Advanced Technical Training for Revenue Officers

Level 1

Lesson 2

Abusive Tax Schemes

Lesson 2

Abusive Tax Schemes

Overview

Introduction

This lesson provides an overview of abusive tax schemes, definition of scheme terms and possible Collection strategies.

Abusive tax schemes evolved from simple structuring of abusive domestic and foreign trust arrangements into sophisticated strategies that take advantage of the financial secrecy laws of foreign jurisdictions and the availability of credit and debit cards from offshore financial institutions.

Lesson Material

- Coursebook

References

- IRC sections 6901, 7210, 7602 through 7610
- IRM 5.11.1.2.5, *Approval of Alter-Ego and Nominee Notices of Levy*
- IRM 5.12.1.2.11, *Nominee and Alter-Ego Situations*
- IRM 5.17.2.5.7.2, *Nominee Liens*
- IRM 5.17.14, *Fraudulent Transfers and Transferee and Other Third Party Liability*
- IRM 5.19, *Liability Collection*
- IRM 25.3, *Litigation and Judgments*
- IRM 25.5, *Summons Handbook*
- http://abusiveshelter.web.irs.gov

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Lesson 5

Abusive Tax Schemes

Instructor Information

Introduction

SLIDE

Show slide #2-1 and introduce the lesson title and topic.

This lesson provides an overview of abusive tax schemes, scheme terminology and possible Collection strategies.

Lesson Data

The following table provides helpful information:

Estimated Time	• 2 hours
Participant Material	• Coursebook
Instructor Material	• Instructor Guide
References	• IRC sections 6901, 7210, 7602 through 7610 • IRM 5.11.1.2.5, *Approval of Alter-Ego and Nominee Notices of Levy* • IRM 5.12.1.2.11, *Nominee and Alter-Ego Situations* • IRM 5.17.2.5.7.2, *Nominee Liens* • IRM 5.17.14, *Fraudulent Transfers and Transferee and Other Third Party Liability* • IRM 5.19, *Liability Collection* • IRM 25.3, *Litigation and Judgments* • IRM 25.5, *Summons Handbook* • http://abusiveshelter.web.irs.gov
Supplies	• Whiteboard and markers • Flipchart and markers • Computer projection system and screen • Slides

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Objectives

At the end of this lesson, you will be able to:

- Define scheme terms.
- Describe abusive tax schemes.
- Describe collection tools used to take enforcement actions against tax schemes.

In This Lesson

This lesson contains the following topics:

Objectives

SLIDE

Show slides #2-2 and #2-3. Present the objectives.

At the end of this lesson, the participant will be able to:

- Define scheme terms.
- Describe abusive tax schemes.
- Describe collection tools used to take enforcement actions against tax schemes.

In This Lesson

This lesson contains the following topics:

Terminology

Abusive Tax Scheme

Generally, an abusive tax scheme has no business purpose other than reducing taxes. It is promoted with:

- the promise of tax benefits.
- predictable tax losses or tax consequences.
- no related economic loss experienced with respect to the taxpayer's income or assets.

Scheme Promoters

Scheme promoters are individuals who support or promote positions contrary to Federal tax laws along with tax preparers both paid and unpaid.

Scheme Participants

Scheme participants are individuals who

- participated in a scheme,
- purchased a product, service or have an interest in a promotion, or
- received any material aid, assistance or advice with respect to the promotion.

Terminology

Abusive Tax Scheme

SLIDE

Show slide #2-4 and review the common themes in scheme promotion.

Scheme Promoters

SLIDE

Show slide #2-5 and define scheme promoters.

Scheme Participants

SLIDE

Show slide #2-6 and define scheme participants.

Reasons for Schemes

Participating in Schemes

Most participants in abusive tax schemes do so for one or more of the following reasons:

- Stop filing tax returns
- Stop paying tax
- Minimize the amount of tax they are required to pay
- Hide income and assets from tax authorities
- Avoid payment or enforced collection by tax authorities

Investor Characteristics

The characteristics of investors in tax schemes include individuals and business entities with

- large constant streams of income,
- substantial gains from one-time events, or
- beliefs that the tax laws do not apply to them.

