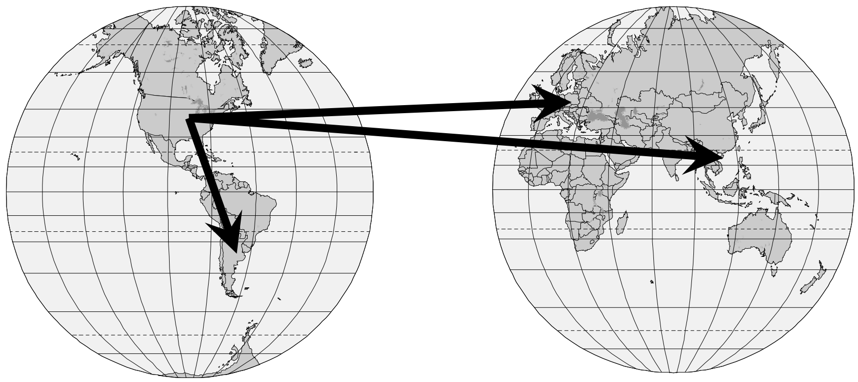
Merric Descent to the Dismal, Decay of Taxpayer Decadence

U.S. Citizen is Taxed on World Wide Income



For so long as a person is a U.S. Citizen or a resident alien, he or she is taxed on his or her world wide income.

1. It does not matter whether a U.S. person opens a Swiss bank account, unless he wishes to commit tax evasion, the interest income is still reported on schedule B of his form 1040.

2. It also does not matter if he buys and sells stocks through a foreign corporation in Hong Kong, such foreign corporation will be classified as a "controlled foreign corporation," and the U.S. person will still be subject to U.S. tax currently.

3. Finally, it does not matter if the U.S. person moves to Argentina, if she retains her citizenship, she is. still taxes her on her world-wide income.

Therefore, unless a U.S. person is willing to expatriate, going offshore does not change the "world-wide" tax status of a U.S. citizen or resident alien.

If this is the case, why are so many people investing offshore?

Keys to an Offshore Tax Motivated Structure

- **Money must move offshore**
- **To a non-flow through entity or tax blessed product**
- **The offshore money must compound free of current taxation**
- **The money returns to the U.S. person on a tax free, capital gain, or deferred basis – Offshore Credit Card?**

KEYS TO AN OFFSHORE TAX MOTIVATED STRUCTURE

In the event it is possible to create an offshore tax motivated structure, the following four events must take place.

I Money Moves Offshore

Either by an income tax deduction or a transfer to a foreign entity, the assets (or money) must move offshore.

II Non-Flow Through Entity

The foreign entity that receives the property must be a non-flow through entity. In other words, it must be either a non-grantor trust or a foreign corporation that does not result in tax back to the U.S. shareholder.

III Money Compounds Abroad

Once offshore inside the non-flow through foreign entity, the money would compound U.S. income tax free.

IV Money Returns to a U.S. Person

Somehow, the U.S. person will most likely want to use some, or all, of the money that went offshore. Therefore, there must be a mechanism which allows the return of the money to the U.S. Please note, in the past, many offshore tax motivated structures used an offshore credit card. The U.S. person would then spend the offshore money by purchasing personal items in the U.S. The offshore entity would pay the credit card bill. Naturally, this amounts to nothing more than simple criminal tax fraud. This is why it is the number one priority on the Service's audit hit list.

The Offshore Credit Card

The Seven Swishes of the Shark Tail

- Subpoena credit card company
- Disclosure of credit card holders
- Audit the offshore credit card holder
- Assert criminal tax fraud
- Individual discloses the promoter
- Raid the promoter's office
- Find another 1,000 fish

OFFSHORE CREDIT CARD

If a U.S. person has an offshore credit card, does that necessarily mean that the U.S. person is committing criminal tax fraud? No. However, unfortunately this may well be the Service's position. There is the following simple seven step procedure that the Service is using to catch offshore promoter's of questionable tax motivated structures.

I Subpoena Credit Card Company

Unfortunately, it does not matter whether it is a Big Five Accounting Firm, a New York Law Firm, Mastercard or Visa, it does not appear that anyone is able to squash a subpoena on criminal tax fraud matters. The first summons to 28 banks turned up 270,000 offshore credit cards. The Services estimates the number of offshore credit cards to be 2 million. For this reason, all the Service need due to start the process is subpoena the credit card company.

II Disclosure of the Offshore Credit Cards

Once compelled by Court order, the holders of offshore credit cards are disclosed to the Service.

III Audit the Offshore Credit Card Holder

During audit, the Service searches for personal expenses charged on the offshore credit card and paid for by unreported offshore money.

IV Assert Criminal Tax Fraud

If personal expenses have been paid for by unreported offshore money, in many (if not most) cases, the Service may easily assert criminal tax fraud.

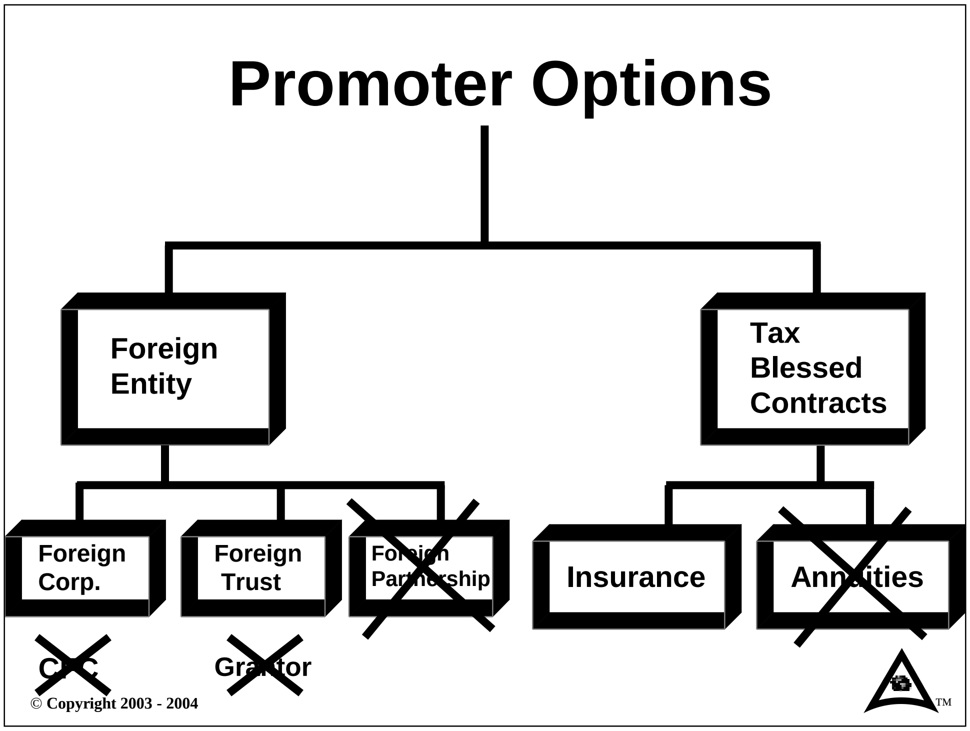
V Individual Discloses the Promoter

Naturally, if a tax motivated structure was involved, the credit card holder discloses the name of the promoter and how the structure worked.

VI Raid the Promoter's Office

If the promoter is large enough and the tax motivated structure egregious enough, the Service raids the promoter's office.

VII Find Another 1,000 Fish



PROMOTER’S OPTIONS

As previously discussed in the Breaking World Wide Taxation, a promoter has three possible entities to break world wide taxation for a U.S. person: the foreign corporation, the foreign trust, and the offshore insurance product.

I Foreign Corporation

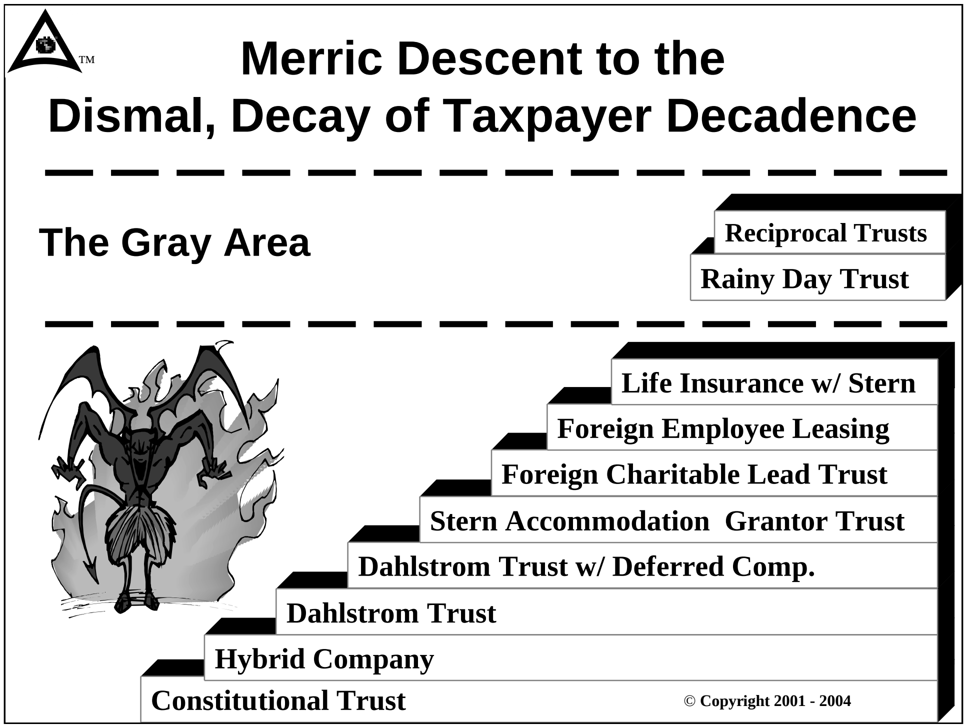
As previously noted, if the U.S. shareholder owns the foreign corporation and it holds primarily investment assets, it will be classified either as a CFC, FPHC, or PFIC and U.S. tax is not avoided. In fact the U.S. tax consequences (unless certain elections are made) are disastrous. So why do so many offshore promoters still tell clients that they might use an international business company (i.e., IBC) to avoid U.S. income tax?

