Part III. Administrative, Procedural, and Miscellaneous

Certain Trust Arrangements

Notice 97–24

This notice is intended to alert taxpayers about certain trust arrangements that purport to reduce or eliminate federal taxes in ways that are not permitted by federal tax law. (The notice refers to such arrangements as ''abusive trust arrangements.'' See Section I. ABUSIVE TRUST ARRANGEMENTS—IN GENERAL, below.) The notice describes some typical abusive trust arrangements, as well as the tax benefits promised by promoters, and then explains the correct tax principles that apply to these trust arrangements. Taxpayers should be aware that abusive trust arrangements will not produce the tax benefits advertised by their promoters and that the Internal Revenue Service is actively examining these types of trust arrangements as part of the National Compliance Strategy, Fiduciary and Special Projects. Furthermore, in appropriate circumstances, taxpayers and/or the promoters of these trust arrangements may be subject to civil and/or criminal penalties.

This notice should not, however, create concerns about the legitimate uses of trusts. For example, trusts are frequently used properly in estate planning, to facilitate the genuine charitable transfer of property, and to hold property for minors and incompetents.

Under the federal tax laws, trusts generally are separate entities subject to income tax (except for certain charitable or pension trusts that are expressly exempted by the tax laws and certain grantor trusts described in sections 671–679 of the Internal Revenue Code). Under these laws and certain court developed doctrines, either the trust, the beneficiary, or the transferor, as applicable, must pay the tax on the income realized by the trust including the income generated by property held in trust.

I. ABUSIVE TRUST ARRANGEMENTS—IN GENERAL

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 tax; deductions for personal expenses paid by the trust; depreciation deductions of an owner's personal residence and furnishings; a stepped-up basis 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 rules applicable to the abusive trust arrangements, as described below.

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 services, purchase and sale agreements, and distributions. Some trusts purport to involve charitable purposes. In some situations, one or more foreign trusts also may be part of the arrangement.

II. EXAMPLES OF ABUSIVE TRUST ARRANGEMENTS

Described below are five examples of abusive trust arrangements that have come to the attention of the Internal Revenue Service. 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. 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, 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 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 to the trust unit holders or to other trusts created by the owner (characterized either as deductible business expenses or as deductible 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 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. In some cases, the trust units are supposed to be canceled at death or ''sold'' at a nominal price to the owner's children, leading to the contention by promoters that there is no estate tax liability.

2. *The Equipment or Service Trust.* The equipment trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The service trust is formed to provide services to the business trust, often for inflated fees. Under these abusive trust arrangements, the business trust may purport 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). 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 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 Charitable Trust.* The owner transfers assets to a purported charitable trust and claims either that the payments to the trust are deductible or that payments made by the trust are deductible charitable contributions. Payments are made to charitable organizations; however, in fact, the payments are principally for the personal educational, living, or recreational expenses of the owner or the owner's family. For example, the trust may pay for the college tuition of a child of the owner.

5. *The Final Trust.* In some multi-trust arrangements, the U.S. owner 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. 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.

III. LEGAL PRINCIPLES APPLICABLE TO TRUSTS

As noted above, 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. 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.

1. *Substance—not form—controls taxation.* 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, for example, *Gregory v. Helvering,* 293 U.S. 465 (1935), XIV–1 C.B. 193; *Helvering v. Clifford,* 309 U.S. 331 (1940), 1940–1 C.B. 105. 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 foreign trust would all be treated as belonging directly to the owner.

2. *Grantors may be treated as owners of trusts.* The grantor trust rules 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. Sections 671—677. In addition, a U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of that property if there is a U.S. beneficiary of the trust. Section 679. 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.

3. *Taxation of Non-Grantor Trusts.* 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. 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. Sections 641, 651, 652, 661 and 662.

4. *Transfers to trusts may be subject to estate and gift taxes.* Transfers to a trust may be recognized as completed gifts for federal gift tax purposes. Further, whether or not the gift tax applies, if the owner retains until the owner's death the use of, enjoyment of, or income from the property placed in a trust, the property will be subject to federal estate tax when the transferor dies. Section 2036(a).

5. *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 nondeductible personal expenses cannot be transformed into deductible expenses by the use of trusts. Furthermore, the costs of creating these trusts are not deductible. See, for example, *Schulz v. Commissioner,* 686 F.2d 490 (7th Cir. 1982); *Neely v. United States,* 775 F.2d 1092 (9th Cir. 1985); and *Zmuda.*

6. *A genuine charity must benefit in order to claim a valid charitable deduction.* Charitable trusts that are exempt from tax are carefully defined in the tax law. Arrangements are not exempt charitable trusts if they do not satisfy the requirements of the tax law, including the requirement that their true purpose is to benefit charity. Furthermore, supposed charitable payments made by a trust are not deductible charitable contributions where the payments are really for the benefit of the owner or the owner's family members. See, for example, *Fausner v. Commissioner,* 55 T.C. 620 (1971).

