income producing property. n24 Petitioners have completely failed to show what, if any, probate expenses could be saved by the creation of these "entities," and have also failed to show that the creation of these "entities" would, in fact, serve to insulate the assets transferred thereto from potential malpractice liability. Moreover, the deduction provided by section 212(2) applies to expenditures for protection or maintenance of the property, itself, not to expenditures relating to a taxpayer's retention of ownership of the property. Epp v. Commissioner, *supra*; United States v. Gilmore, 372 U.S. 39, 44 [*919] (1963); Reed v. Commissioner, 55 T.C. 32, 42 (1970). Thus, even

assuming petitioners are correct when they argue that the transfers of property to the “business trust organizations” would serve to insulate such property from any liability arising from petitioner’s practice of dentistry, expenses incurred to transfer title to property to protect it against potential malpractice claims are not deductible under section 212(2). Epp v. Commissioner, supra. See also Wallace v. Commissioner, 56 T.C. 624, 632 (1971); Cobb v. Commissioner, 10 T.C. 380 (1948), affd. 173 F.2d 711 (6th Cir. 1949), cert. denied 338 U.S. 832 (1949). The deduction must therefore be disallowed under section 212(2).

Section 212(3) allows a deduction for ordinary and necessary expenses paid or incurred in connection with the determination, collection, or refund of any tax. Once again, petitioners have the burden of proving that the disputed payment was both “ordinary and necessary” and expended for the purposes designated in the statute. Rule 142(a); Welch v. Helvering, supra.

Petitioners contend that the cost of the ATEs package is deductible under section 212(3) since it was paid, at least in part, for Federal tax planning. It is true that ordinary and necessary expenses paid for Federal tax planning are deductible under section 212(3). See Merians v. Commissioner, 60 T.C. 187 (1973); Collins v. Commissioner, 54 T.C. 1656 (1970); Schultz v. Commissioner, supra. However, the ATEs package was marketed as a device by which a purchaser thereof could isolate his assets from liability, avoid probate costs (exclusive of estate taxes), as well as reduce his Federal tax liability. Moreover, petitioner has testified that he was motivated, in part, to purchase the package by his desire to isolate his assets from malpractice liability and reduce probate costs. To the extent that the amount in dispute was paid for these purposes, they clearly fall outside of the scope of section 212(3).

Where a petitioner sustains his burden of proof only with respect to a portion of a particular expenditure, and the record contains sufficient evidence so that a reasonable allocation between the deductible and nondeductible portions of a particular expense can be made, we will make an allocation, and allow the deduction in part. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Where, however, the record provides no reasonable basis upon which we can make such an allocation, the deduction must be disallowed in full. Epp v. Commissioner, supra; Luman v. Commissioner, supra; Zmuda v. Commissioner, 79 T.C. 714 (1982).

Petitioners have failed to provide any rational method by which the \$11,000 payment could be allocated between what they contend to be the deductible portion of the expenditure and the nondeductible portion. Thus, even assuming that a portion of the expense in issue falls within the provisions of section 212(3), no portion of the expense can be allowed. Epp v. Commissioner, supra; Luman v. Commissioner, supra; Zmuda v. Commissioner, supra.

Respondent's disallowance of the deduction relating to the \$11,000 ATEs package purchase price will therefore be sustained.

As can be seen, the taxpayer's heavy burden involves not just having to show the amount of the expenditure, and that it is an "ordinary and necessary" expense, but having to allocate it among the various services that a promoter may perform. In most instances, a taxpayer will be unable to specifically break out amounts representing, say, "tax advice," from the other alleged services of the promoter.

8.c. Fees supposedly paid to another entity, but which are returned to the participant/taxpayer ("circular" flow of funds).

