

11-06-96

From: Trust Software & Consulting  
Kent H. Sherrod

Dear Trustee,

Recently I received these letters from a California Trustee for which the first letter was dated June 13, 1996 from the IRS. It was a Preliminary Notice stating that they have information that you may be involved in a trust arrangement used for tax avoidnace purposes. It is fairly specific with court cases.

The Trustee responded on July 26, 1996 to this letter stating that he is involved in a Irrevocable Complex Trust and not in any way a grantor or grantor type trust, and that the stated court cases do not apply.

Again the IRS responded on Sep 4 1996 stating that the letter was not intended to be accusatory, but to inform you of the IRS's position. It states that if you are not in these types of trust or have sold any to others then you may disregard our letter and then they apologized for any misunderstandings.

Know your subject. Stand up for your rights or lose them. Do not let anyone intimidate you.

This is a great and valuable piece to show to all your clients both past and potential new trustees.

Hope this helps you.

Yours in Trust,

A handwritten signature in cursive script, appearing to read "Kent H. Sherrod".

Kent H. Sherrod - Trustee

Internal Revenue Service

Department of the Treasury

District  
Director

P.O. Box 2900, Sacramento, CA 95812

Attn: SA3108 Trust Project

Person to Contact:

Telephone Number: (916) 974-5339

Refer Reply to: Preliminary Notice

Date: June 13, 1996

Dear Taxpayer:

The Internal Revenue Service has information indicating that you may be involved in a trust arrangement used for tax avoidance purposes. The purpose of this letter is to bring to your attention the Internal Revenue Service's position regarding abusive trust arrangements. It is the government's position that trusts will be disregarded for tax purposes and the income will be taxed to the person who controls the trust, if the trust lacks economic substance or has been structured for tax avoidance purposes.

Many of the promoters or sellers of these trusts, suggest that through the formation of "non-grantor" or similar trusts, you can protect assets from liability; however, the structuring of their whole scheme is clearly for tax avoidance. Some of the tax motivated issues are 1) the tax free exchange of assets for Units of Beneficial Interests (UBI's), 2) claiming a new basis based on the fair market value of the assets, 3) reduction or elimination of income by deducting inflated expenses between trusts, 4) deduction of children's school tuition as "scholarships", and/or 5) the elimination of all estate taxes because the assets are no longer held by the decedent.

In addition, promoters advocate the transfer of the personal residence to a trust to create the illusion that the property has been converted to rental property. Then they claim you can deduct the expenses for the upkeep of the property, including utilities, maintenance, and other miscellaneous costs which are usually non-deductible expenses. Each of the tax saving devices highlighted above have major flaws, and have absolutely no merit whatsoever. If the trusts are used to avoid taxes, it will be considered relevant to the determination of whether they were created to avoid taxes.

The courts have consistently supported this position as demonstrated in Schulz v Commissioner, 50 AFTR2d 82-5562, Holman v U.S. 5 AFTR2d 84-862, Schmidt v U.S. 68-AFTR2d 91-5005, Zmuda v Commissioner, 53-AFTR2d 84-1269, Wesenberg v Commissioner, 69 TC 1005, Keefover v Commissioner, TC Memo 1989-151, and Smith v Commissioner, TC Memo 1986-487. These are just a few of the many court cases that illustrate schemes where the trusts lacked economic substance and the grantors retained control and use of the trust assets. The courts have consistently ruled the trusts will be ignored for federal tax purposes.

In the Schulz case, the court stated "...it is fundamental to our income tax regime that personal consumption expenditures--food, clothing, travel, education, entertainment--do not generate income tax deductions unless they are inextricably linked to the production of income. The trust devices here are a transparent attempt to transfer all of the family activities into trust activities and all the families' expenses into expenses of trust administration."


In addition to disregarding the trust entity, the government will pursue civil and/or criminal penalties against taxpayers and promoters who attempt to use trusts to evade their income tax liability. Again, this is supported in the court cases highlighted above.

If you are involved with a trust arrangement that has any of the abusive elements described above, it is advisable to seek professional advice from persons not affiliated with the promotion before any further filing of tax returns. The operations of the trusts and the validity of statements made regarding the tax benefits should be carefully reviewed to ensure the trust is proper and not an indefensible tax avoidance scheme.

