

TRUST WERE SHAMS, DOCTOR SOCKED WITH TAX AND PENALTIES

Steven E. Vlach and Nancy Vlach, TC Memo 2013-116

The Tax Court has held that trusts established for asset protection by a doctor were shams. As a result, the trusts were disregarded and the doctor and his professional corporations owed taxes and penalties.

Facts. Steven E. Vlach is a medical doctor who has practiced since '89. For the years at issue, he worked at a health clinic and an emergency room in facilities in Nebraska.

From '96 until sometime in 2002, Dr. Vlach operated through a professional corporation, Steven E. Vlach, P.C. (Vlach P.C.). After it was dissolved in 2002, he operated through another professional corporation, Sev 711 Consulting Inc. (Consulting Inc.).

In addition to providing traditional medicine services, Dr. Vlach practiced alternative medicine with an emphasis on chelation therapy. Dr. Vlach's medical malpractice insurance did not insure him for his chelation therapy practice but did cover his traditional services. However, in 2003, a new insurance carrier refused to insure him for any medical practice if he continued providing chelation therapy. As a result, Dr. Vlach discontinued his chelation therapy services in early 2003.

In '95, when he first became interested in alternative medicine, he was concerned with asset protection. He attended a seminar presented by Karl Dahlstrom on the use of trusts for asset protection. Dr. Vlach was unaware that before '95, Dahlstrom was involved in several lawsuits memorializing his abusive trust promotions and practices. Convinced that Dahlstrom offered valuable tax planning and asset protection advice, Dr. Vlach purchased trust documents from Dahlstrom to create the following trusts: San Dee Cristo Trust (San Dee Cristo), Mt. Sophris Trust (Mt. Sophris), and the Charitable Remainder Trust of Ixlandia (Ixlandia). Details on the transactions between the Vlachs and the trusts appear below in connection with the Court's analysis of whether they were shams.

IRS determined deficiencies for the Vlachs for tax years 2001 through 2004, Vlach P.C. for 2001 and 2002, and Consulting Inc. for 2003 and 2004.

IRS's view of the trusts. IRS determined that San Dee Cristo, Mt. Sophris, and Ixlandia were sham entities with no economic substance and, as a result, the Vlachs were required to include in their gross income receipts reported by the trusts. It also determined that to the extent the income reported by the trusts was business income, the Vlachs were entitled to a corresponding business expense deduction. IRS disallowed the professional corporations' business expense deductions for payments to the trusts because the trusts were shams and the deductions were not for ordinary, necessary, and reasonable business expenses. In addition, it sought to impose accuracy-related penalties.

Taxpayers' view of the trusts. The Vlachs asserted that San Dee Cristo and Mt. Sophris were legitimate trusts organized under State law to advance Dr. Vlach's alternative medicine practice and protect his personal assets from potential lawsuits related to his medical services. They further

claimed that because San Dee Cristo and Mt. Sophris had legitimate business purposes, the corporations properly deducted all payments made to these trusts as business expenses. They also maintained that Ixlandia was a proper charitable remainder trust.

Test for determining whether trusts were shams. In order to determine whether the trusts should be respected for Federal tax purposes, the Tax Court said it had to consider whether each trust had a valid purpose other than tax avoidance and whether certain other requirements were met. Dr. Vlach said the trusts were not created for tax-avoidance purposes but primarily for asset protection—to protect his personal and business assets from potential lawsuits related to his chelation therapy and alternative medicine services, which were not covered by insurance.

Tax avoidance shown. To pursue this goal, the Vlachs allegedly transferred Dr. Vlach's medical assets to San Dee Cristo and their real estate to Mt. Sophris. However, as the Court noted, they never established that San Dee Cristo and Mt. Sophris owned the medical equipment and real estate purportedly rented by them from the trusts during the years at issue. They also never explained how the trusts provided more protection against potential lawsuits than the corporate form in which Dr. Vlach operated his traditional medical practice.