Compliance's Position

In most abusive trust schemes, various other fees may also be paid. These fees are typically paid to another entity (a second trust, for example), for what are supposedly management services, tax advice, consulting, bookkeeping, or the like. The purpose of calling the fees by those names, of course, is so that they would be considered deductible trade or business expenses under I.R.C. § 162 or deductible "ordinary and necessary" expenses under I.R.C. § 212 for the production or collection of income (212(1)); the management, conservation, or maintenance of property held for the production of income (212(2)); or in connection with the determination, collection, or refund of any tax (212(3)). In reality, however, these funds represent a circular flow of monies from the individual's business, deducted as payments to another trust or other entity, which then come back to the individual. The transactions are not deductible.

Taxpayer's Position

The taxpayer contends that the recipient of the fees rendered services for which a deduction is allowed.

Discussion

The discussion regarding other fees paid to the promoter, in Issue 8(b) above, also applies to these fees. Additionally, amounts claimed as deductions which are "paid" through a sham arrangement, are nothing more than a circular flow of funds (see, e.g., Dahlstrom v. Commissioner, T.C. Memo. 1991-265; Denali Dental Services v. Commissioner, T.C. Memo. 1989-482 (1989)) and do not constitute "payment" under either I.R.C. § 162 or 212. Benningfield v. Commissioner, 81 T.C. 408 (1983).

ISSUE 9

Compliance's Position

The taxpayer's net earnings from the trade or business transferred to a grantor trust or a trust arrangement that is not valid for federal tax purposes is subject to Self-Employment Contributions Act (SECA) tax.

Alternatively, if the taxpayer was an officer of a corporation that transferred its business to the grantor or sham trust, the corporation may remain liable for employment taxes with respect to amounts paid to the taxpayer. Even if the trust is valid (i.e., not a sham or grantor trust), the taxpayer may be liable for SECA tax if the taxpayer does not receive adequate remunerations for services performed by the taxpayer on behalf of the trust.

Finally, where a taxpayer operates a business through a business trust arrangement that leases employees from an employee leasing trust, the party treated as operating the business for federal tax purposes (i.e., the individual taxpayer or the transferee corporation) may be responsible for employment taxes on the remunerations paid to the individuals performing services for the trust.

Taxpayer's Position

The taxpayer may cite Employment Tax Regulation section 1.1402(a)-2(b) for the position that a trust arrangement is not subject to SECA. Section 1.1402(a)-2(b) provides:

The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

In cases involving a corporate business, the taxpayer may also argue that his former role as a corporate officer is now limited to his minimal role of providing services to the trust for which he receives minimal or no direct remuneration.

Finally, in some cases the taxpayer may argue that a employee leasing trust (which has limited assets) is the employer of all the employees and is the entity solely responsible for the related employment taxes.

Discussion

When a trade or business is carried on by a trust, and not an individual, the income derived from business carried on by the trust is not includible in determining the net earnings from self-employment of the individual beneficiary of the trust unless there is a

basis for disregarding the trust for purposes of the Code and finding that the net earnings are actually derived from a trade or business maintained by the individual. If the trust is a grantor trust, or a sham trust, and therefore disregarded for purposes of the Code, the income derived by the trust is attributable to the individual, and the individual is treated as having earnings derived from a trade or business maintained by the individual which is subject to SECA.¹

Alternatively, if the taxpayer was an officer of a corporation that transferred its business to the grantor or sham trust, the party treated as operating the business (i.e., the individual taxpayer or the transferee corporation) may be liable for employment taxes with respect to amounts paid to the taxpayer.

Even if the trust is a valid trust, the individual taxpayer may be subject to SECA tax, because the taxpayer did not receive adequate payments from the trust for services performed by the taxpayer on behalf of the trust as part of the taxpayer's trade or business. If it is determined that the payments received by the taxpayer for services rendered on behalf of the trust were unreasonable or insufficient for the amount of services provided to the trust by the taxpayer as part of the taxpayer's trade or business the taxpayer is subject to SECA tax. The determination of the reasonableness of the payments received by the individual for services performed must be made on the basis of an examination of all of the facts and circumstances. See Alpha Med, Inc. v. Commissioner, 1721 F.3d 942, 946 (6th Cir. 1999) (considering factors enunciated in Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 199 (6th Cir. 1999); Spicer Accounting, Inc. v. United States, 918 F.2d. 90 (9th Cir. 1990).

