Testimony

Before

The Senate Finance Committee

Taxpayer Beware: Schemes, Scams and Cons

TRUST SCAMS ON THE WEB

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1 INTRODUCTION

I created my Tax Prophet website (http://www.taxprophet.com/) in March 1995, to educate the general public regarding U.S. tax laws. I discuss the tax consequences of specific transactions and how taxpayers may reduce their tax liabilities.

Although most e-mail I receive involves questions about the Internal Revenue Code, I also hear from a persistently vocal minority, one claiming that our tax laws are unconstitutional and that it is possible to substantially reduce, if not completely eliminate, taxes via a “pure trust.”

In response to this nonsense, I created the Tax and Trust Scam Bulletin Board (http://www.taxprophet.com/hot/Trustscam.htm) as a resource for people being pressured by these phony trust promoters, but who at that time had no source of opposing information.

This Bulletin Board is a public service designed to combat consumer fraud perpetrated against the public. Admittedly, the most likely participants of these phony trusts are anti-government rebels who deserve little sympathy for their culpable tax evasion. However, trust scam artists prey equally on unsuspecting seniors, the uneducated wealthy, and many citizens who would love to enjoy what they believe are legal ways to save on their taxes. Who among us wouldn’t? The goal of the Bulletin Board is ***not*** to convince hard-core tax protestors or anti-government types that they are wrong; rather, it is to provide those who are being duped with badly needed accurate and current information.

2 HOW A TRUST SCAM FUNCTIONS

2.1 The Decades-Old Pure Trust Scam

The “pure trust” has been around since the late 1950s. They are called “pure trusts” because the trust is allegedly based on the constitution’s guarantee of freedom of contract, rather than on specific state or federal laws.

One of the earliest decisions involving pure trusts was the 1968 California case People vs. Lynam, 261 Cal App 2d 490 (1968), in which the court ruled that the pure trust was a fraud under California law. In an earlier case, People ex. Rel. Mosk v Lynam, 253 Cal App 2d 959 (1967), a California Appellate Court held that advertising the benefits of a pure trust to avoid income taxes amounted to false and deceptive advertising practices. The court enjoined the defendants from promoting “pure trust” plans for managing personal assets.

The defendant employed the identical arguments that “pure trust” hucksters are still promoting today. According to the Mosk v Lynam court:

- The statements to the effect that no state can regulate pure trusts because such trusts are guaranteed by the United States Constitution are untrue and misleading.

- Since beneficial certificates are issued by the trust, and since the trust may operate as a substitute for a voluntary association or corporation, the trust would be subject to regulation by the state. [citation omitted].

- With reference to the purported "guarantee" by the United States Constitution, Lynam [the defendant] stated in his deposition that immunity from state regulation was guaranteed by that clause of the United States Constitution which protects contracts from abrogation. No contract contrary to public policy, however, is protected by that clause.

- The statements to the effect that income accruing to the trust is not taxable to the trust (as an entity) are untrue and misleading.

2.2 Lack of Expertise

The “masterminds” of these trusts appear to have no formal education in either tax law or accounting. Typically, they don’t provide any legal analysis or case law in support of their assertions or discuss the counter-arguments to their positions. It is just hard sell all the way. They rely on the barest technical compliance with trust law, which of course, can still be illegal: When challenging trust arrangements, the IRS and courts scrutinize the substance, not merely the form, of all transactions.

2.3 Distinguishing a Phony Trust from A Legitimate Estate Planning Trust

What makes this particular scam popular is that legal, properly-drafted revocable trusts offer a variety of estate planning opportunities and can eliminate probate fees and costs, and minimize estate taxes. However, they never save the taxpayer income taxes -- in any way. These promoters deliberately confuse legitimate trusts with fraudulent ones, claiming that prominent families (the Rockefellers, Kennedys or Fords) have established family trusts to minimize inheritance taxes, protect assets and maximize privacy. These legal trusts, however, are usually funded by gifts or sales of property; or the person creating the trust remains liable for all income and estate taxes under the grantor trust rules (generally IRC Sections 671-679).

In contrast, every taxpayer caught using these trusts has been charged with all taxes owing, plus interest, and usually penalties.

2.4 Why These Trusts Do Not Work

The IRS and courts look to the substance of the transaction, not its form. When all is said and done, if a taxpayer enjoys the benefits of his property, he is taxed as the owner. It does not matter that he placed his property into a trust with his great aunt as trustee and created reams of paperwork attempting to hide his ownership.

The courts and IRS look to the results, not the methods. These tax scam artists invariably fail to address the critical issue: After the paper shuffle, who winds up with the beneficial use and enjoyment of the property? If it is the taxpayer, then all the intermediate documentation is ignored and the taxpayer is responsible for the tax consequences.

2.5 How to Spot a Fraudulent Trust

Scam trust packages use names such as “Pure Trust,” “Unincorporated Business Organization” (UBO), “Common Law Trust,” "Constitutional Trust," “Complex Trust” and “Pure Equity Trust.”

Employing fear tactics, these hucksters suggest that taxpayers are probably paying more than their fair share of taxes; that without their seminar instruction, taxpayers may lose all their assets as a result of litigation or medical expenses; or that their heirs will have to sell assets to pay for inheritance taxes. Often, they obtain a minister or other cleric as a client, then work on the rest of the church members. Star athletes or other public figures are sometimes present to lend an aura of excitement and respectability to the pitch.

Trust scam hucksters claim their seminars and instructional materials teach taxpayers how to transfer their business, investments and residence assets into trusts to protect against the claims of creditors. They may also "guarantee" that their program will virtually eliminate taxation of self-employment earnings and significantly reduce their income tax liability, usually by deducting inflated expenses between trusts or deducting personal expenses as "business" expenses. Among their claims, they often promise that taxpayers can protect their assets from liabilities, deduct their children's tuition as "scholarships" and eliminate estate taxes at death. But here is the real prize: these trusts allow clients to maintain control of assets transferred to the trust, unlike legal irrevocable trusts that require an independent trustee.

2.6 An Illustration

Sham trust promoters often design their bogus documents as a three-trust scam. Here is how the arrangement supposedly works (see the diagram attached hereto as Exhibit "A"):

1. <u>Trust One</u> (Business Trust) contains business assets (allegedly transferred to this trust on a tax-free basis). When the business trust generates income, it is subject to self-employment taxes.

2. <u>Trust Two</u> (Siphon Trust) is created to lease or sell equipment, services and inventory to the business trust at inflated prices, thereby siphoning-off the income generated in the business trust which would otherwise be subject to self-employment taxes.

3. <u>Trust Three</u> (Personal Residence Trust). All income generated by the siphon trust (and any remaining income in the business trust) is then distributed to the personal residence trust which contains the taxpayer's personal residence. The trust uses an

inflated depreciation deduction for the residence to offset part of the income distributed to it. The taxpayer now lives tax-free in the residence as a "caretaker." As part of the caretaker's package, the trust pays for medical and educational expenses, then deducts those payments as business expenses to further offset income.

Of course, none of this is remotely legal. The tax code does not permit tax-free transfers of property in exchange for trust units. A residence may not be depreciated unless it is used in legitimate rental activity that produces rental income; taxpayers never can claim they are caretakers of their own residences; and any personal deductions for medical or educational expenses must meet stringent code requirements.

Courts typically dismiss these trusts as bogus since they are devoid of economic substance and are entirely an income tax-avoidance device. Also, if the taxpayer directly or indirectly controls the trust, courts might apply "grantor trust" provisions to tax the income directly to the taxpayer, in any event.

3 THE TYPICAL TAX-SCAM PROMOTER

3.1 Viewing the Tax Law with "Tunnel Vision"

Trust scam promoters appear to have no appreciation of the number of judicial doctrines that stress substance over form. For instance, one of their favorite claims is that the pure trust is a constitutional trust created under the freedom to contract (Article I, Section 10 of the U.S. Constitution). If the freedom to contract had no restrictions, then presumably it would be legal to hire a contract killer. Of course, the freedom to contract does not apply when a contract is contrary to public policy.

Likewise, trust scam promoters often rely on IRS Revenue Rulings which govern specific transactions. But these Revenue Rulings do not apply to sham transactions or to a series of transactions that can be collapsed under the "step-transaction" doctrine. The step transaction doctrine holds that a transaction involving a series of pre-arranged and inter-related steps, which are undertaken for tax purposes and lack economic substance, may be analyzed as a whole. The focus is on the end result — the intermediate steps within the transaction may be ignored.

3.2 Tax Protesters vs. Pure Trust Scam Artists

Traditionally, the authors and promoters of illegal tax protester schemes asserted the U.S. government is not legitimate and the Internal Revenue Code is illegal or unconstitutional as applied to them. Noted for a militia-type attitude, their original tactics employed a philosophy of "untaxing" yourself (renouncing the right to receive government benefits such as social security) and thus becoming a "sovereign citizen" who was beyond the reach of the U.S. tax system. Thus, IRS would look for the obvious: Those who did not file or pay their income taxes.