II Foreign Trust

Also, as previously noted, almost anytime a U.S. person settles a foreign trust it will be classified as a grantor trust for tax purposes. If this is the case, the U.S. person reports the income of the trust, and there is no U.S. tax savings or deferral. However, is there a method to create a non-grantor foreign trust?

III Offshore Insurance

Life insurance, whether it is domestic or offshore, is a tax blessed product. However, are there certain things an offshore life insurance company will do that a domestic life insurance company will not?



MERRIC DESCENT TO THE DISMAL DECAY OF TAXPAYER DECADENCE

Different tax planners will make different conclusions regarding many of the above tax motivated structures. Further, different planners will have a different level where they draw the line regarding tax motivated structures that they think will work. The above hierarchy (or descent depending on how you look at it, is where I draw the line regarding tat motivated structures.

I Above the White Line

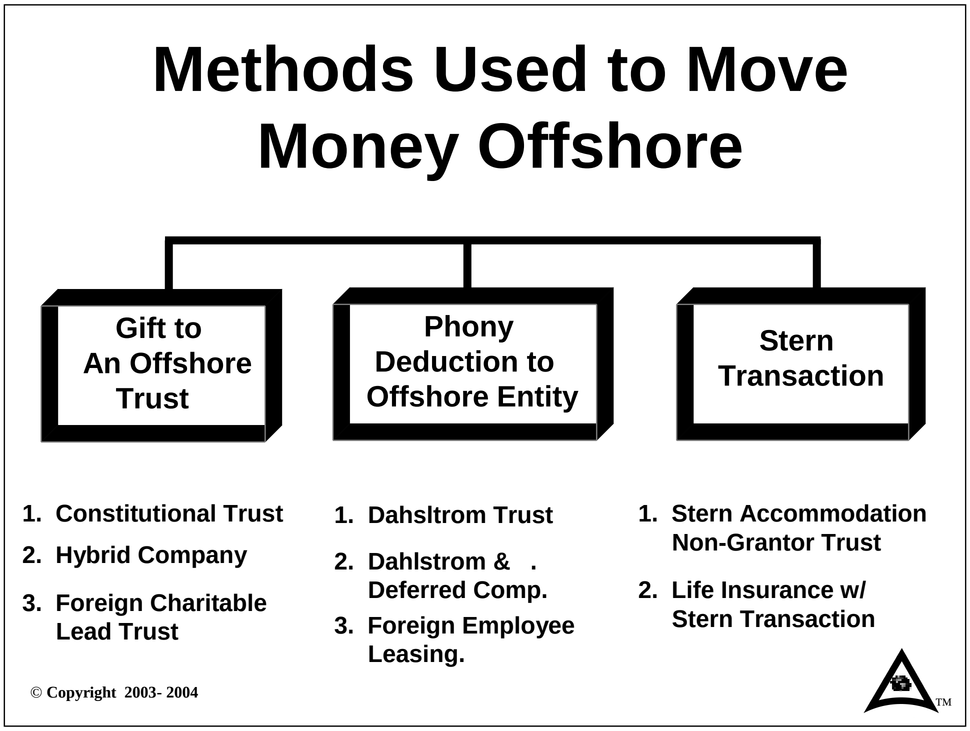
The area above the white line is the area I am comfortable with the tax structures.

II Between the White Line and the Red Line

The area between the white line and the red line (i.e., the gray area) is an areas that I do not think is technically wrong based on today's tax law. However, as a planner, I think these tax planning tools are too gray for me.

III Below the Red Line

On the other hand, those just below the red line, are items that I think will most likely result in at least an accuracy related penalty to the client. In other words, if the tax motivated structures that are immediately past the red line are tried to the Tax Court, I think it will be most likely that the structure will fail and an accuracy related penalty will be imposed. The farther down the descent, the more flagrant that I find the tax motivated structure. Finally, those at the bottom of the structure have either been classified as criminal tax fraud or have a strong likelihood of being classified as criminal tax fraud.



THREE METHODS TO MOVE PROPERTY OFFSHORE

As noted in the breaking world-wide taxation outline, there are primarily the following three methods that are utilized to move money offshore.

I Gifting to an Offshore Trust

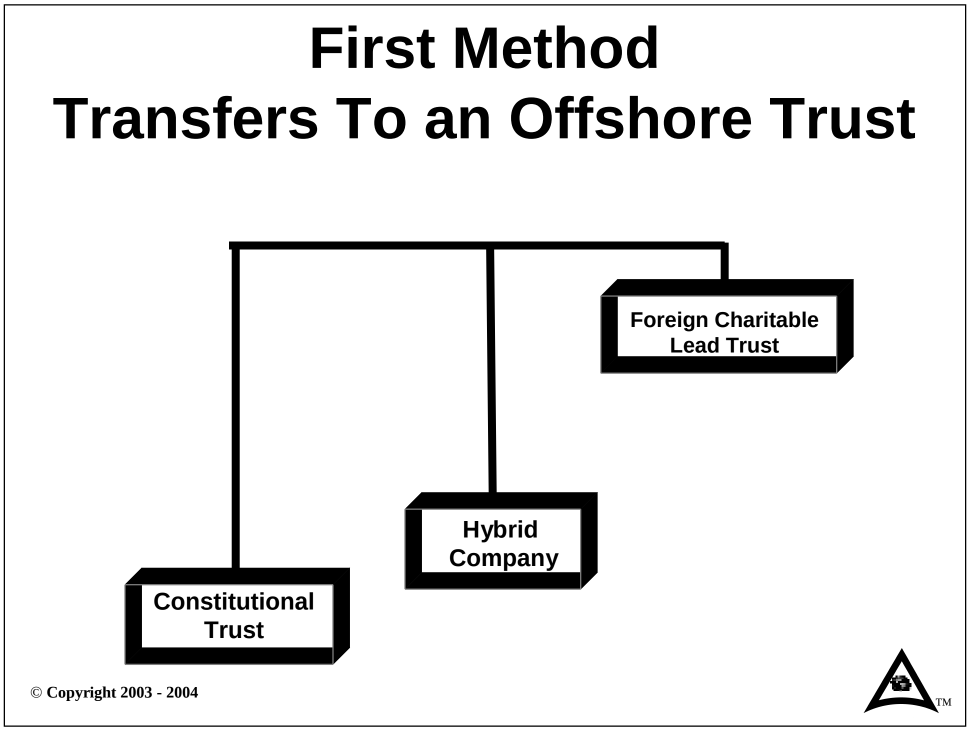
As previously noted, for income tax purposes, a gift to an offshore trust will only be successful in deferring or eliminating income tax if the trust is not classified as a grantor trust.

II Phony Deduction to an Offshore Entity

These methods use an artificially inflated deduction to zero out the income of a closely held U.S. business. The deduction is paid to an offshore entity.

III Stern Transaction

These methods utilize a private annuity (or installment sale) to an offshore entity that is in essence controlled (or most likely controlled) by the client. The offshore entity, that is not subject to U.S. tax then sells the appreciated property and pays no income tax on the sale.



GIFTING TO AN OFFSHORE TRUST

There are the following three tax motivated tax structures that primarily utilize a gift by a U.S. person to an offshore trust.

(1) Constitutional Trust

(2) Hybrid Company

(3) The Foreign Charitable Lead Trust

Constitutional Trust

- **"Constitutional," "Pure," "Equity," or "Contract" Trust – Claims:**
  - No gift tax, because you are exchanging beneficial shares for the property transferred**;**
  - No estate tax, because all you have is the mere expectancy of a distribution;
  - No income tax, because you do not control anything.

CONSTITUTIONAL TRUST

There is both an onshore and offshore version of the Constitutional Trust. It also goes under many names such as the "pure trust," "equity trust," "contract trust," and "apocalypse trust." Further, this trust has been marketed for well over fifty years as the ultimate income, estate, and gift tax savings device.

I Sales Pitch

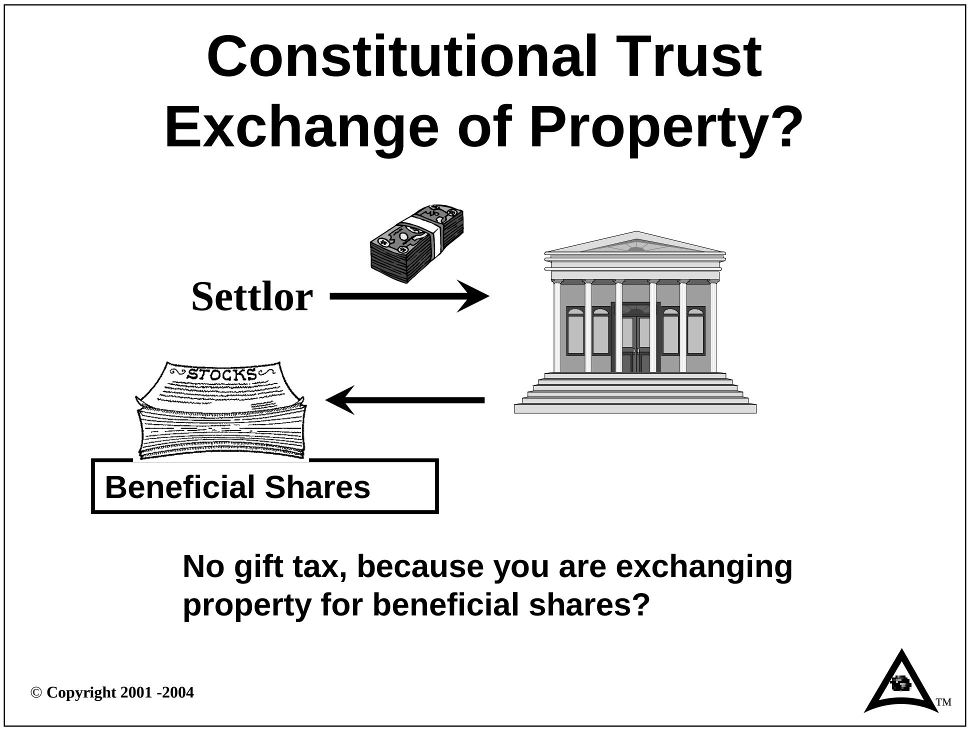
The Constitutional Trust can be easily recognized because it is almost always associated with a standard sales pitch. First, the client recognizes no gift tax, because they are transferring property in exchange for beneficial share in a trust. Second, the property is not included in the client's estate, because all they hold is a mere expectancy of a distribution. Finally, promoters claim that the client does not pay any income tax on the earnings of the trust, because he does not control anything.

