Abusive Trust Tax Evasion Schemes - Questions and Answers

Basic Trust Law

Q: What is a trust?
A: A trust is an entity created and governed under the state law in which it was formed. A trust involves the creation of a fiduciary relationship between a grantor, a trustee, and a beneficiary for a stated purpose. A trust may be created by any of the following methods:

- A declaration by the owner of property that the owner holds the property as trustee;
- A transfer of property by the owner during the owner's lifetime to another person as trustee;
- A transfer of property by the owner, by will or by other instrument taking effect upon the death of the owner, in trust, to another person as trustee or
- An exercise of a power of appointment to another person as trustee or an enforceable promise to create a trust.

Q: Who is a grantor of a trust?
A: The grantor (also known as trustor, settlor, or creator) is the creator of the trust relationship and is generally the owner of the assets initially contributed to the trust. The grantor generally establishes in the trust instrument the terms and provisions of the trust relationship between the grantor, the trustee, and the beneficiary. These will usually include the following:

- The rights, duties, and powers of the trustee;
- Distribution provisions;
- Ability of the grantor to amend, modify, revoke, or terminate the trust agreement;
- The designation and selection of a trustee or successor trustees; and
- The designation of the state under which the terms and provisions of the trust agreement are to be governed.

Q: What is a trustee/fiduciary?
A: The trustee obtains legal title to the trust assets and is required to administer the trust on behalf of the beneficiaries according to the express terms and provisions of the trust agreement. A fiduciary is an individual or organization charged with the duty to act for the benefit of another. A trustee is a fiduciary.

Q: What is a beneficiary?
A: The beneficiaries are those entitled to receive benefits from the trust.

Q: What is a simple trust?
A: "Simple trust" is a term used in the Internal Revenue Code to define a trust that:

- Is not a grantor trust or required to be treated as a grantor trust;
- Is required to distribute all income annually; and
- Does not distribute the corpus of the trust or make charitable contributions. (IRC Section 651).

Q: What is a complex trust?
A: A "complex trust" is a trust that is not defined as a "simple trust" or a "grantor trust" under the Internal Revenue Code.

Q: What is a grantor trust?
A: "Grantor trust" is a term used in the Internal Revenue Code to describe any trust over which the grantor or other owner retains the power to control or direct the trust's income or assets. If a grantor retains certain powers over or benefits in a trust, the income of the trust will be taxed to the grantor, rather than to the trust. (Examples, the power to decide who receives income, the power to vote or to direct the vote of the stock held by the trust or to control the investment of the trust funds, the power to revoke the trust, etc.) All "revocable trusts" are by definition grantor trusts. An "irrevocable

trust" can be treated as a grantor trust if any of the grantor trust definitions contained in Internal Code §§ 671, 673, 674, 675, 676, or 677 are met. If a trust is a grantor trust, then the grantor is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor.

Q: What are irrevocable/revocable trusts?

A: An irrevocable trust is a trust, which, by its terms, cannot be modified, amended, or revoked. For tax purposes an irrevocable trust can be treated as a simple, complex, or grantor trust, depending on the powers listed in the trust instrument. A revocable trust may be revoked and is considered a grantor trust (IRC § 676). State law and the trust instrument establish whether a trust is revocable or irrevocable. If the trust instrument is silent on revocability, then most states consider the trust revocable.

Q: What are testamentary and Inter Vivos trusts?

A: A testamentary trust is created by a will, which begins its existence upon the death of the person making the will, when property is transferred from the decedent's estate. Testamentary trusts are generally simple or complex trusts. A testamentary trust is irrevocable by definition, as it comes into being at the death of the grantor. A living person creates an Inter Vivos trust during that person's lifetime. An Inter Vivos trust can be established as revocable or irrevocable. An Inter Vivos trust can be a simple, complex, or grantor trust depending on the trust instrument.

