

## **New IRS Hit List Against Landlords – Part II**

### **Is Your Trust IRS Legal?**

by Richard Ivar Rydstrom, Esq.

As the dust settles from the February 2007 Congressional Hearings on questionable tax and offshore strategies, including the proposed prohibition of avoiding or deferring taxes with the private annuity (trust) arrangements, let's review the "trust" warnings in IRS Notice 97-24 ([www.irs.gov](http://www.irs.gov)).

The IRS brochure "*Too Good True to be True*" says: The IRS takes fraudulent trust arrangements seriously. It is a matter of maintaining public confidence in the fairness of the tax laws. Recommending prosecution of those who violate the tax laws demonstrates the IRS' commitment to ensuring all taxpayers pay their fair share of taxes. The warnings go on to say:

False claims concerning fraudulent trust arrangements can include:

- **False Claim:** Establishing a trust will reduce or eliminate income taxes or self-employment taxes.

**Truth:** Taxes must be paid on the income or assets held in trust, including the income generated by property held in trust. The responsibility to pay taxes may fall to either the trust, the beneficiary or the transferor.

- **False Claim:** You will retain complete control over your income and assets with the establishment of a trust.

**Truth:** Under legal trust arrangements, you must give up significant control over income and assets. An independent trustee is designated to hold legal title to the trust assets, to exercise independent control over the trust, and to manage the trust.

- **False Claim:** Taxpayers may deduct personal expenses paid by the trust on their tax return.

**Truth:** Non-deductible personal living expenses cannot be transformed into deductible expenses by virtue of assigning assets and income to a trust.

- **False Claim:** Taxpayers can depreciate their personal residence and furnishings and take them as deductions on their tax return.

**Truth:** Depreciation of a taxpayer's residence and furnishings used solely for personal use is not deductible by virtue of assigning the residence to a trust.

Taxpayers must take responsibility for their own actions. Should a taxpayer choose to participate in a fraudulent trust scheme, the taxpayer will not be shielded from potential civil and criminal sanctions.

IRS warns us not to think the word "trust" attached to a strategy or device yields credibility to it; the form and substance must have economic substance and comply with the laws.

Pursuant to the IRS warnings, the following arrangements have been used to promote fraudulent trust schemes:

“1. **Business Trust:** This involves the transfer of an on going business to a trust. Also called an unincorporated business organization, a pure trust or a constitutional trust, it makes it appear that the taxpayer has given up control of his or her business. In reality, however, through trustees or other entities controlled by the taxpayer, he or she still runs day-to-day activities and controls the business’s stream of income. Such arrangements provide no tax relief.

2. **Equipment or Service Trust:** This trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust. This type of arrangement has the same pitfalls as the business trust. It provides no tax relief.

3. **Family Residence Trust:** Taxpayers transfer family residence, including furnishings, to a trust, which sometimes rents the residence back to the taxpayer. The trust deducts depreciation and the expenses of maintaining and operating the residence including, pool service and utilities. These expenses are not deductible and the IRS will disallow them.

4. **Charitable Trust:** Taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, educational, and recreational expenses on behalf of the taxpayer or family member. The trust then claims the payments as charitable deductions on its tax returns. These alleged charitable organizations often are not qualified and have no IRS exemption letter. Therefore, contributions are not deductible.

5. **Foreign Trust:** These trusts often are located in foreign countries that impose little or no tax on trusts and also provide financial secrecy. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to the original owner. The trust promoter claims that this distribution is tax-free. In fact, the income from these arrangements is fully taxable.”

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