Popularity of Schemes

Abusive tax schemes have multiplied for various reasons. Some reasons are:

- Promoters now use websites to market their schemes.
- Taxpayers had large capital gains or other income subject to income tax.
- Internal Revenue Service compliance activity decreased.
- Promoters increased the marketing as ‘legally defensible’ ways to minimize tax burdens.
- Penalties for participating in abusive tax schemes were too small to have a deterrent effect.
- There was no efficient disclosure and reporting system for abusive tax schemes.

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Reasons for Schemes

Participating in Schemes

SLIDE

Show slide #2-7 and list common reasons for abusive tax schemes.

Investor Characteristics

SLIDE

Show slide #2-8 and review the characteristics of investors in tax schemes.

Popularity of Schemes

SLIDE

Show slide #2-9 and review the reasons abusive tax schemes increased over the years.

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Reasons for Schemes, Continued

Flow-Through Entities

Multiple flow-through entities are often used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of

- trusts,
- limited liability companies (LLCs),
- limited liability partnerships (LLPs),
- international business companies (IBCs),
- foreign financial accounts, and
- offshore credit and debit cards.

The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and assets.

Reasons for Schemes, Continued

Flow-Through Entities

SLIDE

Show slide #2-10 and discuss the use of multiple flow-through entities in abusive tax schemes.

Types of Schemes

Common Types

There are many different types of abusive tax schemes. Some of the most common types are:

- Charitable trusts
- Corporate sole
- Questionable W-4
- Section 861
- Trust misuse
- Frivolous arguments
- Form 1099-OID/Form 56 filings scheme

Definitions of these schemes are on the abusive shelter website, http://abusiveshelter/web.irs.gov

Sham Charitable Trusts

In sham charitable trust schemes, taxpayers transfer assets or income to a trust claiming to be a charitable organization. The trust or organization pays for personal, education or recreation expenses of the taxpayer or family members. 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. Charitable deductions are not allowed when the donor receives personal benefit from the alleged gift.

Example

Daryl and Kathy Mercer transfer their home and other assets to the Mercer Charitable Trust. The Mercers continue to live in the home. The trust pays the taxes on the home. It also pays for vacations for the Mercers and jewelry for Mrs. Mercer. These are reported as charitable deductions on the Form 1041, *U.S. Income Tax Return for Estates and Trusts*, for Mercer Charitable Trust.

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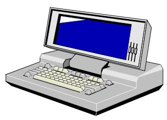
Types of Schemes

Common Types

Show slides #2-11 and #2-12. Review the list of common tax schemes.



Direct the participants to access the website at http://abusiveshelter.web.irs.gov. Link to “AT Issues & Initiatives” for a complete list.

Sham Charitable Trusts

Explain that in a sham charitable trust scheme, the trust is not designated as charitable by the IRS.

Review the example. Stress a charity must have an exemption letter from the IRS to be considered a charitable organization.

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Corporate Sole

Corporate sole promoters exploit state and Federal laws to establish sham one-person, nonprofit religious corporations. Participants in the scheme apply for incorporation under the pretext of being a "bishop" or "overseer" of a religious organization or society. Participants are told they qualify for exemption from Federal income taxes as an organization described in IRC section 501(c)(3).

Abusive Trusts

Common types of abusive trust arrangements include:

- Business trust
- Equipment or service trust
- Family residence trust
- Charitable trust
- Final trust

Abusive Trust Benefits

Promised benefits of abusive trust schemes include:

- Reduction or elimination of income tax
- Deductions for personal expenses
- Having personal expenses paid by trust
- Depreciation deductions for an owner's personal residence and furnishings
- Stepped-up basis for property transferred
- Reduction or elimination of
  - self-employment taxes
  - gift and estate taxes

For years promoters urged taxpayers to transfer assets into trusts. However, some trusts do not deliver the promised tax benefits, and the IRS is actively examining these arrangements. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

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Corporation Sole

Emphasize there are legitimate corporate soles. Point out they are rare and are always associated with a valid religious organization under IRC section 501(c)(3).

Abusive Trusts

SLIDE

Show slide #2-13 and list some common types of abusive trust arrangements.

Abusive Trust Benefits

SLIDE

Show slides #2-14 and #2-15. Discuss the promised benefits of abusive trust schemes.

Emphasize a trust can be legally used for estate planning or to provide income for minors or disabled children.