Additionally, if there are individuals (in addition to the taxpayer) performing services for the trust, who prior to the creation of the trust performed the same or similar services for the taxpayer or the transferee corporation, there may be an additional sham trust situation or employee classification issues. In some cases, in addition to the establishment of a business trust the individual may also have established an employee leasing trust. Under an employee leasing trust, individuals who had previously worked for the individual or the transferee corporation are treated as employees or independent contractors of the employee leasing trust and their services are leased to the business trust. Prior to the establishment of the business trust, the taxpayer or corporation operating the business had employees performing services for the business and the taxpayer or corporation was responsible for payment, withholding and reporting of employment taxes. Thus, there is an issue of whether the individual is attempting to eliminate or reduce the employment tax liability through the establishment of an employee leasing trust. Although this issue is generally a concern when a taxpayer establishes an employee leasing trust as a foreign trust, which is not the subject of this

¹ The requirement that income, for purposes of section 1402, must be from the trade or business carried on by an individual is illustrated in Rev. Rul. 59-162, 1959-1C.B. 224. Under the facts of this revenue ruling an insurance renewal commission would, upon the death of the husband, be paid to the spouse. The ruling held that the insurance renewal commission was not net earnings from self-employment to the spouse because they were not derived from a trade or business maintained by the spouse.

paper, the issue arises whenever a taxpayer or corporation who formerly employed individuals in the business transfers such workers to an employee leasing trust, particularly when the employee leasing trust has limited assets.

Factors used to determine whether the business trust is a grantor or sham trust are also relevant in establishing that an employee leasing trust is a sham. If there was no material change in the grantor's business it is also unlikely that there was any material change in the employer-employee relationship that existed before the trust was created. Thus, the party treated as operating the business for federal tax purposes (i.e., the individual owner of the trust or the transferee corporation) would be responsible for employment taxes.

Also, generally, if there are individuals performing services for the business trust (or an employee leasing trust), there may be employee classification issues regarding whether the individuals performing the services are employees or independent contractors. Although, employment taxes are generally assessed immediately, if there is an issue of whether one or more individuals is an employee of the person, or whether the possible employer is entitled to relief from employment tax liability under section 530 of the Revenue Act of 1978, then the procedures under Code section 7436 (similar to deficiency notice procedures) apply.² See Notice 2002-5, 2002-1 C.B. 320 for details on these procedures. If such workers are independent contractors, the individual owner could also be liable for backup withholding (the current rate is 29%).

ISSUE 10(a)

Compliance's Position

Failure to File

In any instances where the trust is treated as valid (whether an agreed case or in establishing the whipsaw position), and it timely filed a Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts, and failed to properly estimate the tax due, Compliance's position is that examiners should invalidate the extension and assert the failure-to-file penalty under I.R.C. § 6651(a)(1).

Additionally, if the business trust and, if applicable, the employee leasing trust are treated as valid trusts, but a determination is made that individuals performing services for the trust should have been treated as employees rather than independent contractors, a failure to file penalty related to the requisite employment tax returns may be appropriate. However, the notice procedures of section 7436 must be followed.

Taxpayer's Position

² For employment tax purposes there are special limitation periods that must be extended separately from other limitations periods. Thus, complicated employer arrangements should be discussed with counsel to determine the appropriate course of action.

The taxpayer argues, in cases where a trust return was timely filed and sufficient timely payments were made to satisfy the tax shown on the trust return, that there are no grounds for a failure-to-file penalty.