II Service Tax Court Record

Since the mid 1970's, the Service has successfully won in Tax Court. Since this point in time, the Service has won over 175 cases, without exception.

III Criminal Tax Fraud

The last two promoters who were tried for selling these tax motivated vehicles each received jail sentences for over ten years in addition to a fine.



EXCHANGE OF PROPERTY?

The transfer of property in exchange for beneficial shares is a misnomer. The concept of an "exchange" has been added to the structure to mislead the client from the concept of a "gift." What the promoter hopes is that the client (and his or her advisor) will think that the transfer of assets is a tax free exchange.

A. IRC 351 Exchange of Stock for Assets

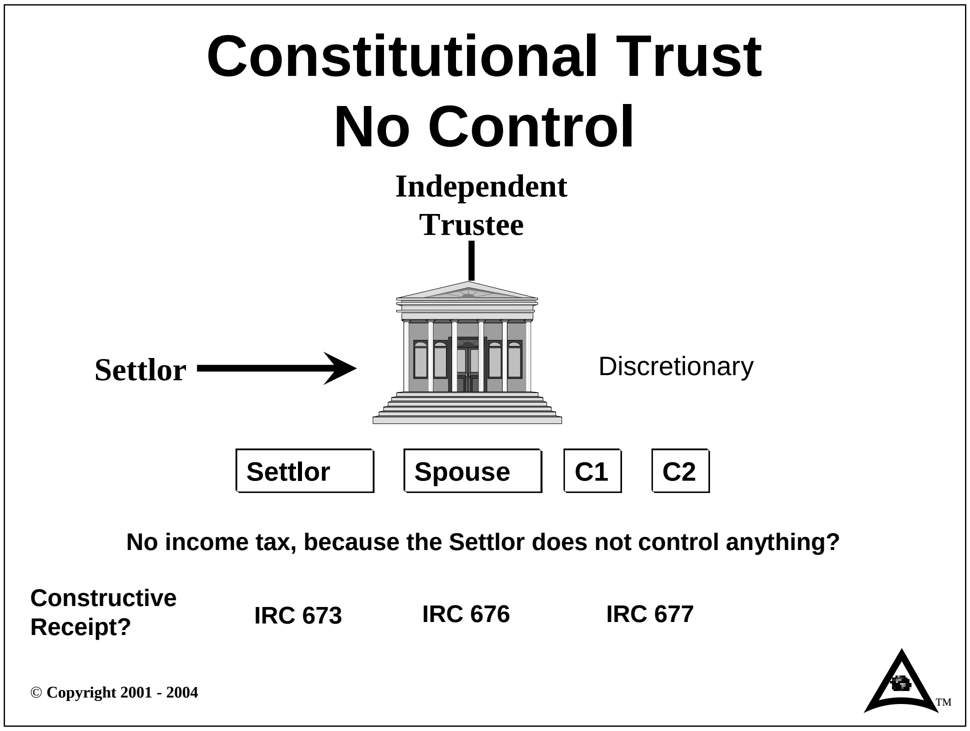
Generally, an exchange is taxable, unless some code section makes such a transfer non-taxable. For example, when property is transferred to a corporation in exchange for stock, no gain or loss is recognized under IRC 351(a) if the transferring persons have control (own 80% or more within the meaning of IRC 368(c)) after the transfer.

B. IRC 721 Exchange of Partnership Interest For Assets

Also, when a partner transfers property to a partnership in exchange for a partnership interest, no gain or loss is recognized. IRC 721(a)

C. Exchange of Property With a Trust

However, no similar non-recognition rule exists regarding a transfer to a trust. Further, the beneficial shares that are received have no voting, rights, no rights to share in the profits, and no liquidation rights. In essence, the beneficial shares are a right to nothing. When property is transferred in return for nothing, it is a gift, not an exchange.



Control

Promoters of the Constitutional, pure, equity, or contract trust argue that the settlor is not taxed on the earnings of the trust, because he does not control anything. Again, this is a play on words.

I Constructive Receipt

The issue of "control" is concerned with the doctrine of constructive receipt. Further, it is true, that with an independent trustee, the Settlor does not have control and the doctrine of constructive receipt would not apply.

II Grantor Trust Rules

However, the doctrine of constructive receipt is not the only tax principal. There is also all the grantor trust rules to consider.

A. IRC 673 – 5% Reversionary Interest

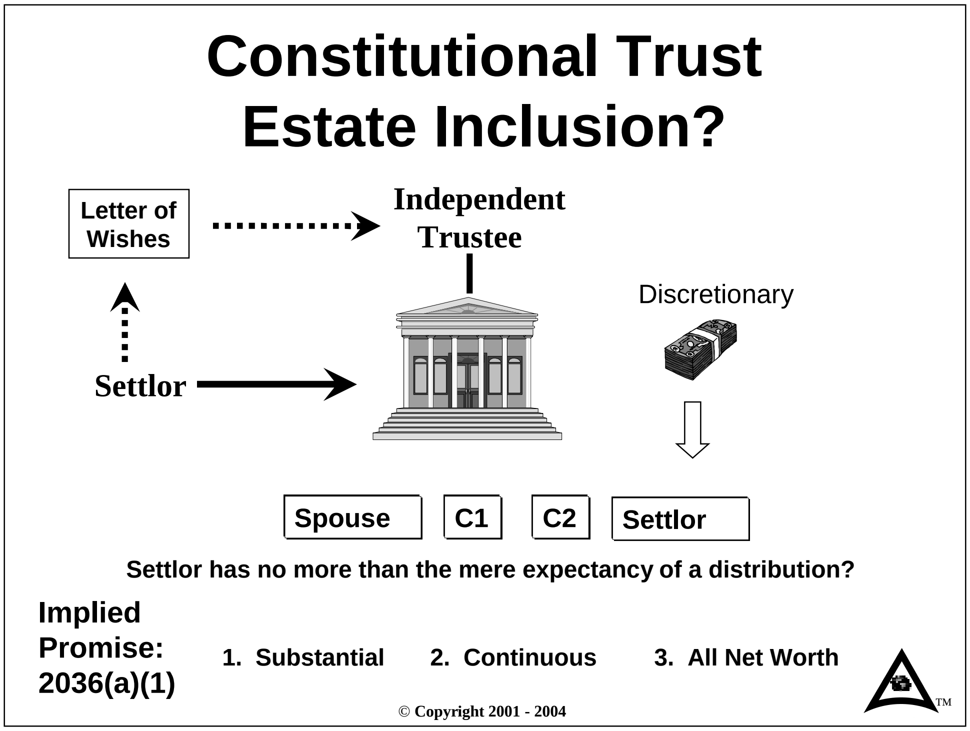
Whenever the grantor retains a 5% or greater reversionary interest, the trust is classified as a grantor trust. In the case of a discretionary trust, IRC 673(c) assumes the maximize exercise of discretion.

B. IRC 676 – Revest Title in Grantor

Whenever any non-adverse person (i.e., the independent trustee) may revest property in the grantor, the trust is classified as a grantor trust.

C. IRC 677 – Income for the Benefit of the Grantor or Spouse

Whenevery any non-adverse person may pay income to the grantor or the grantor's spouse, the trust is classified as a grantor trust.



Mere Expectancy of a Distribution

A discretionary interest in a trust is not a property interest. For estate purposes, neither is a beneficial interest that is based on ascertainable standards. Therefore, if the Settlor's interest does not vest by the terms of the trust in his estate, under the general estate tax inclusion rules there would be no tax. In this respect, the promoters of the constitutional, pure, equity, or contract trusts are correct, the settlor has nothing more than a "mere expectancy of a distribution." However, there are two parts of IRC 2036(a) that the settlor must be concerned with.

I Support Obligation

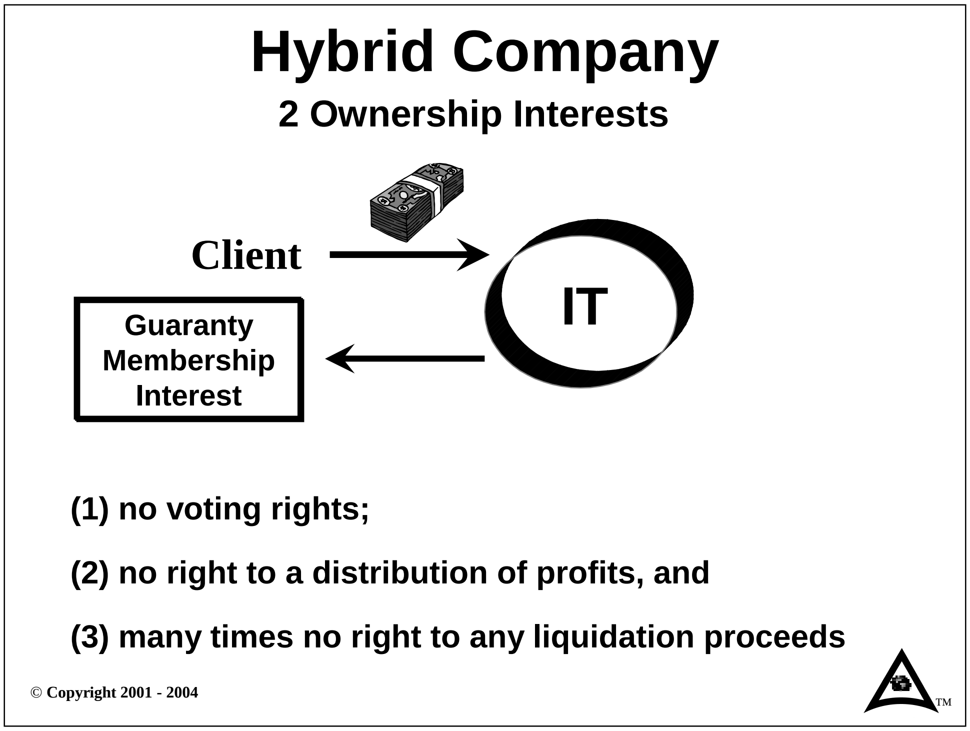
If the creditors of the settlor can reach his or her interest in the trust, the assets of the trust may be used to satisfy a support obligation. Under the lawas of 46 states, a self-settled trust provides no asset protection. Therefore, in these states, a creditor may reach all of the assets of the trust, and the entire trust will be included in the settlor's estate under IRC 2036(a)(1).

II Implied Promise

There is a second theory regarding estate inclusion known as the implied promise theory. If there is an implied promise between the settlor and the independent trustee that the trustee will distribute monies whenever the settlor needs them, the trust assets will be included in the settlor's estate. There are three lines of cases under the implied promise theories:

A. Continuous Distributions Over the Life of the Trust
B. A Substantial Distribution of a Large Portion of the Trust
C. Transfer of Substantially All of the Settlor's Assets

These cases are the exact same cases that are cited under the rainy day trust outline for estate tax inclusion.



HYBRID COMPANY

Gibraltar, Isle of Man, and the Turks and Caicos have laws that allow for an entity known as a "hybrid company." At first glance, it appears that a hybrid company has both characteristics of a corporation and a limited liability company.

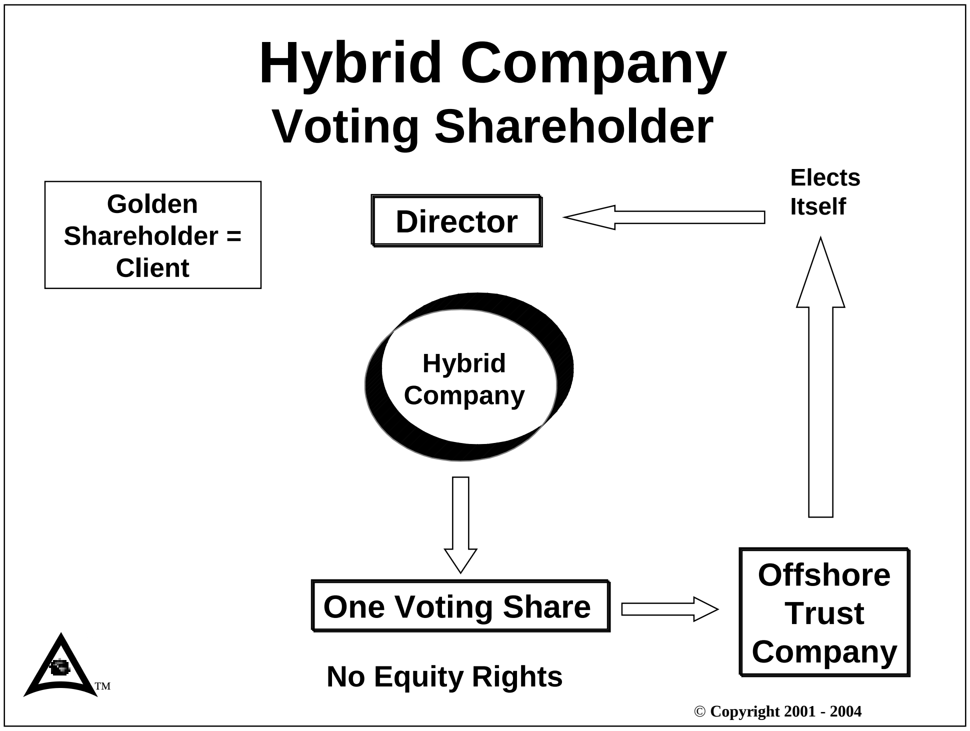
I Two Types of Ownership Interests

The hybrid company issues two type of equity interests. First, there are guaranty membership interests and there are voting shareholder interests.

A. Guaranty Membership Interests

With the typical hybrid company structure, the client transfers virtually all of the contributed capital to the hybrid company in exchange for a guaranty membership interest. Pursuant to the terms of the guaranty membership interest, the client will guaranty to contribute a nominal amount to the hybrid company (typically $20) if the hybrid company is insolvent. In this sense, the term "guaranty member" is a misnomer. The term "guaranty" is virtually meaningless due to the trivial amount involved.

In addition, the membership interest is usually close to worthless, because the guaranty member receives no voting rights, no rights to a distribution of profits, and many times the Memorandum of Association provides no contractual obligation to pay any liquidation proceeds. In essence, the guaranty member has a right to a distribution, when and if the manager of the hybrid company decides to make a distribution.



B. Voting Shareholder

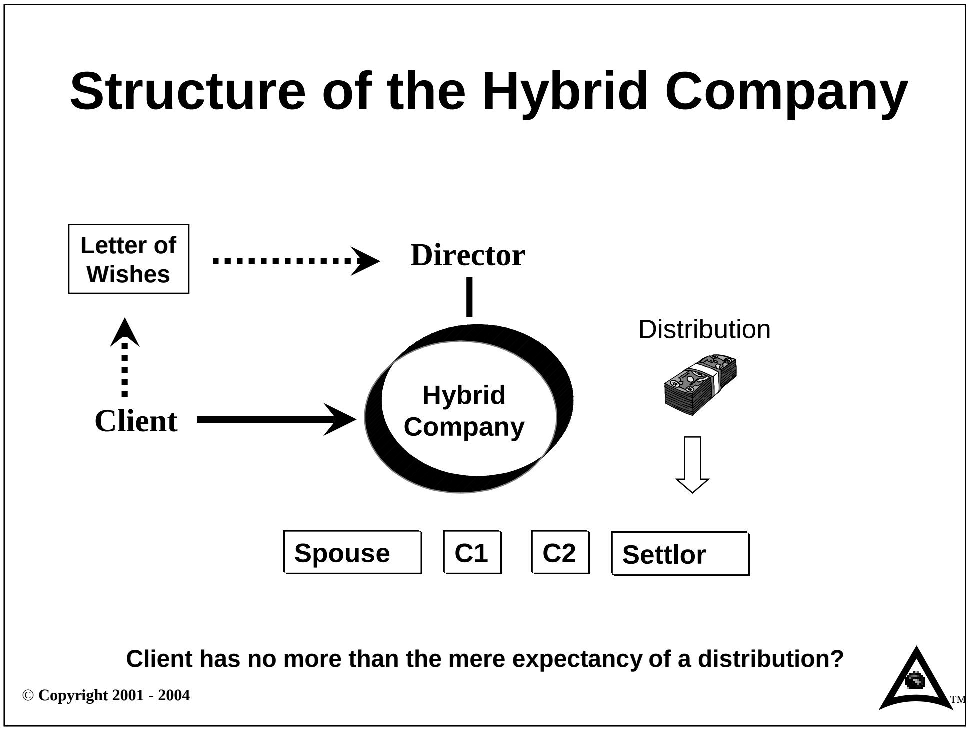
As noted before, the guarantee member(s) receive no voting rights. Rather, in exchange for a trivial amount of $100, one voting share is issued to the offshore trust company. The offshore trust company then votes itself as the director of the hybrid company.

C. Golden Shareholder

In the Memorandum of Association, some hybrid companies are drafted to have a "golden shareholder." In essence, a golden shareholder is more analogous to a "protector" position of a trust. By the terms of the Memorandum of Association, the golden shareholder typically has the power to veto director decisions, remove directors, and appoint new directions. Typically if a golden shareholder provision is provided for it is held by the client.

D. Letter of Wishes

In the event that there is no golden shareholder, similar to the Constitutional Trust, the client advises the director of his requests through a "letter of wishes."



II Structure of the Hybrid Company

A client may gift membership interests to his or her spouse and children. Naturally, gifts to a spouse are non-taxable for gift tax purposes. But promoters of the hybrid company argue that gifts to children are not taxable, because the client has nothing more than the mere expectancy of a distribution.

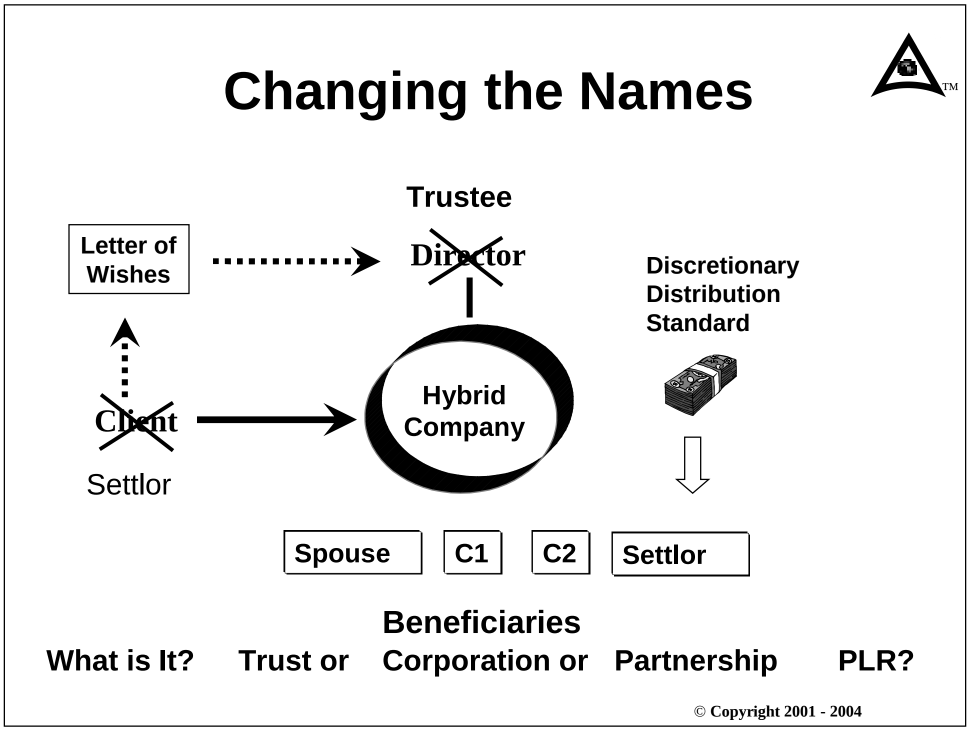
A. Income, Estate, and Gift Tax

In fact, not only do promoters of the hybrid company argue that there are no gift tax issues, but they claim there is no income tax, because the guaranty member does not control anything, and there is no estate tax, because, the client again has nothing but a mere expectancy of a distribution.