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Questionable W-4's

In questionable W-4 schemes, promoters advise participants on strategies for opting out of Form W-4 filing requirements. The purpose of this scheme is to minimize or eliminate Federal tax withholding from wages. Many times participants are advised to write "exempt" or claim maximum exemptions on their Form W-4.

> **Example**
>
> Larry Smith attends a seminar where the promoter advises that only income from foreign countries is taxable. The promoter also advises wages from sources within the United States are not considered income for tax purposes. When Mr. Smith returns to work, he completes a Form W-4 claiming exempt.
>
> The promoter may also sell a package to assist Mr. Smith in filing a claim for withholding already paid to the IRS.

Section 861

Some taxpayers, promoters and tax preparers claim that under IRC sections 861 through 865, individual U.S.-based income is not subject to Federal income tax. These Code sections define whether income is from sources within the United States or outside the United States. Based on this argument, some employers

- refuse to withhold and pay Form 941 taxes
- request refunds of prior year's employment tax payments
- encourage employees not to file their income tax returns

The argument has no merit and is frivolous.

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Questionable W-4's

Point out a Form W-4 claiming exempt or a maximum number of exemptions are seldom legitimate when involving taxpayers identified as participants in abusive tax schemes.

Section 861

Point out this scheme involves employers refusing to withhold and pay Form 941 taxes and encouraging their employees to not file income tax returns.

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Frivolous Arguments

Promoters make frivolous claims such as

- the Sixteenth Amendment concerning Congressional power to levy and collect income taxes was never ratified,
- wages are not income,
- filing a return and paying taxes are merely voluntary, or
- filing Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy.

These arguments are consistently dismissed by the court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law.

Form 1099-OID/ Form 56/Filing

This scheme involves the filing of frivolous Form 1099-OID, *Original Issue Discount*, or other bogus financing instruments, such as bonded promissory notes. The scheme evolved from the old argument that the Government has created a "straw man," or artificial representative, for each United States citizen and there is some type of account at the Treasury Department for this straw man. Individuals are attempting to use this "account" to pay debts and claim false withholding credits. By filing income tax returns with false withholding credits, taxpayers may receive large refunds to which they are not legally entitled.

Frivolous Arguments

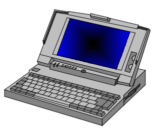
Review some of the frivolous arguments promoters use to justify nonpayment of taxes.

Ask the participants:

Has anyone encountered frivolous arguments in your casework?

Possible Responses:

Responses will vary. Allow time for the participants to discuss their experiences.



Direct the participants to access the website at http://www.irs.gov/pub/irs-utl/friv_tax.pdf for a list of frivolous arguments.

Form 1099-OID/ Form 56/Filing

Stress the Form 1099-OID/Form 56, *Notice Concerning Fiduciary Relationship*, filing scheme has been growing throughout the country.

Explain Form 56 is being used by participants in this scheme to designate the Secretary of the Treasury or other IRS official as their fiduciary. Unfortunately, this can result in correspondence being mailed to the IRS official, or in some instances, the filing of a Notice of Federal Tax Lien or issuance of a levy against the IRS official.

Explain that a taxpayer using this scheme files an income tax return with Form 1099-OID, *Original Issue Discount*, attached. The Form 1099-OID falsely states a withholding amount that equals the amount of income reported on the return. This results in a large refund to which the taxpayer is not legally entitled.

Accessing Offshore Funds

Accessing Funds

Although unreported funds in an offshore bank account are earning interest or used for investment purposes, the taxpayer usually wants access to the money. The taxpayer can use several methods to access the funds. The most common methods are:

- Fraudulent loans
- Credit and debit cards

Fraudulent Loans

In some instances there will be a shell company established in the same locality as an offshore bank account. This may be due to local laws requiring a "business reason" to have a bank account. These companies are called international business corporations (IBC).

To access funds through a fraudulent loan, the taxpayer's IBC makes a loan to the taxpayer. The funds are wire transferred to the taxpayer's U.S. bank account. Since these wired funds are allegedly loans, they are not taxable.

Many times ownership of the IBC is through bearer shares, so it is very difficult to prove the loan is a complete sham. Adding to the difficulty is that the promoters provide their clients with loan documents to make the transaction appear legitimate.