The pure trust scam artists, however, have taken a different tack: They claim taxes are legal, and for, say, $20,000 they'll help you reduce or eliminate your tax burden, by setting up your "pure trust." The documents usually make no logical sense but are just a mishmash of-trust concepts combined with anti-tax rhetoric. Under the traditional pure trust approach, tax returns are filed, but income disappears through a series of phony deductions. The scam artists believed that IRS would not audit trust tax returns. This approach became obsolete when IRS released Notice 97-24, announcing a nationwide crackdown on bogus trusts.

Recently, the tax protestors have discovered the virtues of selling the pure trust. They have modified their position and now explain that a person no longer must "untax" himself, but rather that the pure trust be formed in a "foreign" jurisdiction, while the individual remains eligible to receive government benefits – It's a "have your cake and eat it too" approach.

But because forming a legitimate foreign trust is expensive, not to mention the fact that the clients would lose control of their assets, these savvy tax protestors have devised a theory — based on a frivolous interpretation of the Internal Revenue Code — that classifies all 50 states as "foreign" to the U.S. government. And here is the bonus: The "foreign" trust could reside in the same state as the taxpayer!

Thus, by creating a trust that is classified as "foreign" under U.S. tax laws, the income received would be "foreign source," therefore, the trust would not file tax returns. Distributions made to the taxpayer would be considered tax-free foreign-source gifts or foreign-earned income that, supposedly, would be excludable under IRC Sec. 911. Of course, none of this actually works under our tax laws.

In this way, the tax protestors devised a scheme to hide the income and existence of these trusts from IRS yet still operate openly in the U.S. as a "foreign trust" which is allegedly not subject to tax reporting or filing requirements.

4 TAX SCAMS AND THE INTERNET

An internet search for the terms "pure trust" will produce dozens of unique websites advertising these schemes. Some websites have existed for years. The sheer volume of such websites touting the pure trust lends legitimacy to the concept. After reading several of these sites, the average citizen could— and may—believe there is truth in their claims.

A typical trust-scam artist uses the pitch, "If this were illegal, don't you think the government would arrest me? They haven't, therefore, what I'm telling you must be legal."

In addition to creating an atmosphere of legitimacy, the web allows, by sheer numbers, the trust-scam artist to reach a worldwide audience. Similar schemes are cropping up in Australia and Canada, with a scope extending to other countries. Because each trust scam is designed to extract a huge fee before any bogus documents are even produced, unless the government moves quickly to shut down these scams, the damage is done to unsuspecting consumers long before any tax returns are filed or audited. Often there are no tax returns filed, so large sums of wealth are slipping below the government's radar screen.

Since trust scam operations rely on keeping one step ahead of the IRS, a sham trust promoter might use the other tax fraud websites as a resource to update and fine-tune his swindle. For instance, the "foreign jurisdiction" argument is being refined and used in a variety of illegal contexts because of its prevalence on the web. A trust scammer can now point to the number of tax "experts" on the web saying essentially the same thing he is touting, another technique to buttress his scam's legitimacy.

Finally, the e-mail portion of the web is vital to the trust promoters since is allows them to spam (send thousands of unwanted e-mails touting their trust fraud) for free. It is the combination of having a website and the use of spam that makes the web such an effective marketing tool for trust scammers.

5 MEASURES TO PREVENT THE PROLIFERATION OF TRUST SCAMS ON THE WEB

5.1 Create A Strike Force

First, the IRS needs a federal strike-force committed to consistently monitoring the websites and activities of trust-scam artists. One to two employees should be searching for new trust scams on the web first thing each and every morning. At midmorning, they should report the new activities, and by noon there should be a meeting to decide whether a suspicious website promotes tax fraud. The decision should be made by early afternoon.

If a website is promoting tax fraud, immediate action must be taken. I cannot emphasize this enough. The entire website should be downloaded and preserved as evidence. Once this is accomplished, the person or company who manages the webside (usually known as the webmaster) and the ISP (the internet service provider) should be notified and given a set time, say 12 hours, to remove the website.

Within the strike force, several attorneys experienced in these matters would be authorized to appear in federal court to stop the sites. An attorney should be notified when the notice to cease and desist has gone to the web site. If the site is not down within the prescribed time, legal proceedings should commence immediately.

The strike force should also report to other government agencies combating fraud i.e. SEC, FDA, so that a coordinated crackdown on fraud can be imitated.

Finally, the strike force should be monitoring e-mail spamming by trust scam artists. This is easily done because several groups follow and report on Internet spamming. A two-pronged approach aimed at finding trust scam websites and those touting their trust frauds through spamming, would be extremely effective in stopping this activity.

5.2 Resource Center - Fight Propaganda with Education

IRS must provide a comprehensive web-based resource center involving trust scams. Every court case should be categorized and listed with links to the actual case. Every DOJ and IRS press release should be posted at the website as well. Also, legal briefs and arguments used in court cases against these groups should be available. The website should contain an e-mail subscription list and a newsletter discussing current trust scams matters. These should be sent to the press and others who request them.

A crucial element of the IRS website should be a list of suspect websites along with links to actions taken against the site (press releases, legal proceedings). A list of trust scam spammers should also be maintained.

Instructional materials, such as “How to Spot an Illegal Trust,” “New Scams: How They Work and Why They are Illegal,” should be essential parts of the web site. Links to other news stories and publications should be provided as well.

The website should be designed and promoted in the same manner as the IRS’s recent website devoted to Small Businesses (http://www.irs.ustreas.gov/smallbiz/index.htm) which could be used as a model. Links to the trust scam resource center should appear on the home pages of each IRS website. Instructions to the Form 1040 should contain a paragraph stating that using trusts to avoid income taxes is illegal.

5.3 IRS Needs a Public Relations Offensive

IRS spokespersons need to counter the trust scam artists whenever they appear in any media. The IRS approach needs to be simple and direct: These scams do not work, they are illegal and IRS will come after you if you use them. IRS should avoid arguments as to the scammer’s philosophy or logic. Taxpayers are impressed by results – IRS does not accept these arguments – rather than philosophical debates.

Another aspect of the PR offensive should be targeted articles and advertisements in industry-specific publications. For instance, if a doctor or dentist is convicted of a trust scam crime, an article should appear in the professional publications (American Medical Association or American Dental Association) monthly magazines warning these professionals not to engage in this conduct. In other words, IRS needs to leverage its court victories by making sure those within the same profession or industry get the message. IRS might speak at annual conventions or have a booth at trade shows, dealing with trust scams within the profession.

A PR offensive should be directed at the trustees of these trusts since the trustees could be a family friend or relative who is unaware of the serious risk he or she is taking by acting as a trustee of the fraudulent trust. This can be accomplished through general business and finance television programs, magazines and newspaper stories.

6 CONCLUSION

Trust scams have existed for more than four decades. Recently, they have moved from the realm of the snakeoil salesman to the world-wide reach of the Web. This is a growing problem, both from a consumer protection and revenue loss viewpoint. The mere existence of these websites reinforces the legitimacy of the trust scammer's claims and undermines the confidence of honest taxpayers in the system.

IRS has the tools to combat this problem before it spirals further out of control. A simple three-pronged approach is feasible: (1) the identification of these websites and the swift action to shut them down (2) the design of a comprehensive resource center composed of information pertaining to trust scams; and (3) a concentrated PR effort in the media, including IRS spokespersons confronting trust scammers in the media.

If IRS considers the cost of audit and collections personnel chasing down trust scams once they have entered the tax system, eliminating these websites at the earliest moment becomes cost-effective as well.

Recommended Anti-Fraud Websites

Quatloos, (http://www.quatloos.com/) by Jay D. Adkisson - the leader in using the Web to expose tax and financial scams and frauds.

Why You Shouldn't "Trust" Trust Educational Services (formerly National Trust Services)(http://pweb.netcom.com/~rogermw/nts.html) by Roger M. Wilcox. who claims he got burned by National Trust Services ("NTS") to the tune of $9,500 for a worthless trust. An excellent analysis and critique of the trust scam business from the victim's perspective.

The Tax Protestors FAQ (http://evans-legal.com/dan/tpfaq.html#liable) by Daniel B. Evans. Mr. Evans has taken the time and trouble of refuting dozens of tax protestor arguments by providing case law citations. An invaluable resource for those dealing with these arguments.

The Tax Protestor Hall of Fame (http://www.geocities.com/CapitolHill/2278/) a list of cases with descriptions dealing with tax-protestor arguments.

The Militia Watch Dog Website, "Trusts and the Untrustworthy, Pure Trusts and the Patriots for Profit" (http://www.militia-watchdog.org/puretrust.htm). Mark Pitcavage, Ph.D., describes the historical development of the "pure trust" and the involvement by militia groups.