The Court said that the Vlachs' claims that the trusts were not created for tax-avoidance purposes were also undermined by the fact that Dr. Vlach purchased the trust documents from Dahlstrom, an abusive trust promoter, and executed the form documents without variation and according to Dahlstrom's instructions. They did not seek independent legal or tax advice when creating the trusts and employed a tax return preparer referred by Dahlstrom to report their income and expenses.

During the years at issue, the trusts' income came primarily from three sources, namely, rent payments from the Vlachs, payments from the corporations, and income from vitamin and chelation therapy sales, the latter two of which were never taxed. With respect to the corporations' payments, the corporations transferred a portion of Dr. Vlach's taxable earnings from his traditional medical practice, which ranged from approximately 45% of his earnings in 2001 and 2002 to 20% in 2003 and 2004, to San Dee Cristo and Mt. Sophris, and then deducted the payments as business expenses. The corporations paid zero tax. San Dee Cristo and Mt. Sophris then reported a transfer of their net income, which included the corporations' payments, the Vlachs' rent payments, and the income from vitamin and chelation therapy sales, to Ixlandia. San Dee Cristo and Mt. Sophris deducted the payments to Ixlandia as nontaxable income distributions and, like the corporations, reported zero tax. The income distributions to Ixlandia, however, were made only to the extent necessary to pay the Vlachs a life annuity. Dr. Vlach's taxable earnings from his traditional medical practice and his sale of vitamin and chelation therapy services therefore became effectively nontaxable as a result of their erroneous reporting of the trust transfers.

Accordingly, the Tax Court concluded that San Dee Cristo, Mt. Sophris, and Ixlandia were a series of trusts formed according to Dahlstrom's instructions to disguise or eliminate taxable earnings from Dr. Vlach's business activities and, as such, were created primarily for tax-avoidance purposes.

Additional tests for disregarding trusts. The Court said that tax motivation alone, however, is not sufficient grounds for disregarding the trusts. Rather, it also had to consider the following four

factors: (1) the grantor-taxpayer's relationship to the trust property materially changed after the trust was created; (2) the trust had an independent trustee; (3) an economic interest in the trust passed to other beneficiaries; and (4) the taxpayer felt bound by restrictions imposed by the trust or the law of trusts.

The Vlachs conceded that the trusts did not have independent trustees during the years at issue. Looking at the remaining three factors, the Court found that the Vlachs, as grantors, conducted their business and personal lives in the same manner as before the trusts were created. Dr. Vlach continued his medical practice as a physician at the clinic and, until 2003, as an emergency room physician. He also continued his chelation therapy and alternative medicine practices at the clinic until he was forced to discontinue his services for insurance purposes. Dr. Vlach used the same office equipment that he had used before, and, except for their '96 move, the Vlachs lived in the same house with the same furnishings, clothing, and maintenance as before the trusts were created. Thus, the Vlachs' relationship to the trust property did not materially change after the trusts were created.

Also, except for Ixlandia's \$100 donation to Cedar Catholic High School in 2004, the Court couldn't identify any economic interest that passed to beneficiaries other than the Vlachs under the trust arrangement. Finally, the documents did not impose any meaningful restrictions on the Vlachs.

Accordingly, the Court concluded that San Dee Cristo, Mt. Sophris, and Ixlandia were shams, lacking economic substance, and were to be disregarded for Federal income tax purposes. It then went on to explain how the income and allowable expenses attributed to the trusts were to be allocated among the parties. For example, the Court disallowed deductions for various expenses paid by the professional corporations to the trusts and found that Dr. Vlach had to report income and self-employment income.

The Court also imposed most of the accuracy-related penalties sought by IRS. However, it found that Dr. Vlach created San Dee Cristo to operate his alternative medicine practice and intended to treat San Dee Cristo as a business trust. Accordingly, it found that the Vlachs were not liable for any accuracy-related penalties for the years at issue with respect to underpayments relating to San Dee Cristo's alternative medicine income and expenses that should have been reported on their individual returns.

References: For sham trusts, see FTC 2d/FIN ¶ C-5106 ; TaxDesk ¶ 651,033 .