Discussion

Section 6081 and Treas. Reg. § 1.6081-1 provide that the Service may grant a reasonable extension of time for filing any return, declaration, statement or other document. Other than in the case of a taxpayer residing abroad, the extensions may not be granted for more than 6 months. I.R.C. § 6081(a) and Treas. Reg. § 1.6081-1(a). Treas. Reg. § 1.6081-6 provides for an automatic three-month extension of time to file a trust income tax return. To be valid, the extension request must be submitted on Form 8736, be filed on or before the date prescribed for filing the trust income tax return, and show the full amount properly estimated as tax for the trust for the taxable year. Treas. Reg. §§ 1.6081-6(b)(1) – (3). The automatic extension may be terminated provided that a notice of termination is mailed to the taxpayer granting the taxpayer 10 days notice in which to file his tax return. Treas. Reg. § 1.6081-6(d).

If the tax liability is not properly estimated, the taxpayer is treated as not having filed a valid request for extension and is thus liable for the late filing penalty. Typically, when a request for discretionary extension is denied, a 10-day grace period is allowed for the taxpayer to get the return filed. Rev. Rul. 64-214, 1964-2 C.B. 472. However, G.C.M. 39014 (7/28/1983) stated that where the application is determined to be invalid on its face or later found to be invalid, the Service should apply the failure to file addition to tax and should not send the taxpayer a notice of termination because the extension is void.

An application is treated as invalid if the taxpayer's tax liability provided in the application is not properly estimated. See Rev. Rul. 79-113, 1979-1 C.B. 389. While the regulations do not provide a definition for the term "proper estimate", Rev. Rul. 79-113, 1979-1 C.B. 389 states that "if the taxpayer had, at the time the estimate was made, information discrediting the estimate, then the requirement that tax be properly estimated will not have been met and the Form 4868 will be considered as invalid." While this revenue ruling specifically addresses Form 4868, we see no reason why the same logic would not apply to Form 8736 as well.

In Crocker v. Commissioner, 92 T.C. 899 (1989) the Tax Court held that the taxpayers' applications for extensions of time were invalid because the taxpayers failed to comply with the Income Tax Regulations. Therefore, the extensions were invalid and the taxpayers were liable for the failure to file addition to tax under section 6651(a)(1). The Tax Court stated that in order for a Form 4868 to be valid, the taxpayer must use available evidence of tax liability, and must make a reasonable attempt to locate that evidence to make a proper estimate. Id., at 908. The mere fact that an estimate is incorrect does not make the Form 4868 invalid. Id., at 906-907. However, "if a taxpayer, in his Form 4868 request for an automatic extension, estimated his tax liability to be zero, even though he had, at the time he submitted the request, ample evidence

discrediting the estimate, the Form 4868 would be invalid.” Id., at 908. The reasonableness of the estimate is a determined on a case-by-case basis.

ISSUE 10(b)

Compliance’s Position

Estimated Tax Penalty

In any instances where the trust is treated as valid (whether an agreed case or in establishing the whipsaw position), Compliance’s position is that if insufficient estimated tax payments were made on the trust liability, examiners should assert the penalty under I.R.C. § section 6654.

Taxpayer’s Position

The taxpayer argues, in cases where sufficient timely estimated tax payments were made (in relation to the liability shown on the return as filed), or the trust otherwise qualifies for a statutory exceptions to the penalty, there is no grounds for a penalty.

Discussion

I.R.C. § 6654 provides for a penalty when individuals, estates and most trusts underpay any required installment(s) of estimated income tax liabilities reportable on Forms 1040 (U.S. Individual Income Tax Return) and Forms 1041 (U.S. Fiduciary Income Tax Return).

The Tax Reform Act of 1986, effective for tax years beginning after December 31, 1986, provided that all estates and most trusts are required to make estimated tax payments in the same manner as individuals. Note exception: Charitable trusts and any private foundation organized as a trust, will be subject to the corporate estimated tax provisions under I.R.C. § 6655, rather than I.R.C. § 6654.

When a taxpayer fails to pay over to the Service estimated income tax for income received from his business activities, or when payments of tax, either through withholding or by estimated tax payments, do not equal the payments required by statute, the penalty is automatic, unless the taxpayer can show that one of the statutory exceptions apply. The burden of proving such an exception is on the petitioner. Habersham-Bey v. Commissioner, 78 T.C. 304, 319-20 (1982); Grosshandler v. Commissioner, 75 T.C. 1, 20-21 (1980).

For tax years beginning after December 31, 1983, I.R.C. § 6654(e)(3)(A) provides that the estimated tax penalty may be waived if the failure to make the estimated tax payment is due to casualty, disaster or other unusual circumstances such that the imposition of the penalty would be against equity and good conscience. This is not equivalent to reasonable cause.

For example, reliance on the advice of a competent tax advisor may constitute reasonable cause that would warrant relief from other penalties, but it does not provide a basis for a waiver of the estimated tax penalty under I.R.C. § 6654(e)(3)(A).

In order for the waiver to be available, the failure to make the payment must be caused by:

- ? Casualty
- ? Disaster, or
- ? Other unusual circumstances, and
- ? Imposition of the penalty would be against equity and good conscience.

Examples of situations where the waiver **may be granted** if it is determined that imposition of the penalty would be against equity and good conscience:

- ? The taxpayer's records are destroyed by fire or flood or other natural disaster. In many instances of natural disaster, area wide guidance on conditions for waivers will be issued.
- ? The taxpayer becomes seriously ill or is seriously injured and is unable to manage his affairs.
- ? The taxpayer designates that an overpayment of tax shown on a prior return is to be credited against estimated tax, but the overpayment is offset for either past-due child support or nontax federal debt under I.R.C. § 6402(c), and the taxpayer is not notified of the offset before the due date of the estimated tax installment.

Examples of situations where the waiver **may not be granted**:

- ? Reliance on the advice of a competent tax advisor.
- ? Retroactive application of a statute or regulation unless the statute or regulation specifically grants a waiver of the estimated tax penalty or the Service announces in the Internal Revenue Bulletin that such a waiver has been granted.
- ? Erroneous advice from the IRS unless such advice falls within the provisions of I.R.C. § 6404(f), Abatement of Any Penalty or Addition to Tax Attributable to Erroneous Written Advice by the Internal Revenue Service, of the Internal Revenue Code or Treas. Reg. § 301.6404-3 of the regulations.

Restrictions on the estimated tax penalty exist in certain bankruptcy and other specialized fact situations.

ISSUE 10(c)

This guideline addresses I.R.C. § 6662 asserted on grounds of negligence or disregard of rules or regulations and/or a substantial understatement of income tax.

Compliance's Position

Accuracy-Related Penalty

Compliance asserts the accuracy-related penalty on underpayments of tax attributable to domestic abusive trust schemes. The accuracy-related penalty can apply to the underpayment of employment taxes as well.

Taxpayer's Position

The taxpayer generally argues he has reasonable cause for not imposing the penalty, because he relied in good faith on the advice of the preparer/promoter.

Discussion

BACKGROUND

The widespread marketing of abusive trusts of the 1970s was discouraged by a series of decisions against the taxpayers. A new generation of abusive trust arrangements that appeared in the 1990s were no more technically valid than their predecessors.

Domestic abusive trust schemes have gained popularity for a variety of reasons, including:

- ✍ The desire of individuals to reduce the amount of taxes they pay.
- ✍ Unscrupulous promoters advising taxpayers that by transferring their business(es) and other assets into trusts, they can claim many of their home and other personal expenses as business deductions.
- ✍ Sole proprietors being advised that they can eliminate their self-employment tax by transferring their business into a trust.

The Service has prominently warned against these schemes in its publications, in the media, and in letters to some of the individual purchasers.

In April 1997, the Service's Notice 97-24³ described certain trust arrangements that purport to reduce or eliminate federal taxes in ways that are not permitted by federal tax law. In November 1999, the Service's Publication 2193, "Should Your Financial Portfolio Include Too Good To Be True Trusts?" cautioned the public about promoters who sell trust arrangements promising exceptional tax benefits.

³ Notice 97-24, "Certain Trust Arrangements," 1997-1 C.B. 409.

Also, federal courts have enjoined numerous promoters of abusive trust arrangements from activities connected with marketing the schemes.⁴

Accuracy-Related Penalty

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things:

- (1) negligence or disregard of rules or regulations,⁵
- (2) any substantial understatement of income tax,⁶
- (3) any substantial (or gross) valuation misstatement under chapter 1.⁷

The penalty applies only when a tax return is filed.⁸ There is no stacking of the accuracy-related penalty components. The maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement).⁹

⁴ Courts have enjoined promoters who market frivolous tax avoidance schemes that utilize these frivolous arguments. See, e.g., United States v. Estate Preservation Services, 202 F.3d 1093 (9th Cir. 2000) (ordering an injunction against a promoter of a trust scheme who made fraudulent statements that expenses related to a personal residence could be deducted if the residence was transferred to a trust); United States v. Buttorff, 761 F.2d 1056, 1060 (5th Cir. 1985) (ordering an injunction against a promoter of a trust scheme who made fraudulent statements that personal consumption expenses could be deducted if personal property was transferred to a trust). The Department of Justice has obtained District Court orders enjoining promoters of abusive trust schemes from one or more of the following activities: promoting the scheme, preparing returns, representing taxpayers before the IRS. The conditions of an injunction vary between cases. Abusive trust promoters under injunction include: Harry Anderson, 4/20/2004; Clifton Beale, 2/5/2004; Rex Black, 12/9/2002; Charles R. Chung, 9/11/2003; Samuel S. Fung, 2/11/2004; Charles Scott Grace, (Estate Preservations Services); Ronald Green, 7/6/2004; Robert Henkell, 2/21/2001; Randall Brian Jarvis, 7/1/2003; Robert Lawrence (Joy Foundation), 5/9/2003; Robert Lawrence (Joy Foundation) 5/9/2003; Kevin Mahoney, 7/8/2002; Jack L. Malone (Joy Foundation), 10/22/2002; Yvonne Malone (Joy Foundation), 10/22/2002; Robert & Carol Mosher, 3/16/2004; Roderick Prescott, 6/3/2003; Lewis Ratfield, 9/30/2002; Michael Richmond, 12/13/2002; William Sefton (Estate Preservation Services), 12/22/2001; Thomas Edward Settles, 3/25/2003; David Carroll Stephenson, 3/11/2004; Robert Welti, 2/14/2003. This information comes from press releases published on the Department of Justice Tax Division website. The injunctions are searchable by year, for example, <http://www.usdoj.gov/tax/taxpress2001.htm>, <http://www.usdoj.gov/tax/taxpress2002.htm>, <http://www.usdoj.gov/tax/taxpress2003.htm> and <http://www.usdoj.gov/tax/taxpress2004.htm>

⁵ I.R.C. § 6662(b)(1)

⁶ I.R.C. § 6662(b)(2)

⁷ I.R.C. § 6662(b)(3)

⁸ I.R.C. § 6664(b)

⁹ Treas. Reg. § 1.6662-2(c). See also DHL Corp. v. Commissioner, T.C. Memo. 1998-461, *aff'd in part and rev'd on other grounds, remanded by* 285 F.3d 1210 (9th Cir. 2002) where the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under section 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable.

For purposes of I.R.C. § 6662, the term “underpayment” is generally the amount by which the taxpayer’s correct tax is greater than the tax reported on the return.

The Service has the “burden of production in any court proceeding with respect to the liability of any individual for any penalty.”¹⁰

Negligence or Disregard of Rules or Regulations

Negligence is any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code and includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly.¹¹ Negligence includes the failure to exercise due care or the failure to do what a reasonable and prudent person would do under the circumstances.¹²

Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be “too good to be true” under the circumstances.¹³

Domestic abusive trust schemes are often marketed to sole proprietors with promises of tax savings based on transformation of personal expenses to trust deductions and the elimination of self-employment tax. Taxpayers who previously filed correctly have a basis in experience for suspecting such offers are “too good to be true.” Whether they inquired beyond the promoter’s material or their explanation of why they did not, is part of the evidence indicating an attempt to determine the correct tax liability. (See Reasonable Cause below.)

