

IR-2004-26, March 1, 2004

IRS Updates the "Dirty Dozen" for 2004:
Agency Warns of New Scams

WASHINGTON - In an update of an annual consumer alert, the Internal Revenue Service urged taxpayers to avoid falling victim to one of the "Dirty Dozen" tax scams and a variety of other schemes. In the new 2004 ranking, several new scams have reached the top of the consumer watch list, including abusive trusts and the "claim of right" doctrine.

In addition, the IRS has taken a new step this year and issued 10 new pieces of legal guidance involving scams in the "Dirty Dozen" and other tax schemes. The new guidance debunks the schemes and provides new legal details to help tax practitioners and taxpayers.

"At the IRS, we're augmenting our enforcement resources to attack schemes and scams. While we're actively targeting promoters, taxpayers themselves should be wary of anyone who promises to eliminate their taxes," said IRS Commissioner Mark W. Everson. "Don't be fooled by these outrageous claims. There is no secret way to escape paying taxes."

The IRS and other federal agencies are aggressively pursuing and successfully prosecuting promoters of these schemes and many of their clients for fraud and tax evasion. Participation in these schemes can result in imprisonment, fines and repayment of taxes owed with interest and penalties. Even innocent taxpayers involved in these schemes can face a staggering amount of back interest and penalties.

Taxpayers who suspect tax fraud can report it to the IRS at 1-800-829-0433. More information on tax scams and schemes is available by visiting "The Newsroom" section of IRS.gov.

The IRS urges people to avoid these common schemes:

1. **MISUSE OF TRUSTS.** Promoters of abusive tax transactions are increasingly urging taxpayers to transfer assets into trusts. The promoters promise a variety of benefits, such as the reduction of income subject to tax, deductions for personal expenses paid by the trust and reduction of gift or estate taxes. Taxpayers should be aware that abusive trust arrangements will not produce the tax benefits advertised by their promoters and that the IRS is actively examining these types of trust arrangements. More than a dozen injunctions have been obtained against promoters, and numerous promoters and their clients have been criminally prosecuted. Before entering any trust arrangements, taxpayers should seek the advice of a trusted tax professional.
2. **"CLAIM OF RIGHT" DOCTRINE.** In this emerging scheme, people file returns and attempt to take a deduction equal to the entire amount of their wages. The promoters advise them to label the deduction as "a necessary expense for the production of income" or "compensation for personal services actually rendered". The deduction is based on a complete misinterpretation of the Internal Revenue Code and has no basis in law.
3. **CORPORATION SOLE.** Participants in this scam apply for incorporation under the pretext of being a "bishop" or "overseer" of a one-person, phony religious organization or society. The idea is that the arrangement entitles the individual to exemption from federal income taxes as a nonprofit, religious organization as described in tax laws. When used as intended, Corporation Sole statutes enable religious leaders - typically bishops or parsons - to become incorporated as individuals as a way of separating themselves legally from the control and ownership of church assets. But the rules have been twisted at seminars where promoters charge fees of up to \$1,000 or more per person. Would-be participants are mistakenly told that Corporation Sole laws provide a "legal" way to escape paying federal income taxes, child support and other personal debts.

4. OFFSHORE TRANSACTIONS. Some people use offshore transactions to avoid paying United States taxes. Use of an offshore bank account, brokerage account, credit card, wire transfer, trust, offshore employee leasing or other arrangement to hide or underreport income or to claim false deductions on a federal tax return is illegal. A taxpayer involved in these schemes could be subject to payment of taxes, interest, penalties and potential criminal prosecution. This was the top scam in the 2003 "Dirty Dozen." A special program last year has yielded more than \$170 million in taxes, interest and penalties, and the IRS and the states continue to aggressively pursue taxpayers and promoters in this area.

5. EMPLOYMENT TAX EVASION. The IRS has seen a number of illegal schemes that instruct employers not to withhold federal income tax or other employment taxes from wages paid to their employees. These schemes are based on an incorrect interpretation of "Section 861" and other parts of the tax law and have been refuted in court. Recent court cases have resulted in criminal convictions of promoters. Employer participants could also be held responsible for back payments of employment taxes, plus penalties and interest. Employees who have no withholdings are still responsible for payment of their personal taxes.

