

Part III – Administrative, Procedural, and Miscellaneous

Sections —6065, 6702

Rev. Rul. 2006-19

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by filing a Form 1041, U.S. Income Tax Return for Estates and Trusts, listing income in the amount stated on their W-2, but claiming a deduction on the return for a “fiduciary fee” in the exact amount of that income. These taxpayers then request a refund of the full amount withheld with respect to that income.

This revenue ruling emphasizes that an individual cannot escape taxation by attributing income to a purported trust. The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions, based on arguments relating to trusts. The Service will take vigorous enforcement action against frivolous arguments relating to trusts. The Service processes frivolous returns and other similar documents submitted to the Service through the Service’s Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether taxpayers can eliminate their federal income tax liability by attributing income to a trust and claiming expense deductions related to that trust.

FACTS

Individual taxpayer A files a Form 1041 trust income tax return for the 2005 taxable year. On it, taxpayer A lists the full amount of income reported on his W-2, but claims a deduction for a “fiduciary fee” in the same amount. Taxpayer A requests a refund of the full amount of withholding.

LAW AND ANALYSIS

Many frivolous trust schemes involve the purported transfer of income and expenses to a trust, on the theory that the income and expenses then become that of the trust. Such schemes are ignored for federal tax purposes because taxpayers cannot assign personal income to a trust in order to avoid tax, because such trusts are shams for federal tax purposes, and because the grantor trust rules of the Internal Revenue Code (sections 671 through 679) tax the income to the individual grantor and not to the trust. See, e.g., United States v. Krall, 835 F.2d 711, 714 (8th Cir. 1987); United States v. Buttorff, 761 F.2d 1056, 1060-61 (5th Cir. 1985).

Income is ordinarily taxed to the person who earned it, and tax liability may not be shifted by assigning the income to another person. Commissioner v. Culbertson,

337 U.S. 733, 739-740 (1949); Helvering v. Eubank, 311 U.S. 122 (1940); Lucas v. Earl, 281 U.S. 111 (1930). The taxpayer is taxable on assigned income even if the income is paid directly to a trust. Wheeler v. United States, 768 F.2d 1333 (Fed. Cir. 1985); Saunders v. Commissioner, 720 F.2d 871 (5th Cir. 1983); Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd, 570 F.2d 210 (7th Cir. 1978). Thus, assignments of personal income and expenses to a trust are not valid for federal income tax purposes.

Even if the taxpayer created a valid trust under state law, the trust would be ignored for federal tax purposes because it is a sham. When the form of the transaction has not, in fact, altered economic relationships, income is taxed according to the substance of the transaction. Markosian v. Commissioner, 73 T.C. 1235 (1980). This rule applies regardless of whether the entity has a separate existence recognized under state law (see Furman v. Commissioner, 45 T.C. 360 (1966), affd. per curiam 381 F.2d 22 (5th Cir. 1967)), and regardless of the form of the entity, such as a trust or common law business trust. See Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984).

In addition, the grantor trust provisions of the Internal Revenue Code require the attribution of the income and expenses of the trust to the individual. These provisions provide that all items of income, deduction, and credit of the trust, shall be included in computing the taxable income and credits of the grantors and other persons who have substantial powers of ownership or control over the trust. The power to control the beneficial enjoyment of the corpus or the income of the trust, the power to borrow from or deal with the trust without adequate and full consideration or security, the power to revoke the trust or to have the corpus or income revert to the grantor, the power to use

the corpus or income of the trust for the benefit of the grantor, or similar powers, result in the trust being ignored for federal tax purposes and all income and allowable expenses being attributed to the individual grantor. See sections 671-679; Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980); Rev. Rul. 75-257, 1975-2 C.B. 251.

Finally, because no trust is deemed to exist for federal tax purposes, there is no fiduciary relationship upon which trustees' fees could be predicated and there is no ordinary and necessary business expense which could validly be claimed for such amounts. Thus, the claimed expense for trustees' fees would be disallowed.

HOLDING

Individual taxpayers must file Form 1040 to report earned income and may not file Form 1041 reporting income through a trust in order to avoid federal income tax liability.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who attempt to avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay tax based on a frivolous argument face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should

have paid; (3) a \$500 penalty imposed under section 6702 when the taxpayer files a document that purports to be a return but that contains a frivolous position or suggests a desire by the taxpayer to delay or impede the administration of federal income tax laws; (4) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; and (5) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on these frivolous positions also may face criminal prosecution under the following provisions: (1) section 7201, for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years; (2) section 7203, for willful failure to file a return, the penalty for which is a significant fine and imprisonment for up to 1 year; and (3) section 7206, for making false statements on a return, statement, or other document, the penalty for which is a significant fine and imprisonment for up to 3 years.

Persons, including return preparers, who promote these frivolous positions and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a \$250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who knew or should have known that the taxpayer's position was frivolous (or \$1,000 for each return or claim for refund if the return preparer's actions were willful, intentional or reckless); (2) a penalty of up to \$1,000 under section 6700 for each activity promoting abusive tax shelters; (3) a \$1,000 penalty under section 6701 for aiding and abetting the

understatement of tax; and (4) criminal prosecution under section 7206, resulting in a significant fine and imprisonment for up to 3 years, for assisting or advising about the preparation of a false return or other document under the internal revenue laws.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office on (202) 622-7950 (not a toll-free call).