Disregard includes any careless, reckless, or intentional disregard of rules or regulations.¹⁴ Treas. Reg. § 1.6662-3(b)(2) defines “rules or regulations,” “careless,” “reckless,” and “intentional” as follows:

- ? “Rules or regulations” include the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code and revenue

¹⁰I.R.C. § 7491(c) applies with respect to examinations that are commenced after July 22, 1998; See IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, sec. 3001(c), 112 Stat. 727; Higbee v. Commissioner, 116 T.C. 438, 446-447 (2001).

¹¹I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(1); Sandvall v. Commissioner, 898 F.2d 455 (5th Cir., 1990) (deductions were not supported by facts and taxpayers failed to meet their burden of substantiating their deductions); Elliott v. Commissioner, 90 T.C. 960, 974 (1988)(records were kept in a cursory and sloppy fashion).

¹²Allen v. Commissioner, 925 F.2d 348, (9th Cir 1991), affg. 92 T.C. 1 (1989) (taxpayers were negligent for not having investigated arrangement which permitted them a tax deduction ten times greater than their own cash outlay and tax savings almost double amount of their outlay); Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff’g 43 T.C. 168 (1964); Neely v. Commissioner, 85 T.C. 934, 947 (1985).

¹³Treas. Reg. § 1.6662-3(b)(1)(ii); Elliott v. Commissioner, 90 T.C. 960, 974 (1988)

¹⁴I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(2)

- rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.
- ? A disregard of rules or regulations is “careless” if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation.
 - ? A disregard is “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe.
 - ? A disregard is “intentional” if the taxpayer knows of the rule or regulation that is disregarded.

Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling (including Public Notice 97-24, dealing specifically with abusive trust arrangements), the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of the notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if, in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This applies only if a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.¹⁵ In view of the great weight of case law against the use of abusive trusts, it is unlikely that a taxpayer can satisfy this exception by showing that there is a realistic possibility of being sustained on the merits.

Substantial Understatement

For individual taxpayers, a substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000.¹⁶ An “understatement” is defined as the excess of the tax required to be shown on the return over the tax actually shown on the return, less any rebate.¹⁷

One important issue relevant to the potential assertion of the accuracy-related penalty attributable to a substantial understatement is whether the transaction constitutes a tax shelter. The same determination also limits the applicability of certain defenses against the accuracy-related penalty.

¹⁵ Treas. Reg. § 1.6662-3(b)(2)

¹⁶ I.R.C. § 6662(d)(1)

¹⁷ I.R.C. § 6662(d)(2)(A)

Tax Shelter Aspect Impact on Accuracy-Related Penalties

A tax shelter is defined as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.¹⁸ Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, or the mischaracterization of the substance of the transaction.¹⁹ If the purpose exceeds any other purpose than to avoid or evade Federal income tax, the transaction is a “tax shelter”.

There are special rules in cases involving tax shelters.²⁰ The adequate disclosure exception of I.R.C. § 6662(d)(2)(B)(ii)²¹ does not apply. Also, the substantial authority exception of I.R.C. § 6662(d)(2)(B)(i)²² does not apply to corporate taxpayers and can apply to noncorporate taxpayers only if (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

A noncorporate taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities and, based on that analysis, reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor’s analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it.²³

In no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the requirements of Treas. Reg. §1.6664-4(c)(1) are met. Refer to Reliance On The Advice Of Others below.

¹⁸ I.R.C. § 6662(d)(2)(C)(iii)

¹⁹ Treas. Reg. § 1.6662-4(g)(2)(i)(c)

²⁰ I.R.C. § 6662(d)(2)(C)

²¹ I.R.C. § 6662(d)(2)(B) allows for a reduction for understatement due to position of taxpayer or disclosed item. I.R.C. § 6662(d)(2)(B)(i) allows for the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment.

²² I.R.C. § 6662(d)(2)(B) allows for a reduction for understatement due to position of taxpayer or disclosed item. I.R.C. § 6662(d)(2)(B)(ii) allows for any item if the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer.

²³ Treas. Reg. § 1.6662-4(g)(4)

Reasonable Cause

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.²⁴ Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.²⁵

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect.

Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Refer below to “Reliance On The Advice Of Others”.

Reliance On The Advice Of Others

Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable.²⁶

Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.²⁷

The two aspects of this defense needing definition, then, are (1) reasonable reliance on a tax professional, and (2) good faith.

Reliance must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter and that the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about.²⁸ In Neonatology Associates P.A., v.

²⁴ Treas. Reg. § 1.6664-4(b)(1)

²⁵ I.R.C. § 6664(c)(1); Larson v. Commissioner, T.C. Memo. 2002-295 (2002).

²⁶ United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney).

²⁷ Long Term Capital Holdings, et. al., v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).

²⁸ Treas. Reg. §1.6664-4(c); Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221 (3rd Cir. 2002) (citing Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, T.C. Memo 1995-610).

Commissioner, 115 T. C. 43 (2000), aff'd 299 F.3d 221 (3d Cir. 2002), the Court required the taxpayer to prove the following by a preponderance of the evidence:

1. The advisor was a competent professional who had sufficient expertise to justify reliance.
2. The taxpayer gave to the advisor the necessary and accurate information.
3. The taxpayer actually relied in good faith on the advisor's judgment.

It is well established that taxpayers generally cannot "reasonably rely" on the professional advice of a tax shelter promoter.²⁹ Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true".³⁰ The advice relied upon must have been received before the filing of the return containing the position taken. Courts look for corroborative evidence to establish the existence, timing, and nature of the advice.³¹

Good faith is evaluated on a number of points. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.³²

The court weighs the quality of evidence presented in support of these points. If the evidence is not strong and specific, the court will reject the reasonable cause argument, as it did in Long Term Capital Holdings, et al, 330 F. Supp. 2d 122 (D. Conn. 2004).

²⁹ Rybak v. Commissioner, 91 TC 524, 565 (1988) (the taxpayers relied only upon advice of persons who were not independent of promoters and negligence penalty sustained); Gilmore Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) ("Appellants cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest."), affg T.C. Memo 1993-480; Neonatology Associates, P. A., 299 F.3d at 221 ("Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about").

³⁰ Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), affd without published opinion 921 F.2d 280 (9th Cir. 1991). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true". Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993) (reliance on promoters or their agents is unreasonable), affg Donahue v. Commissioner, T.C. Memo. 1991-181; Roberson v. Commissioner, 98-1 USTC 50,269 (6th Cir. 1998); Elliott v. Commissioner, 90 T.C. 960, 974 (1988), affd without published opinion, 899 F.2d 18 (9th Cir. 1990); Gale v. Commissioner, T.C. Memo 2002-54; Gilmore & Wilson Construction Co. v. Commissioner, 99-1 USTC 50,186 (10th Cir. 1999) (reliance on representations of the promoters and offering materials unreasonable).

³¹ Long Term Capital Holdings, et. al., 330 F. Supp. 2d 122 (D. Conn. 2004).

³² Treas. Reg. § 1.6664-4(c)(1)(i).

In essence, the testimony and evidence offered by Long Term regarding the advice received from King & Spalding amounted to general superficial pronouncements asking the Court to “trust us; we looked into all pertinent facts; we were involved; we researched all applicable authorities; we made no unreasonable assumptions; Long Term gave us all information.” The Court's role as fact finder is more searching and with specifics, analysis, and explanations in such short supply, the King & Spalding effort is insufficient to carry Long Term's burden to demonstrate that the legal advice satisfies the threshold requirements of reasonable good faith reliance on advice of counsel.

Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate those underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter.³³

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law.³⁴

³³ Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment).

³⁴ Treas. Reg. § 1.6664-4(c)(1).

SETTLEMENT GUIDELINES

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