6. RETURN PREPARER FRAUD. Unscrupulous return preparers can cause a lot of problems for taxpayers who use their services. Abusive return preparers derive financial gain by diverting a portion of the taxpayer's refund for their own benefit, charging inflated fees for the return preparation services, and increasing their clientele by advertising guaranteed larger refunds. Taxpayers should choose carefully when hiring a tax preparer - no matter who prepares the return, the taxpayer is ultimately responsible for all of the information on that return.

7. AMERICANS WITH DISABILITIES ACT. Another scheme seen for several years involves the purchase of equipment and services that the promoter alleges meets the strict criteria of the Disabled Access Credit, which was created with the passage of the "Americans with Disabilities Act". A minimal payment is made and a non-recourse note signed. The investor then provides insignificant services to complete the purchase agreement. This scheme is based on an incorrect interpretation of law and an over-inflated value of the services rendered.

8. AFRICAN-AMERICANS GET A SPECIAL TAX REFUND. Thousands of African Americans have been misled by people offering to file for tax credits or refunds related to reparations for slavery. There is no such provision in the tax law. Some unscrupulous promoters have encouraged clients to pay them to prepare a claim for this refund. But the claims are a waste of money. Promoters of reparations tax schemes have been convicted and imprisoned. And taxpayers could face a \$500 penalty for filing such claims if they do not withdraw the claim. Related scams include claiming an illegal tax credit by misusing Form 2439, "Notice to Shareholder of Undistributed Long-Term Capital Gains." The slavery reparations scam was at the top of the 2002 "Dirty Dozen," and, although claims have fallen considerably, the IRS continues to see activity in this area.

9. IMPROPER HOME-BASED BUSINESS. This scheme purports to offer tax "relief" but in reality is illegal tax avoidance. The promoters of this scheme claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. But the tax code firmly establishes that a clear business purpose and profit motive must exist in order to generate and claim allowable business expenses. This scam has been around for years, but the IRS continues to see activity in this area.

10. FRIVOLOUS ARGUMENTS. Frivolous arguments are false arguments that are unsupported by law. When a scheme promoter says "I don't pay taxes - why should you" or urges you to "untax yourself for \$49.95," beware. The ads may claim that the promoter knows the "secret" for never paying taxes again, but that's just plain wrong. The U.S. courts have continuously rejected this and other frivolous arguments. Unfortunately, people across the country have paid for the "secret" of not paying taxes or

have bought "untax packages." Then they find out that following the advice contained in them can result in civil and/or criminal penalties. Numerous sellers of the bogus schemes have been convicted on criminal tax charges. More than a dozen injunctions have been issued.

11. IDENTITY THEFT. Identity thieves use someone's personal data to steal his or her financial accounts, run up charges on the victim's existing credit cards, apply for new loans, credit cards, services or benefits in the victim's name and even file fraudulent tax returns. The IRS is aware of several identity theft scams involving taxes or the IRS.

In one example, fraudsters sent bank customers fictitious bank correspondence and IRS forms in an attempt to trick them into disclosing their personal and banking data. In another, abusive tax preparers have used clients' Social Security numbers and other information to file false tax returns without the clients' knowledge. For taxpayers, it pays to be choosy about disclosing personal and financial information. And the IRS encourages taxpayers to carefully select a reputable tax professional.

12. SHARE/BORROW EITC DEPENDENTS. Unscrupulous tax preparers "share" one client's qualifying children with another client in order to allow both clients to claim the Earned Income Tax Credit. For example, one client may have four children but only needs to list two to get the maximum EITC. The preparer will list two children on the first client's return and the other two on another client's tax return. The preparer and the client "selling" the dependents split a fee. The IRS prosecutes the preparers of such fraudulent claims, and participating taxpayers could be subject to civil penalties.

Beyond the "Dirty Dozen," the IRS sees many more tax schemes. In one, a telephone caller says you've won a prize, and all you have to do to get it is to pay the income tax due - to the caller. Other scams can play off recent news events, such as one last year targeting members of the military.

"Taxpayers should think carefully before paying for services or signing important documents," Everson said. "Don't be a victim of these scams or others that promise the moon. They carry a high price."