When examining bank statements, look for wire transfers or questionable deposits. These could reflect fraudulent loans. Bank statements may reveal large and repetitive deposits indicating that those are not loans, but merely disbursements to the taxpayer. A review of wire transfer deposits should reveal the name and location of the offshore bank.

Credit and Debit Cards

One of the most popular methods in recent years to access offshore funds is the use of a bankcard. Once the foreign bank account is established, the taxpayer receives a bankcard. The taxpayer can use the bankcard to withdraw cash and pay for everyday expenses. Primary card processors are Visa and MasterCard. Internet banking is also a growing trend.

Credit bureau reports may contain the card vendor location. You may be able to issue a levy to attach the account if there is a correspondent branch in the U.S.

Accessing Offshore Funds

Accessing Funds

SLIDE

Show slide #2-16 and discuss the two common ways taxpayers access funds from offshore accounts.

Fraudulent Loans

Explain why fraudulent loan schemes are difficult to trace. Emphasize bank statements need to be reviewed.

Credit and Debit Cards

Point out credit and debit cards are a quick and easy way to access offshore funds. Stress credit reports may show the credit card. However, bank records with wire transfers may be a better source.

Collection Actions

Collection Actions

Examination issues Letter 531, *Notice of Deficiency*, after determining income from schemes is in fact taxable to the individuals. However, these income tax deficiencies are assessed against the individual, who supposedly has no income and no assets.

You can protect the Government's interest in trust assets by:

- Filing nominee liens and serving nominee levies
- Initiating suits to set aside fraudulent conveyances
- Enforcing the nominee lien
- Using other collection tools, such as administrative transferee assessments

Nominee Lien

A nominee situation normally involves a fraudulent conveyance or transfer of a taxpayer's property to avoid legal obligations. To establish a nominee lien situation, it must be shown that while a third party may have legal title to the property, it is the taxpayer who owns and enjoys the full use and benefits of the property.

Nominee Levy

Approval of a nominee levy may be requested after or simultaneously with Area Counsel's review and approval of the nominee lien. This levy is used to liquidate assets or conduct a seizure and sale. A request for approval of a nominee levy is usually prepared with the nominee lien request.

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Collection Actions

Collection Actions

Show slide #2-17 and list the possible collection actions that can be used to resolve a scheme case.

Nominee Lien

Emphasize that in nominee situations, the taxpayer still controls the property.

Ask the participants:

How can you show the taxpayer retains use or control of the property in a nominee situation?

Possible Responses:

- *Maintains the property*
- *Uses the property as collateral for loans*
- *Pays taxes on the property*
- *Lives in property*

Nominee Levy

Remind the participants a request for approval of a nominee levy is usually prepared with the nominee lien request.

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Suit to Set Aside Fraudulent Conveyance

A fraudulent conveyance or transfer of property consists of one or more acts of intentional wrongdoing by the taxpayer with the specific purpose of evading tax.

The two principal types of fraud necessary to set aside a conveyance are

- constructive fraud, and
- actual fraud.

Constructive Fraud

Constructive fraud exists when property is transferred for inadequate consideration and the transferor is

- insolvent when the transfer occurs, or
- made insolvent by the transfer.

Actual Fraud

Actual fraud occurs when property is transferred with the actual intent to

- hinder,
- delay, or
- defraud

a creditor in collection of a debt owed to them.

Collection Action

In a suit to set aside a fraudulent conveyance, the United States collects the transferor’s tax from the transferred property.

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Suit to Set Aside Fraudulent Conveyance

Explain that although litigation takes more time, is it often the best case strategy.

Ask the participants:

What is the primary factor you consider when determining if a suit to set aside a fraudulent conveyance is appropriate?

Possible Response:

The strength of the evidence of fraud.

SLIDE

Show slide #2-18 and list the two types of fraud usually associated with a fraudulent conveyance.

Constructive Fraud

SLIDE

Show slide #2-19 and explain when constructive fraud exists.

Actual Fraud

SLIDE

Show slide #2-20 and explain when actual fraud occurs.

Collection Action

Point out any tax due on the transfer of property is collected from the transferred property in fraudulent conveyance situations.

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Enforcement of the Federal Tax Lien

Generally, a suit to set aside a fraudulent conveyance is combined with a suit to enforce the Federal tax lien (FTL) once the transferor's ownership in the property has been reinstated.

Administrative Transferee Assessments

An administrative transferee assessment imposes a transferee liability on a third-party transferee of the taxpayer's property. The liability is then collected from the third party's property.

An administrative transferee usually involves income, gift and estate taxes. Other taxes can be pursued in certain cases where the liability of the transferee arises from the liquidation of a partnership or corporation, or a corporate reorganization under IRC section 368(g).

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Enforcement of the Federal Tax Lien

Explain a suit to set aside a fraudulent conveyance is generally combined with a suit to enforce the FTL.

Ask the participants:

When would you consider a suit to enforce the Federal tax lien?

Possible Responses:

- *Clouded title*
- *Conflicting property interest, such as third party in possession of property*
- *Property cannot be readily seized and sold*
- *Taxpayer has partial interest in property*

Administrative Transferee Assessments

Explain that in an administrative transferee assessment, a third party is assessed the tax.

Ask the participants:

What are some advantages of an administrative transferee?

Possible Responses:

- *Usually faster and less expensive than litigation*
- *Can collect from all assets of transferee, not just transferred property*

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Research for Suits

Before considering a suit recommendation, research the following sources of information:

- IRP
- Accurint
- Revenue agent report (RAR)
- Tax returns
- Bank statements
- Credit bureau report
- Currency and Banking Retrieval System Report (CBRS)
- UCC filings
- Secretary of State charters
- County real and personal property records

Research for Suits

Show slides #2-21 and #2-22. Review the sources to research for a suit and what can be found in each source.

Ask the participants:

What other sources have you used? Why was it helpful?

Possible Responses:

Responses will vary. Allow time for the participants to discuss their experiences.

Lesson 2

Abusive Tax Schemes

Objectives

- Define scheme terms.
- Describe abusive tax schemes.

Objectives

- Describe collection tools used to take enforcement actions against tax schemes.

Abusive Tax Scheme

- Promise tax benefits
- Predictable tax losses or consequences
- No economic loss

Scheme Promoters

Individuals supporting or promoting positions contrary to Federal tax laws

Scheme Participants

Individuals

- participated in a scheme
- purchased product, service or interest in promotion
- received material aid

Reason for Schemes

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- Stop filing returns
- Stop paying tax
- Minimize amount of tax paid
- Hide income and assets
- Avoid payment or collection

Investor Characteristics

Advanced Technical Training for Revenue Officers Level 1

SB/SE

Individual and business entities with

- Large income streams
- Substantial one-time gain
- Beliefs that tax laws do not apply to them

Scheme Popularity

- Websites to market schemes
- Large gains subject to income tax
- Compliance activity decreased
- Promoters increased marketing
- Penalties too small
- Inefficient reporting system

Flow-Through Entities

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- Trusts
- LLC
- LLP
- IBC
- Foreign accounts
- Offshore credit and debit cards

Common Schemes

- Charitable trusts
- Corporate sole
- Questionable W-4

Common Schemes

- Section 861
- Trust misuse
- Frivolous arguments
- Form 1099-OID/56 filings

Abusive Trusts

- Business
- Equipment or service
- Family residence
- Charitable
- Final

Promised Benefits

- Reduce or eliminate income tax
- Deductions for personal expenses
- Personal expenses paid

Promised Benefits

- Depreciation deductions
- Stepped-up basis
- Reduce or eliminate
  - self-employment taxes
  - gift and estate taxes

Accessing Offshore Funds

- Fraudulent loans
- Credit and debit cards

Collection Actions

- Nominee liens and levies
- Suits
- Enforcing the nominee lien
- Administrative transferee assessments

Types of Fraud

- Constructive
- Actual

Constructive Fraud

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SB/SE

- Transfer for inadequate consideration
- Transferor
  - Insolvent, or
  - made insolvent by transfer

Actual Fraud

Property transferred to

- hinder
- delay
- defraud

a creditor

Research Sources

- IRP
- Accurint
- RAR
- Tax returns
- Bank statements
- Credit bureau

Research Sources

Advanced Technical Training for Revenue Officers Level 1
SB/SE

- CBRS
- UCC
- State charters
- Property records