B. Tax Nothing

In essence, the promoters of the hybrid company argue that that it is a "tax nothing." It is not a corporation, it is not a trust, it is not a partnership, it is a nothing. Further, since it is a "foreign nothing," promoters argue that it is exempt from U.S. tax.

Nowhere in the IRC is there such a thing as a "tax nothing." If it is an entity, it is either classified as a corporation, partnership, or trust. If it is not an entity, rather a contract investment, then it is either taxable under the OID rules, an insurance contract, or an annuity.



III Changing the Names

At first glance, the hybrid company is quite confusing, because all of the names given to the various parties are in essence misnomers. However, what happens if the term client is replaced by settlor, guaranty membership interest by beneficiaries, and director by trustee. Further, the manager's ability to make a distribution when and if they wish to any guarantee member is nothing more than a discretionary distribution standard.

A. Tax Classification as a Trust

If this is the case, it is most-likely that the hybrid company will be classified as a trust for U.S. tax purposes. As such, it is nothing more than a "take off" on the Constitutional Trust, except for the misleading names of the parties involved. As such, the same cases and code sections that apply to the Constitutional Trust also applies to the hybrid company.

1. <u>Income Tax</u>

The trust would be classified as a grantor trust under IRC 673; 676; 677, and 679. In this sense, the trust is a grantor trust, not once, but four times. This does not mean that the U.S. taxpayer pays income tax on the trust's income four times. But it does mean that the promoter's claims that both the trust assets and the settlor are exempt from U.S. income tax are completed false.

2. Completed Gift

Similar to the self-settled estate planning trust (sometimes referred to as the "rainy day trust"), transfers to the hybrid company would be a completed gift for gift tax purposes. *W. Arthur Cullman v. Comm.,* TC Memo 1981-666; Rev. Rul. 77-378; PLR 93326006; and PLR 9837007. In other words, if the hybrid company is classified as a trust, which is most likely the case, at time of creation gift tax will be incurred, the client's unified credit used, and to the extent the client's unified credit has been fully utilized, gift tax will be payable.

3. Included in the Estate

. Again, similar to self-settled estate planning trust (sometimes referred to as "the rainy day trust"), the assets may well be included in the client's estate at time of death. As noted in the Core Planning Modules outline, under IRC 2036(a)(1), the assets are included in the settlor's (i.e., creator of the hybrid company), if either:

a. there is an implied promise that the assets will be returned, in whole or part, to the creator of the hybrid company (Treas. Reg. 20.2036-1(a)(1)) or

b. a creditor can reach the assets of the hybrid company to satisfy a claim of the creator. Treas. Reg. 20.2036-1(a)(1); *Estate of McCabe*, 475 F.2d 1142 (Ct. Cl. 1973))

For a further discussion of these issues, please see the Core Planning Modules outline.

B. Classified as a Corporation or Partnership?

On the other hand, a hybrid company may own an operating business and the Memoradum of Association may be drafted where it is more likely that the entity will be classified as either a partnership or a corporation. If the hybrid company is classified as a corporation, it will most likely be classified as a foreign corporation with the following four negative tax ramifications:

(1) all capital gain is converted to ordinary income;

(2) in the event that a U.S. shareholder (i.e., guarantee member) dies, there is no step-up in basis under IRC 1014(b)(5);

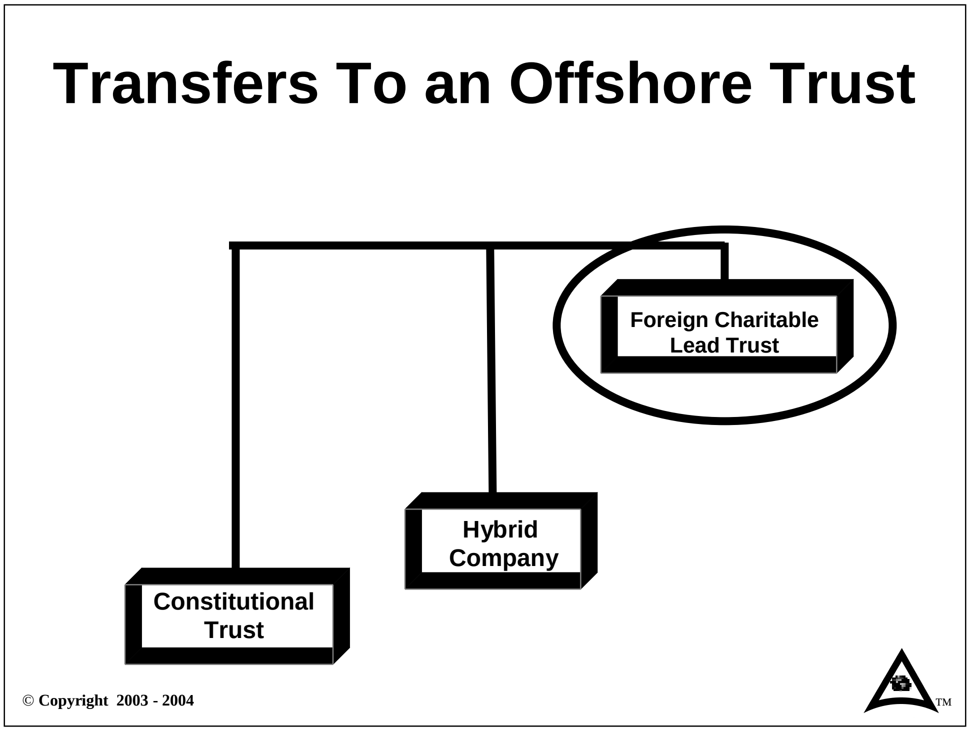
(3) capital losses will be suspended until the hybrid company is liquidated; and

(4) and dividend income on any U.S. equity securities will be subject to double taxation. Please see the U.S. Person and World Wide Taxation outline.

Please note, the default rule for offshore entities is unless the check-the-box election is made, the entity is classified as a corporation, not a partnership. Treas. Reg. 301.7701-3(b)(2).

C. Request a Private Letter Ruling

In the event the U.S. client does not file the proper U.S. tax returns to report the fire foreign entity, there are significant penalties. This issue is tremendously compounded if the client files the wrong U.S. reporting returns, because the client is uncertain whether the entity is classified as a foreign partnership, a foreign trust, or a foreign corporation. Therefore, should a client create a hybrid company, the planner should insist the client obtain a private letter ruling to insure how it will be classified for federal income tax purposes.



GIFTING TO AN OFFSHORE TRUST

There are the following three tax motivated tax structures that primarily utilize a gift by a U.S. person to an offshore trust.

(1) Constitutional Trust

(2) Hybrid Company

(3) The Foreign Charitable Lead Trust

Gift to a Foreign Trust

- **The Constitutional Trust and the Hybrid Company**
  - **Argue that they are Tax Nothings**
- **The Foreign Charitable Lead Trust Argues That It is a Non-Grantor Trust**

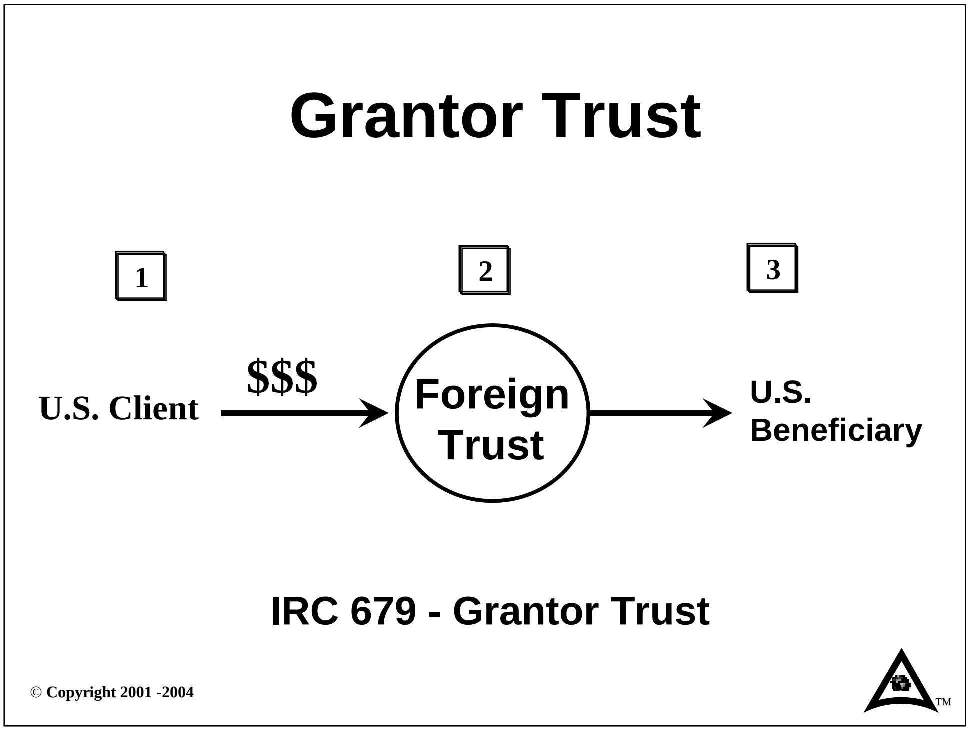
GIFTS TO A FOREIGN TRUST

I The Tax Nothing Argument

Summarizing the tax motivated structures that are based on gifts to a foreign trust, both the Constitutional Trust and the hybrid company attempt to argue that they are tax nothings. Unfortunately, there is no support anywhere in the IRC that something is a tax nothing. If it is an entity, it is either a trust, a partnership, or a corporation. If the tax motivated structure is not an entity, but rather a contract (i.e., an annuity, insurance contract, bank account, share of stock, or certificate of deposit) it either has favorable tax treatment under the code by specific code section or it is taxable currently. There is no such thing as a tax nothing.