7. *Special rules apply to foreign trusts.* If an arrangement involves a foreign trust, taxpayers should be aware that a number of special provisions apply to foreign trusts with U.S. grantors or U.S. beneficiaries, including several provisions added in 1996. For example, a U.S. person that fails to report a transfer of property to a foreign trust or the receipt of a distribution from a foreign trust is subject to a tax penalty equal to 35 percent of the gross value of

the transaction. Other examples of these provisions are the application of U.S. withholding taxes to payments to foreign trusts and the application of U.S. excise taxes to transfers of appreciated property to foreign trusts. See sections 6048, 6677, 1441, and 1491.

8. *Civil and/or criminal penalties may apply.* The participants in and promoters of abusive trust arrangements may be subject to civil and/or criminal penalties in appropriate cases. See, for example, *United States v. Buttorff,* 761 F.2d 1056 (5th Cir. 1985); *United States v. Krall,* 835 F.2d 711 (8th Cir. 1987); *Zmuda* and *Neely.*

IV. IRS ENFORCEMENT STRATEGY FOR ABUSIVE TRUSTS

The Internal Revenue Service has undertaken a nationally coordinated enforcement initiative to address abusive trust schemes—the National Compliance Strategy, Fiduciary and Special Projects. This initiative involves Service personnel from the Assistant Commissioner (Examination), Assistant Commissioner (Criminal Investigation), and the Office of Chief Counsel.

As part of this strategy, the Service seeks to encourage voluntary compliance with the tax law. Accordingly, taxpayers who have participated in abusive trust arrangements are encouraged to file correct tax returns for 1996, as well as amended tax returns for prior years, consistent with the explanation of the law set forth in this notice.

For information regarding issues addressed in this notice, taxpayers may call (202) 622–4512 (not a toll-free number).

Consolidated Returns; Consolidated and Controlled Groups; Correction

Notice 97–25

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correcting Amendments.

SUMMARY: This document contains technical corrections to final regulations [T.D. 8560[1994–2 C.B. 200]; T.D. 8597[1995–2 C.B. 147]; T.D. 8660 [1996–1 C.B. 195]] which were published in the **Federal Register** on Monday, August 15, 1994 (59 FR 41666); Tuesday, July 18, 1995 (60 FR 36671); and Thursday, March 14, 1996 (61 FR 10447); respectively. The final regulations amend the consolidated return investment adjustment provisions, intercompany transaction provisions and the provisions limiting losses and deductions from transactions between members of a nonconsolidated controlled group.

DATES: The correcting amendments affecting §§ 1.267(f)–1, 1.1502–13(f)(2)-(ii), (g)(5), (l)(1), 1.1502–20, 1.1502–32(b), and 1.1502–80(b) are effective July 18, 1995. The correcting amemdments affecting §§ 1.1502–11, 1.1502–19, 1.1502–32(f), 1.1502–43, 1.1502–76 and 1.1502–80(d)(1) are effective January 1, 1995. The correcting amendments affecting § 1.1502–13(f)(6) are effective March 14, 1996. For dates of applicability see §§ 1.267(f)–1(l), § 1.1502–11(b)(5), 1.1502–13(l)(1), 1.1502–13(f)(6)(v), 1.1502–19(h), 1.1502–32(h), 1.1502–76(b)(5), 1.1502–80(d), and other relevant provisions.

FOR FURTHER INFORMATION CONTACT: William Barry of the Office of Assistant Chief Counsel (Corporate), (202) 622–7770 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these correcting amendments are under sections 267 and 1502 of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors and omissions which may prove to be misleading and are in need of clarification.

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Accordingly, 26 CFR Part 1 is corrected by making the following correcting amendments:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for Part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.267(f)–1 [Corrected]

Par. 2. Section 1.267(f)–1 is amended as follows:

1. In paragraph (c)(1)(iii), the first sentence is revised.

2. Paragraph (l)(2) is revised.

The revisions read as follows:

§ 1.267(f)–1 Controlled groups.

* * * * *

(c) * * * (1) * * *

(iii) * * * To the extent S’s loss or deduction from an intercompany sale of property is taken into account under this section as a result of B’s transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. * * *

* * * * *

(l) * * *

(2) *Avoidance transactions.* This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section.

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§ 1.1502–11 [Corrected]

Par. 3. Section 1.1502–11 is amended by revising paragraph (b)(2)(iii), Example 3. (e) to read as follows: § 1.1502–11 Consolidated taxable income.

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(b) * * *

(2) * * *

(iii) * * *

Example 3. * * *

(e) Under paragraph (b)(2)(ii) of this section, S’s $30 of loss limited under this paragraph (b) is treated as a separate net operating loss.

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§ 1.1502–13 [Corrected]

Par. 4. Section 1.1502–13 is amended as follows:

1. In paragraph (f)(2)(ii), a sentence is added before the last sentence of the paragraph.

2. In paragraph (f)(6) introductory text, the last sentence is revised.

3. In paragraph (g)(5), *Example 5.*(c), the tenth sentence is revised.

4. In paragraph (l)(1) the third, fourth, and fifth sentences are revised.

The addition and revisions read as follows: