Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

N(35)000-146

July 15, 1997

Subject: Abusive Trusts Arrangements Cancellation Date: October 13, 1997

The purpose of this Notice is to request all District Counsel and Regional Counsel attorneys to notify Field attorney, Richard Kennedy, Rocky Mountain Associate District Counsel Office, Western Region, or National Office attorney, Melissa C. Liquerman, Passthroughs & Special Industries Branch, Field Service Division, of any cases involving the use of trust arrangements as tax avoidance vehicles. The Service in Notice 97-24, 1997-16 I.R.B. 6, alerted taxpayers about certain trust arrangements that purport to reduce or eliminate federal taxes in ways that are not permitted by federal tax law ("abusive trust"). The abusive trust arrangement issue is a significant compliance issue and thus is subject to the notification procedures described in Chief Counsel Notice N(35)000-139(a), issued September 24, 1996. This issue will be added to the list of significant issues requiring National Office notification when that list is next updated.

When trusts are used for legitimate business, family or estate planning 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. In the abusive trust arrangements, presently being marketed as tax avoidance vehicles, the original owner of the assets, which 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. These arrangements seek to reduce or eliminate the purchaser's tax liability without reducing real income or the taxpayer's control over the income or property. This type of arrangement is not permitted under federal tax law.

Several well-established tax principles control the proper tax treatment of these abusive trust arrangements. If the person who transferred property into the trust (called the "grantor") retains control over the trust property or income, then that person will be taxed on the income. I.R.C. §§ 671-679; and

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Wesenberg v. Commissioner, 69 T.C. 1005 (1978). Under the substance over form 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); and Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984). If the trust is not a sham and is not a grantor trust, the trust is taxable on its income, reduced by amounts distributed to beneficiaries. See sections 641, 651, 652, 661, and 662. Alleged charitable payments made by the trust, which in substance are for the benefit of the owner or the owner's family members, are not deductible charitable contributions. See, e.g., Fausner v. Commissioner, 55 T.C. 620 (1971). The courts have consistently held that non-deductible personal expenses cannot be transformed into deductible expenses by the use of trusts. See, e.g., Schulz v. Commissioner, 686 F.2d 490 (7th Cir. 1982); Neely v. United States, 775 F.2d 1092 (9th Cir. 1985). In addition, transfers to a trust may be subject to gift taxes and/or the property may be included in the grantor's estate upon death.

The courts have sustained the imposition of civil or criminal penalties against taxpayers who attempt to use trusts to evade tax liability as well as against the promoters who sell these arrangements. Accordingly, in addition to disregarding the trust entity, the Government may pursue civil and criminal penalties against such taxpayers and promoters. See, e.g., Wesenberg, supra; United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985); United States v. Krall, 835 F.2d 711 (8th Cir. 1987); and Zmuda, supra.

If you are assisting a revenue agent or appeals officer with a case involving an abusive trust arrangement, please notify Field attorney, Richard Kennedy, WR:RMD:SLC, at (801) 799-6630, or National Office attorney, Melissa C. Liquerman, DOM:FS:P&SI, at (202) 622-7860, who are respectively coordinating the Field and National Office's efforts as to the abusive trust arrangements. Information regarding these cases will help identify promoters of abusive trust arrangements and assist in the nationally coordinated enforcement initiative addressing abusive trust arrangements. Information regarding these cases will also help ensure uniformity with respect to the Service's litigating position.

/s/

JUDITH C. DUNN
Associate Chief Counsel
(Domestic)