

Abusive Tax Shelters

The Internal Revenue Service today said using abusive tax shelters and structures to avoid paying taxes continues to be a problem and remains on its annual list of tax scams known as the “Dirty Dozen” for the 2015 filing season.

"The IRS is committed to stopping complex tax avoidance schemes and the people who create and sell them," said IRS Commissioner John Koskinen. "The vast majority of taxpayers pay their fair share, and we are warning everyone to watch out for people peddling tax shelters that sound too good to be true."

Compiled annually, the “Dirty Dozen” lists a variety of common scams that taxpayers may encounter anytime but many of these schemes peak during filing season as people prepare their returns or hire people to help with their taxes.

Illegal scams can lead to significant penalties and interest and possible criminal prosecution. IRS Criminal Investigation works closely with the Department of Justice (DOJ) to shutdown scams and prosecute the criminals behind them.

Abusive Tax Structures

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

IRS Criminal Investigation (CI) has developed a nationally coordinated program to combat these abusive tax schemes. CI's primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme, such as accountants or lawyers. Just as important is the investigation of investors who knowingly participate in abusive tax schemes.

What is an abusive scheme? The Abusive Tax Schemes program encompasses violations of the Internal Revenue Code (IRC) and related statutes where multiple flow-through entities are used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

Whether something is “too good to be true” is important to consider before buying into any arrangements that promise to “eliminate” or “substantially reduce” your tax liability. If an arrangement uses unnecessary steps or a form that does not match its substance, then that arrangement is an abusive scheme. Another thing to remember is that the promoters of abusive tax schemes often employ financial instruments in their schemes; however, the instruments are used for improper purposes including the facilitation of tax evasion.

The IRS encourages taxpayers to report unlawful tax evasion. [Where Do You Report Suspected Tax Fraud Activity?](#)

Misuse of Trusts

Trusts also commonly show up in abusive tax structures. They are highlighted here because unscrupulous promoters continue to urge taxpayers to transfer large amounts of assets into trusts. These assets include not only cash and investments, but also successful on-going businesses. There are legitimate uses of trusts in tax and estate planning, but the IRS commonly sees highly questionable transactions. These transactions promise reduced taxable income, inflated deductions for personal expenses, reduced (even to zero) self-employment taxes, and reduced estate or gift transfer taxes.

These transactions commonly arise when taxpayers are transferring wealth from one generation to another. Questionable trusts rarely deliver the tax benefits promised and are used primarily as a means of avoiding income tax liability and hiding assets from creditors, including the IRS.

IRS personnel continue to see an increase in the improper use of private annuity trusts and foreign trusts to shift income and deduct personal expenses, as well as to avoid estate transfer taxes. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering a trust arrangement.

Captive Insurance

Another abuse involving a legitimate tax structure involves certain small or “micro” captive insurance companies. Tax law allows businesses to create “captive” insurance companies to enable those businesses to protect against certain risks. The insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members.

The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to \$1.2 million per year in net written premiums.

In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and “selling” to the entities often times poorly drafted “insurance” binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant “premiums,” while maintaining their economical commercial coverage with traditional insurers.

Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to \$1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities’ captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade.