Folks:

Take-Away: While it is easy to create a Trust that complies with the Michigan Trust Code, there is no assurance that the Trust will be respected for federal tax purposes.

Background: It is not difficult to create a Trust in Michigan. The specific requirements to create a Trust include: (i) the settlor must possess the mental capacity to create the Trust; (ii) the settlor indicates an intention to create the Trust; (iii) the Trust has a definite beneficiary, or it is either a charitable Trust or a Trust for a noncharitable purpose or the care of animals (limited to 21 years); (iv) the trustee has duties to perform; and (v) the same person is not the sole trustee and the sole beneficiary. [MCL 700.7402(1).] The term *definite beneficiary* means that the beneficiary can be ascertained now or in the future, limited however by the applicable rule against perpetuities. [MCL 700.7402(2).] To be effective, the Trust must be properly funded, such that title to the assets has been transferred from the settlor's name into the name of the Trust.

Taxation of Trusts: The income tax treatment of a Trust and its beneficiaries is governed by IRC 641 through IRC 688. [Subchapter J of the Tax Code.] Generally, Trusts are taxed as separate entities. [IRC 641(b).] A Trust may deduct amounts distributed or required to be distributed to a beneficiary. [IRC 651 and 661.] The beneficiary is taxed on amounts received from the Trust during a year to the extent of the Trust's distributable net income for that year. [IRC 652, 662.] Distributable net income normally means the Trust's taxable income. [IRC 643(a).] Thus, a Trust will have no tax liability and it will exist solely as a conduit if it distributes or is required to distribute all its income. A Trust is taxed at its own rates on accumulated income. [IRC 641(a).] Accordingly, when a Trust makes a distribution which includes some accumulated income, the

beneficiary is taxed at his/her own rates up to the Trust's distributable net income for the year of distribution, and the beneficiary is not taxed on amounts more than the Trust's distributable net income. [*Edward L. Stephenson Trust v. Commissioner, 81 Tax Court 283 (1983.)*

While the ability to create and fund a Trust is simple under the Michigan Trust Code, courts may still find a Trust arrangement to be invalid, or a sham when it is used to avoid paying income taxes. Such was the situation in a recent Tax Court case.

Aldridge v Commissioner, Tax Court Memo 2024-24 (February 21, 2024)

Facts: After spending $9,500 in tuition paid to the National Trust Services in 1992 at a two-day seminar, Jim and Shirley Aldridge followed the advice they received and they devised a family trust system that purportedly allowed them to control the amount of tax they would pay, by converting their living expenses to business expenses. Thus, Jim and Shirley subsequently transferred all their business and personal assets in a tiered trust arrangement, collectively called the Aldridge Family Trust System. Then a series of other Trusts were created by them, one to hold their home, another to hold their vehicles, another to hold their business (they sold American Silver Eagle coins). The vehicle Trust then leased the vehicles to Jim and Shirley, but no rent or other payment was ever made for the use of the vehicles.

Jim was so excited about this series of Trust that he became a trust 'counselor', and he gave seminar and presentations to prospective clients about the purported tax benefits of a family trust system, by assigning all future income to the Trusts.

Suffice it to say that Jim and Shirley reported no taxable income for the years 1999 through 2004 relying upon their Family Trust System. Using a bank deposit analysis, the IRS concluded that Jim and Shirley's reportable income for those years ranged from $281,000 to $3,105,883. Which is why, during this litigation for deficiency of payment of taxes, Jim was serving a

9-year prison sentence and Shirley was serving a 5.5-year prison sentence for filing false tax returns.

Dispute: The IRS claimed that the Trusts' income had to be attributed to Jim and Shirley because the Trusts were shams without economic substance, and therefore the Trusts should be disregarded. Jim and Shirely had the burden of proof to establish by a preponderance of evidence that they IRS's determination was in error.

Tax Court: The Tax Court Judge found the multiple Trusts that Jim and Shirely created to be shams, and thus disregarded.

> **Free to Minimize Taxes- To a Degree:** The Court noted that taxpayers are generally free to structure their affairs to minimize taxes, and that an arrangement will be treated as a Trust under the Tax Code where the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. [Regulation 301.7701-4.]
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> **Trust as a Bona Fide Transaction:** Consequently, an arrangement will be classified as a Trust by the IRS for income tax purposes if it is a bona fide transaction that involves a trustee, a beneficiary, and trust property. *Bibby v. Commissioner, 44 Tax Court 638 (1965.)*
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> **Economic Substance Four-Part 'Test:'** In contrast, a Trust will be disregarded for tax purposes if in substance it lacks any valid purpose but is simply a tax-avoidance device. Whether the Trust lacks economic substance is a question of fact. Courts apply a four-factor 'test' to the Trust to determine if the Trust lacks economic substance: (i) whether the taxpayer's relationship to the property transferred to the Trust materially changed after the Trust's creation; (ii) whether the Trust has an independent trustee; (iii) whether an economic interest passed to other trust beneficiaries; and (iv)

whether the taxpayer feels bound by the restrictions imposed by the Trust instrument or the law of trusts. If the Trust lacks economic substance apart from tax considerations, the Trust is a sham and is not recognized for federal tax purposes. *Wegbreit v Commissioner, Tax Court Memo 2019-82*.

Relationship with Assets Remained the Same: The Aldridges failed the four-part test. First, their relationship with their property did not differ in any material respect following the creation of their Trusts. They continued to reside in their home, drive the same vehicles, wear the same clothing, and they retained unfettered access to all their personal property. They paid all their personal expenses out of the bank accounts titled in the names of their four separate Trusts. Nor did their business activities change when their business Trust was created: it operated in the same manner, followed the same business strategy, retained the same staff, and operated with the same bank account.

No Independent Trustees: What was important to the Tax Court was that none of the four Trusts had an independent trustee. The Aldridges served as co-trustees of the four Trusts, the Trust were operated in concert with one another, under the same administrative and management entity and with funds routinely transferred from one entity to another. *"There was no independent party who exercised any meaningful role in the operation of any of the Trusts. Rather, petitioners controlled all aspects of the Trusts during the years at issue."*

No Economic Interest Passed to Beneficiaries: Apparently the sole beneficiary of the Aldridge Family Trust was their minor child. The beneficiaries of the other Trusts were the Aldridge Family Trust. The minor child never filed a tax return, and the Family Trust reported no income being paid to the child. *"Rather, the Trusts were operated for the economic benefit of petitioners. Petitioners used the Trusts' funds to pay the mortgage on their home, purchase*

motorcycles and other vehicles, and pay their personal expenses, including food, clothing, and vacations."

Did Not Adhere to Restrictions: Nor did Jim and Shirley act as though they were bound by the restrictions imposed by the Trust agreements or the law of trusts. *"Although petitioners purposed to observe certain trust formalities, such as by maintaining separate bank accounts, maintaining minutes of trust decisions, and insisting on signing trust-related documents with "T" next to their names, they disregarded their obligations as trustees, in ore substantive ways- they did not take efforts to make the trust property productive… [while] the [Trust] agreements do not specify any rent payments, there is no evidence that any rent was ever paid."*

Conclusion: While a Trust may be valid under Michigan law, it may still be disregarded for federal tax purposes.

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