Persons wishing to correct their returns when they have determined that the trusts are not valid, are encouraged to file amended returns. The corrected returns should reflect the reporting of income and expenses as if the trusts never existed. This should result in income and allowable deductions being reported on the individual return and the trust returns reflecting no income, expenses, or tax.

If you have any questions, please contact the person whose name and telephone number appears above.

Sincerely,

 District Director

Manager

INTERNAL REVENUE SERVICE  
DEPARTMENT OF THE TREASURY  
55 South Market Street  
San Jose, California 95113  
Mail Stop HQ-4125

EG-1210/TN-4210

July 26, 1996

Dear Mr.

This is my response, to your letter dated June 13, 1996. In your letter you indicated that I might be involved in a trust arrangement used for tax avoidance. I appreciate your concern for me, but I assure you that the trust of which I am manager of is not set up for tax avoidance. The valid purpose for the trust, is stated in the Trust Indenture. The Trust is in fact an Irrevocable Complex Trust and not in any way a grantor or grantor type trust, thus the court cases to which you refer are not applicable.

You are provided ten (10) days to respond (in writing), if you disagree, or I will consider the matter closed.

Further, I am requesting that a copy of this letter be permanently placed in my file.

Sincerely,

Manager

Mike Jenkins  
INTERNAL REVENUE SERVICE  
DEPARTMENT OF THE TREASURY  
55 South Market Street  
San Jose, California 95113  
Mail Stop HQ-4125

Re: EG-1210/IN-4210

Dear Mike Jenkins:

This is my timely response to the letter dated April 18, 1996, that you hand delivered to me on June 13, 1996. In your letter, you indicated that I might be involved in a Trust arrangement used for tax avoidance.

I appreciate your concern for my well being, but I assure you that the Trusts that I am a Trustee of, are not set up for tax avoidance. The purpose for creating the Trust, is stated in the "Trust Indenture" (agreement), in the "Declaration of Purpose". Thus, the court cases that your letter referred to do not apply to the Trusts we discussed. The Trusts are in fact Irrevocable Complex Trusts and are required to file a 1041.

Again, the purpose of this letter is to notify you that the Trusts that I am a Trustee of, are in fact, Irrevocable Complex Trusts. You are provided ten (10) days to respond (in writing), if you disagree, or I will consider the matter closed.

Further, I am requesting that a copy of this letter be permanently placed in my file.

Sincerely,

District  
Director

SEP 4 1996

Dear Mr.

We are responding to your letter of July 26, 1996, wherein you questioned why you were sent a Preliminary Notice regarding the use of non-grantor or irrevocable trusts as a means of reducing your income tax liability.

It is the policy and practice, as well as the obligation, of the Internal Revenue Service (IRS) to provide accurate information to taxpayers, and to inform and protect the public against further acts of abusive tax practices. The IRS has found that many individuals frequently claimed tax benefits based upon false or misleading information from promoters, only to have the IRS later disallow the tax benefits they claimed.

It is unfortunate if you perceive the language of our letter to be offensive or misleading in any manner. We realize that the terminology used in the codes of law are sometimes difficult to understand. Interpretations by even the most reputable accountants can sometimes result in a complex and technical debate. Please be assured that we intend for all taxpayers and representatives to be treated fairly and equitably, and in accordance with our standard rules and regulations.

The primary mission of the IRS is to foster voluntary compliance with the tax laws and regulations. Integrity is vital to the proper administration of these laws. The IRS will continue to protect the rights of the taxpayers and to act in a manner which ensures the trust and confidence of the public.

The letter we sent to you was not intended to be accusatory, but to inform you of the IRS' position with regards to Pure Equity Trusts, also referred to as Asset Preservation Trusts (APT), and the conflict which exists between them and the IRS and the tax benefits associated with the non-grantor trusts they are advocating. We wish to prevent or minimize the penalties and interest which may result from an individuals' involvement in

these trusts by encouraging them to obtain a "second opinion" or review the court cases that we've cited. As the letter states, the courts have consistently rejected the use of this type of trust arrangement as a valid method of tax planning.

If, however, you have not created any of these types of trusts for yourself and have not sold any to others, you may disregard our letter, and in all likelihood, you will not hear from us again regarding this matter.

We apologize for any misunderstandings. If you have any questions concerning this matter, you may contact Chuck Slater, Group Manager of Examination Group 1201, at (916) 974-5056.

Sincerely,

Assistant District Director