Trust Taxation Questions

Q: IRS instructions for Form 1041 and Schedules A, B, D, G, I, J and K-1 provide general tax information and guidance for completing Form 1041. What law controls trust taxation?

A: Taxation of trusts can be found in subchapter J (Estates, Trusts, Beneficiaries, and Decedents - Sections 641 through 692) of the Internal Revenue Code. State law generally governs the legal standing of a trust and is important in some definitions included in the Internal Revenue Code.

Q: Do trusts have a requirement to file federal income tax returns?

A: Trusts must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, for each taxable year where the trust has $600 in income or the trust has a non-resident alien as a beneficiary. However, if the trust is classified as a grantor trust, it is not required to file a Form 1041, provided that the individual grantor reports all items of income and allowable expenses on his own Form 1040, U.S. Individual Income Tax Return. Thus, the grantor/individual would pay the total tax liability upon the filing of his return for that taxable year.

Q: How does a trust compute its income tax liability?

A: A trust computes its income tax liability in much the same way that an individual does and is allowed most of the credits and deductions that an individual is allowed. Similarly, deductions not allowed to individuals are not allowed to trusts. For example, personal living expenses such as food, utilities, recreational expenses, children's education, depreciation of one's personal residence, etc. are not allowed as a trust deduction any more than as an individual deduction. Trusts are also required to prepare a Schedule K-1 for their beneficiaries, showing them the amounts distributed by the trust to them. These amounts must be reported on the beneficiaries' returns.

Q: I have been told that I can assign income to a trust and I will not be taxed on that income. Is this true?

A: No. Income that is earned by one person cannot be assigned to another for federal income tax purposes. You would still be liable for income taxes due on income earned, even though it was directly paid to the trust.

Q: May a trust deduct contributions to a charity?

A: A simple trust cannot. A complex trust may, but the deduction must meet rules similar to those for deductions by individuals (except for the percentage limitations of IRC Section 170) and be explicitly allowed in the trust instrument. Trusts that claim a charitable deduction generally must also file Form 1041-A, U.S. Information Return for Trust Accumulation of Charitable Amounts. In a grantor trust, the deduction would be attributable to the grantor and be governed by IRC Section 170, charitable deduction rules.

Q: Will I owe Federal Gift Taxes on property contributed to a trust?

A: The creation of a trust, or the contributing of property to a trust may or may not have gift tax implications, which would require the filing of Form 709, Gift Tax Return. For gift tax purposes, a gift is complete to the extent the donor (the person making the gift) has irrevocably parted with dominion and control over all or part of the transferred property, whether directly or indirectly, leaving the donor without the power to change its disposition, whether for the benefit of the donor or for the benefit of others. Where a grantor trust has been established, generally no gift tax would be due on property contributed. In situations where an Inter Vivos irrevocable trust is the recipient of property contributed, a gift tax return would generally be due. Testamentary trusts would be subject to estate and gift tax rules/filing requirements.

Q. The information presented by the promoter sounded legitimate. Now I have concerns regarding this promotion. Who do I contact to report information on the promotion and promoter?

A. Contact the Internal Revenue Service at 1-866-775-7474 or e-mail the Tax Shelter Hotline at irs.tax.shelter.hotline@irs.gov.

Q. Can I get more information on the Internet?

A. Yes. Additional information is available at the following IRS websites:

- The Tax Scams/Fraud Alerts site provides information on tax scams and explains how to report suspected tax fraud.
- Find out some of the red flags that might be present in the Abusive Tax Shelters section on IRS.gov.
- The IRS Newsroom's page on Tax Scams/Consumer Alerts describes a number of common tax scams. If any of these apply to your investment, you should consult a tax professional not involved in promoting the investment. Or you may contact IRS to determine how it will treat such a promotion.
- Or find the following publications:
  - Publication 334, Tax Guide for Small Business
  - Publication 17, Your Federal Income Tax for Individuals
  - Publication 3995, Is It Too Good To Be True - Recognizing Illegal Tax Avoidance Schemes (PDF)

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