II Non-Grantor Trust Argument

Both the foreign charitable lead trust and the first "Stern transaction" discussed later take the position that the foreign trust is a "non-grantor" trust for tax purposes. If structuring this transaction is possible, a foreign "non-grantor" trust would <u>not</u> be subject to tax on foreign source income, most U.S. interest, and capital gains (except for real estate). In other words, if a U.S. person could possibly create a non-grantor foreign trust, the U.S. taxpayer would be able to avail himself or herself of significant tax advantages. Unfortunately, (except at time of death) as discussed in the following pages, the ability for a U.S. person to create a non-grantor trust most likely does not exist.



IRC 679 – GRANTOR TRUST

I IRC 679 is Unique to Foreign Trusts

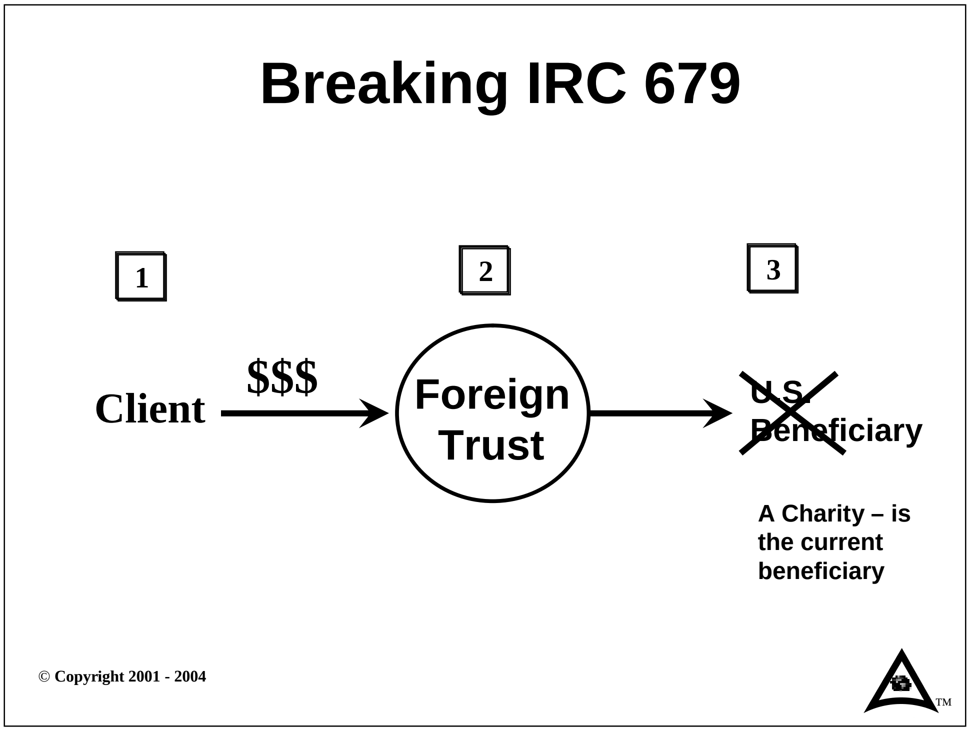
Code Section 679 is unique when compared to the other grantor trust rules. The other grantor trust rules deal with issues of whether the grantor (and or his or her spouse) is a beneficiary of the trust. IRC 673; 673; 677. Whether the settlor retains certain administrative powers or the trustee may exercise these administrative powers on behalf of the Settlor. IRC 675. Also, if the Settlor retains too much control over the selection of a related trustee, this may result in grantor trust classification. IRC 674. Regardless of whether these grantor trust sections apply, any trust that is classified as a foreign trust for tax purposes is also a grantor trust under IRC 679.

II IRC 679

During the life of the transferor (i.e., settlor), anytime the following three requirements are met, the trust is classified as a grantor trust for tax purposes:

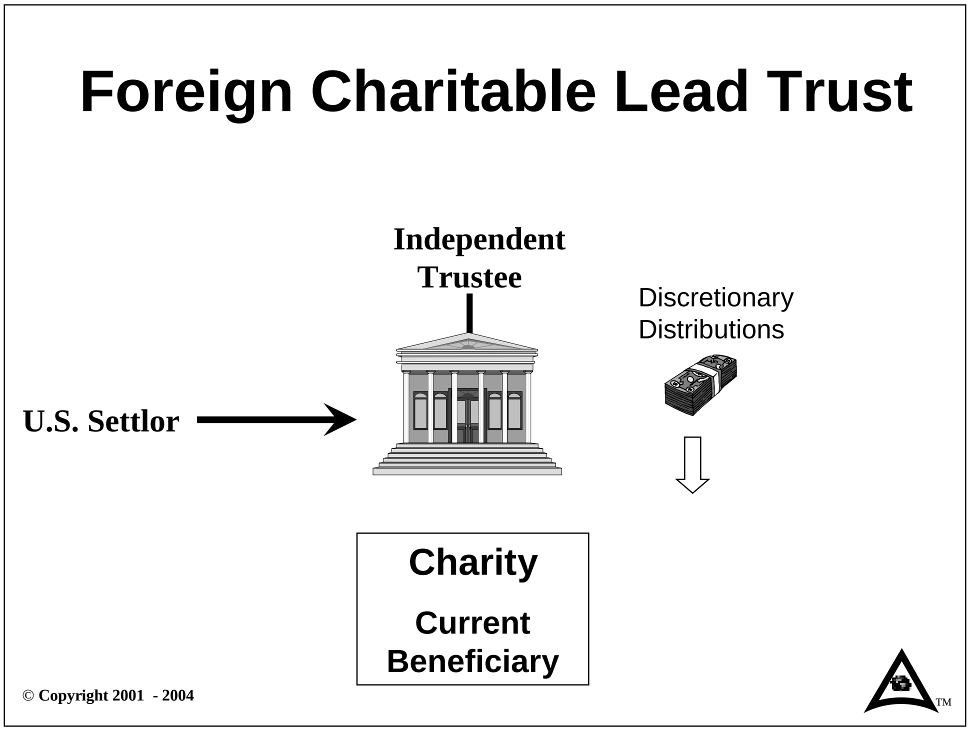
(1) a U.S. person transfers
(2) property to a foreign trust; and
(3) there is any U.S. beneficiary. IRC 679(a)(1).

Please note there is an exception for property that is transferred at time of death (IRC 679(a)(1)) and sometimes this is used in combination with an IRC 663 trust discussed in the advanced estate planning outline. However, this exception is not what is being relied upon for either the foreign charitable lead trust or the Stern transaction discussed later.



BREAKING IRC 679

In order to get the grantor trust rule of IRC 679, a tax motivated structure will need to break one of the three prongs of IRC 679: (1) U.S. person; (2) foreign trust; or (3) a U.S. beneficiary. For the tax savings to exist, the trust must be classified as a foreign person (i.e., a foreign trust). Therefore, breaking this prong is not an option. A method to break the first prong – U.S. person - (which is no longer viable) is discussed later in the outline. Therefore, promoters of the foreign charitable lead trust argue that they have found a method to break the last prong – the U.S. beneficiary. To do this, a charity is designated as the current beneficiary of the trust.



FOREIGN CHARITABLE LEAD TRUST

I Terminology

As with most tax motivated structures, the names given to the various devices are misleading. In this case, the term foreign charitable lead trust is quite misleading. Most planners would think that a charitable lead trust is a split interest trust where the charity receives an income interest, and the client's beneficiaries receive the remainder interest. But this is not the case with the tax motivated foreign charitable lead trust.

II Discretionary Trust

The foreign charitable lead trust is drafted as a truly discretionary trust. There is no income interest, and the only discretionary beneficiary during the life of the settlor is the charity. In fact, believe it or not, no U.S. beneficiary is named in the trust. Rather, one year after the settlor's death, the settlor's children have the option to elect in as a beneficiary of the foreign charitable lead trust. Obviously, this is no more than a mere play on words. The reason the settlor's children are not listed as U.S. beneficiaries is because if they were, the foreign trust would be classified as a grantor trust when it was created – the three requirements under IRC 679 would have been met.

III Literal Language of IRC 679

The literal language of IRC 679(c)(1) states:

For purposes of this section, a trust shall be treated as having a U.S. beneficiary for the taxable year <u>unless</u>:

Where's U.S. Beneficiary?

- Children have the ability to elect in as a beneficiary 1 – 2 years after death of settlor
- No U.S. beneficiary "during year"
  - IRC 679(c)
- Legislative Intent –
  - Any U.S. Beneficiary no matter how remote or contingent
    - Add a Beneficiary
    - Oral Agreement

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GIFTS TO A FOREIGN TRUST

I The Tax Nothing Argument

Summarizing the tax motivated structures that are based on gifts to a foreign trust, both the Constitutional Trust and the hybrid company attempt to argue that they are tax nothings. Unfortunately, there is no support anywhere in the IRC that something is a tax nothing. If it is an entity, it is either a trust, a partnership, or a corporation. If the tax motivated structure is not an entity, but rather a contract (i.e., an annuity, insurance contract, bank account, share of stock, or certificate of deposit) it either has favorable tax treatment under the code by specific code section or it is taxable currently. There is no such thing as a tax nothing.

II Non-Grantor Trust Argument

Both the foreign charitable lead trust and the first "Stern transaction" discussed later take the position that the foreign trust is a "non-grantor" trust for tax purposes. If structuring this transaction is possible, a foreign "non-grantor" trust would <u>not</u> be subject to tax on foreign source income, most U.S. interest, and capital gains (except for real estate). In other words, if a U.S. person could possibly create a non-grantor foreign trust, the U.S. taxpayer would be able to avail himself or herself of significant tax advantages. Unfortunately, (except at time of death) as discussed in the following pages, the ability for a U.S. person to create a non-grantor trust most likely does not exist.

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated <u>during the taxable year</u> to or for the benefit of a U.S person, and

(B) if the trust were terminated at any time <u>during the taxable year</u>, no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person.

IV Promoter's Interpretation Conflicts With The Legislative Intent

Unfortunately, the promoter's interpretation of IRC 679(c) conflicts with the legislative history and intent behind the code section.

A. Language of 679(c)

Promoters tend to place heavy reliance on the "during the taxable year" part of this code section. They argue that since there is no current U.S. beneficiary while the Settlor is alive, IRC 679 does not apply. After the Settlor's death, the grantor trust rules would not apply, because the grantor trust has deceased.

B. Legislative Intent

Under both the House Report, Senate Report, and General Explanation of IRC 679(c)[S. Rep. No. 938 at 219; 90 H.R. Rep. No. 658 at 210; General Explanation p. 222.], a U.S. beneficiary is presumed in the following two situations:

1. <u>Amended to Include a U.S. Beneficiary</u>

If a trust may be amended in any way so as to add a U.S. beneficiary, the trust is deemed to have a U.S. beneficiary.

2. <u>Oral Agreement</u>

A trust is also deemed to have a U.S. beneficiary, if there is any oral agreement that a U.S. beneficiary.

C. Ability For The Settlor's Children to Elect In

The ability of the Settlor's children to elect in as beneficiaries is not an oral agreement to add a U.S. beneficiary, it is a <u>written agreement</u> that specifically affects the trust from inception. Further, there is not a mere possibility that the trust may be amended. The written agreement that allows the Settlor's children to elect in is conclusive evidence of the ability to amend the trust to include a U.S. beneficiary.

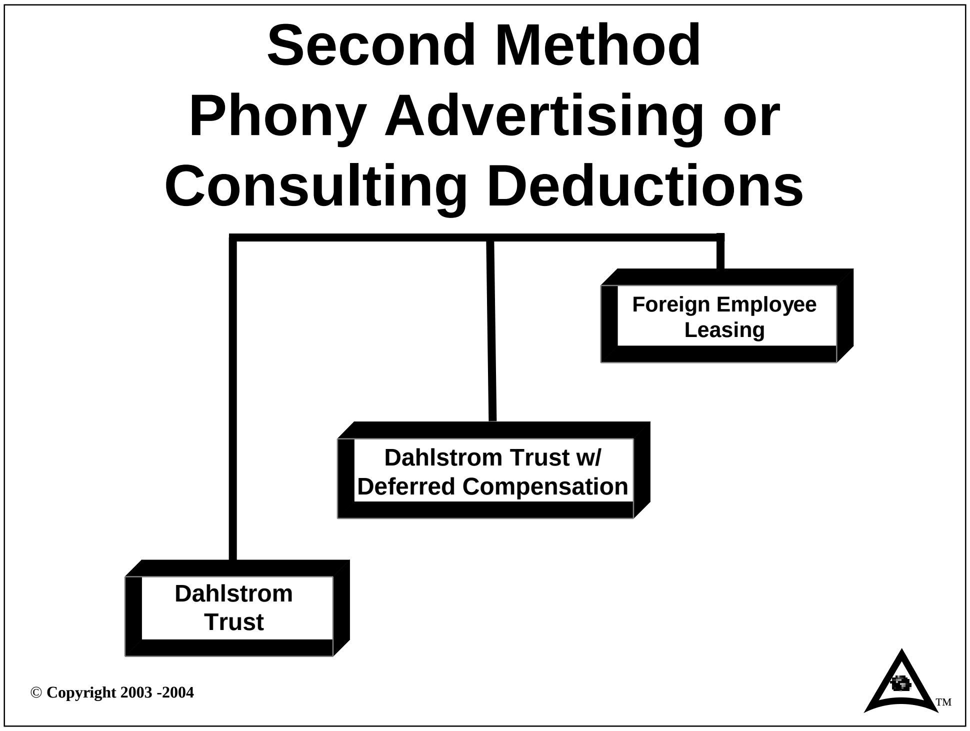
From just a common sense point of view, a client/settlor would not enter the transaction unless he or she could guaranty his or her children as beneficiaries of the foreign trust. In this respect, the legislative history contemplates that many would try to hide the true U.S. beneficiaries of the foreign trust by "elect in agreements," and possibly even an oral agreement.

D. No Other Authority

Currently, other than the legislative history, there are no cases, revenue rulings, or even private letter rulings that are on point. In this respect, one might argue that the foreign charitable lead trust is not even adverse to any authority.

E. Penalties

If the trust is classified as a grantor trust, failure to have properly filed Form 3520 result in a 35% penalty. Failure to file Form 3520-A, a 5% penalty per year. Both penalties are computed on the fair market value of the trust assets.



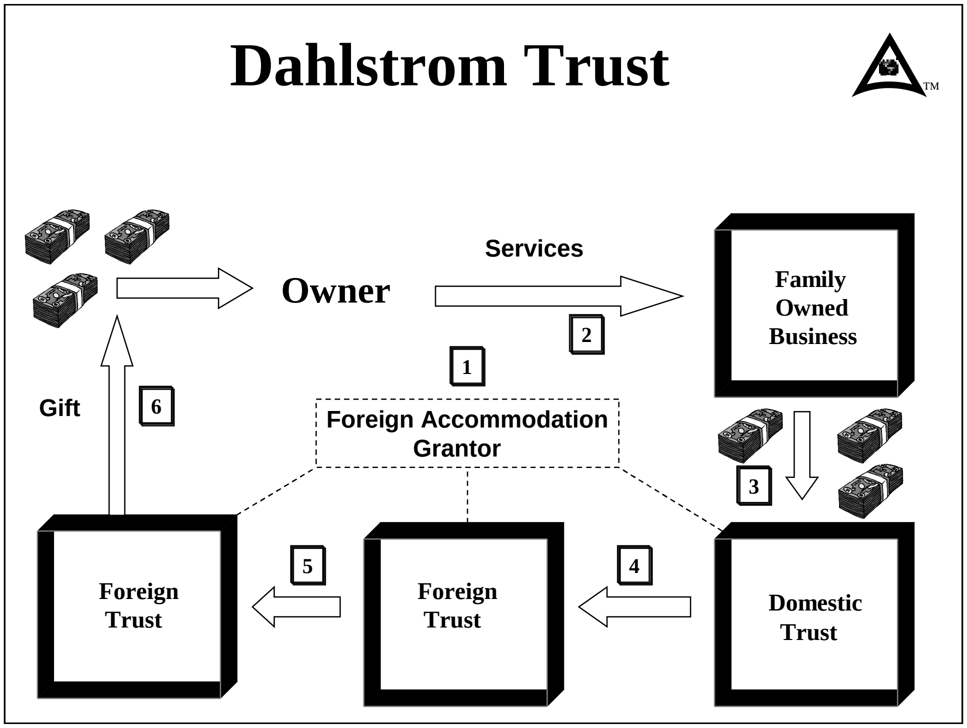
PHONY CONSULTING DEDUCTIONS

The second primary method to move money offshore is the use of a phony consulting deduction that is paid by the client's U.S. business to an offshore entity. The following three tax motivated structures have been utilized this way.

(1) Dahlstrom Trust

(2) Dahlstrom Trust w/ Deferred Compensation

(3) Foreign Employee Leasing Program



DAHLSTROM TRUST

I Foreign Accommodation Grantor

A foreign person, affiliated with the promoter, creates three trusts (one domestic and two foreign). The first foreign trust is the only beneficiary of the domestic trust. The second foreign trust is the only beneficiary of the first foreign trust. The U.S. owner and his family are beneficiaries of the third foreign trust.

II Services

The owner continues to perform services for the family owned business. <u>However</u>, these services are performed pursuant to a "consulting or managerial contract" with the domestic trust.

III Domestic Trust

The profits of the family owned business are siphoned out to the domestic trust pursuant to the business consulting agreement, whereby the owner performs services for the business. The domestic trust distributes all of its income to the foreign trust and takes a distribution deduction. Therefore, theoretically, the domestic trust pays no tax.

IV First Foreign Trust

The first foreign trust receives the income and distributes all of its income to the second foreign trust through a distribution deduction. Therefore, theoretically, the foreign trust pays no tax.

V Second Foreign Trust

The second foreign trust theoretically pays no income tax, because it is a foreign taxpayer, not subject to U.S. taxation. The income is allowed to accumulate tax free in the second foreign trust.

VI Repatriation

Later, the foreign trust distributes the income as a tax free gift (sometimes this is a promissory note that is then forgiven).

DAHLSTROM TRUST CASES

The following list details over 20 Dahlstrom type cases. In every case, the Service won under a "sham entity" or "sham transaction" theory. The author is aware of no case where a court has upheld the validity of a Dahsltrom type trust arrangement.

1. *Zmuda v. Commr.,* 79 TC 714 (1982); affd. 731 F.2d 1417 (9th Cir.)
2. *Professional Services v. Commr.,* 79 TC 888 (1982)
3. *Olaf C. Akland, et. al,* TC 1983-249
4. *U.S. v. Dahlstrom*, 713 F.2d 1405 (9th Cir. 1983)
5. *Akland, et. al., v. Commr.,* 767 F.2d 618 (9th Cir.)
6. *Ibabao Medical Corp.*, TC Memo 1988-285
7. *Tatum, Gary E.*, TC Memo 1988-579
8. *Denali Dental Services, et. al.*, TC Memo 1989-482
9. *Pauli, Richard S.*, TC Memo 1989-481
10. *Able Company*, TC Memo 1990-500
11. *Tatum, Gary E.*, TC Memo 1990-119
12. *Sandvall v. Comm.,* TC Memo 1989-189; affd. 898 F.2d 455 (5th Cir. 1990)
13. *Dahlstrom, Karl*, TC Memo 1991-264;
14. *Dahlstrom Karl,* TC Memo 1991-265
15. *Bordor, Frank*, TC Memo 1993-456
16. *Trenerry, Nancy*, TC Memo 1994-500
17. *Spencer, Peter*, TC Memo 1994-531
18. *U.S. v. Scott*, 37 F.3d 1564 (10th Cir. 1994)
19. *Buckmaster, Forest*, TC Memo 1997-236
20. *Rendell, David*, TC Memo 1995-593; affd., 129 F. 3d 127 (9th Cir. 1997)
21. *Anderson v. Commr.*, TC Memo 1994-366; 106 F.3d 406 (9th Cir. 1997)
22. *Johnson, Shirley*, 116 TC 111 (2001)

Summary of
The Dahlstrom Trust

- **The Dahlstrom Trust is Now Considered Tax Fraud**
  - **9th Circuit Reverses Criminal**
  - **Morals**
    - **Be the first to create the tax scam**
    - **Have a heroic and original idea**
    - **Make sure you are the first in line to face criminal charges**
- **The IRS Won the Case Under the Sham Theory**

EVOLUTION FROM THE DAHLSTROM TRUST

The foreign employee leasing evolved from a tax scam known as the Dahlstrom Trust. In order of progression, first there was the Dahlstrom Trust, then the offshore non-grantor trust combined with the international business company, and deferred compensation program. Finally, the latest twist to this offshore tax device is the foreign employee leasing arrangement.

I Dahlstrom Trust

When the Service went after Mr. Dahlstrom for syndicating his so called "Dahlstrom Trust" scheme, the Ninth Circuit did not find Mr. Dahlstrom guilty of criminal tax fraud, because the illegality of the transaction had not been established at the time of the transaction. *U.S. v. Dahlstrom*, 713 F2d 1405 (1983). However, within two years of the Ninth Circuit's opinion, verdicts for tax fraud were upheld by the Ninth Circuit for Dahlstrom Trust transactions. ***Akland, et. al. v. Comm.,*** 767 F.2d 618 (1985). By 1990, it was becoming more common for the Tax Court to uphold a civil fraud penalty, even if the taxpayer was not a promoter. *Able Company*, TC Memo 1990-500; *Tatum, Gary*, TC Memo 1990-119; ***Rendell v. Commr.***, 129 F.3d 127 (9th Cir. 1997).

II Sham Trust Theory

The Internal Revenue Service ("Service") won the case under the "sham trust" theory of taxation. The sham trust theory is a "substance over form" argument. In essence, under a sham theory, the trust is disregarded for tax purposes, because it lacks any economic substance other than the tax motive.

Since the first case involving a Dahstrom type trust, ***Zmuda v. Commr.***, 79 TC 714 (1982), there have been over twenty such cases. The Service has won all of them under the sham trust theory of taxation. In all cases the author is aware of, the taxpayer was required to pay negligence penalties, substantial understatement penalties, and in some cases, civil tax fraud penalties.

Sham Theory

- **Sham Entity Theory**
  - Trust, Partnership, Corporation
- **Sham Transaction Theory**
  - **Business Purpose and/or**
  - **Economic Profit**

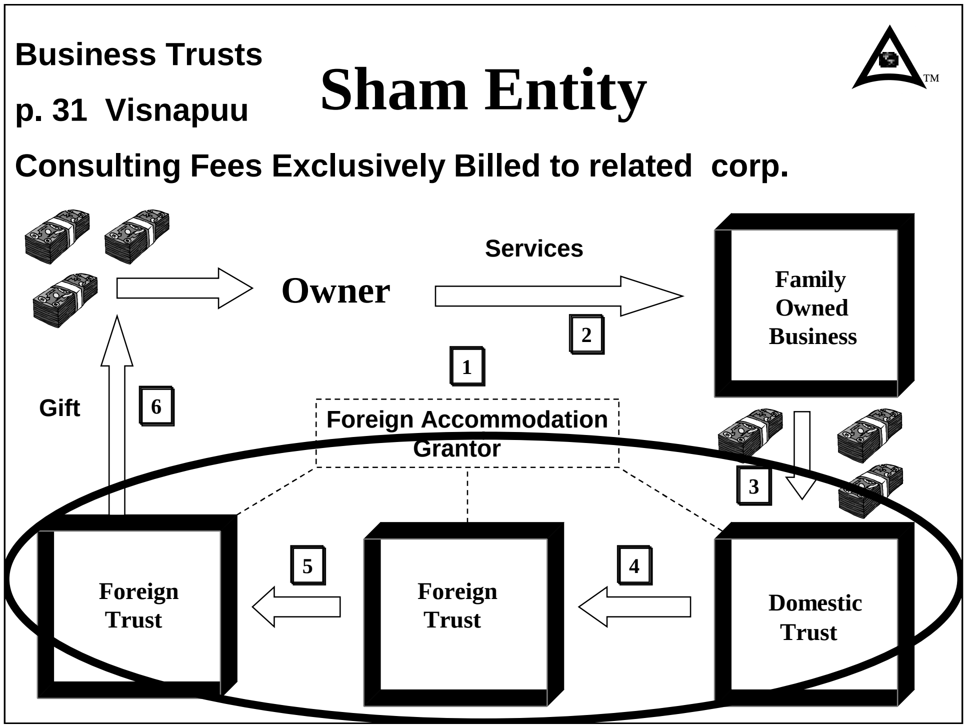
Right to structure a transaction does not give the taxpayer a right to structure a "paper entity" to avoid tax – Markosian v. Comr.

SHAM THEORY

The Internal Revenue Service may attack a transaction under either the sham entity or sham transaction theory. The sham entity or sham transaction theory is a "substance over form" argument. In essence, under a sham theory, the form of the transaction or the entity is disregarded; and for tax purposes, taxation is imposed as if the transaction never took place.

Under a sham entity or transaction theory, transactions (or entities) that have no significant purpose <u>other than to avoid tax and do not reflect economic reality</u> will not be recognized for Federal income tax purposes. <u>*Zmuda v. Commr.*</u>, 79 TC 719 (1982), affd. 731 F.2d 1417 (9^{th} Cir. 1984). It should be noted that just because a transaction or entity reduces a taxpayer's tax does not mean that it is a sham. Taxpayers have a legal right, by whatever means allowable under the law to structure their transactions to minimize their tax obligations. *Gregory v. Helvering*, 293 U.S. 465 (1935). However, this right does not bestow upon the taxpayer the right to structure a <u>paper entity</u> to avoid tax when that entity does not stand on the solid foundation of economic reality. *Markosian v. Commr.*, 73 TC 1235 (1980).

In many respects, the two sham theories (i.e., the sham entity and the sham transaction theories) are the same. Both sham theories concentrate on business profit and/or economic substance issues. However, because some courts have made some minor differences in the analysis, both theories are analyzed separately in this outline.



SHAM ENTITY

The sham entity theory looks at the particular entity or entities involved, rather than the entire transaction. To date, the sham entity analysis has generally has been applied to "sham trusts." However, the sham rule applies regardless of whether the entity has a separate existence recognized under state [or international] law and whether, in form, it is a trust, a common-law business trust, or some other form of juristic entity. *Bordor, Frank*, TC Memo 1993-456; Zmuda *v. Comm.*, 731 F.2d 1417 (9th Cir. 1984); *Golsen v. Commr.*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971). While courts holding an entity is a sham may use a slightly different analysis (depending on whether the entity is a trust, corporation, or partnership), as noted previously, the central theme through the analysis is did the entity have a business or economic purpose other than the tax benefits. *Zmuda v. Commr.*, 731 F.2d 1417 (9th Cir. 1984); *Able., Able Company*, TC Memo 1990-500; *Visnapuu, Herk*, TC Memo 1987-354; *Merryman v. Commr.*, 873 F.2d 879 (5th Cir. 1989).

I Sham Trust

Under the sham trust analysis, in order to support a deduction, the requisite "payment" must be one in substance, not merely in form, and must be made to an entity with economic substance which is recognized for Federal tax purposes. *Professional Services v. Commr.*, 79 T.C. 888 (1982). If a transaction has not altered any cognizable economic relationships, the court may look beyond the form of the transaction to the substance of the transaction. *Markosian v. Commr.*, 73 T.C. 1235 (1980). The principle of looking to the substance of the transaction applies regardless of whether the transaction creates a separate entity under state (local or international) law. *Zmuda v. Commr.*, 79 TC 719, 720 (1982). While some courts have held whether a trust is a sham (i.e., lacks economic substance) is a factual question that must be determined by each case (*Professional Services v. Commr.*, 79 TC 888 (1982), most courts use the following four factor test given in *Markosian v. Commr.*, 73 TC 1235, 1243 (1980):

SHAM ENTITY CONTINUED

1. Whether the taxpayer's relationship, as grantor, to the property purportedly transferred into trust differed materially before and after the trust's formation;
2. Whether the trust had a bona fide independent trustee;
3. Whether an economic interest in the trust passed to trust beneficiaries other than the grantor; and
4. Whether the taxpayer honored restrictions imposed by the trust or by the law of trusts.

II Corporation Sham Analysis

A corporation is to be recognized as a separate taxable entity if (1) the purpose of the formation of the corporation is the equivalent of a business activity or (2) the incorporation is followed by a carrying on of the business. *Moline Properties v. Commr.*, 319 U.S. 436 (1943). A corporation is not treated as carrying on a business merely because it engages in certain corporate formalities such as holding corporate meetings, adopting bylaws, electing officers and directors, issuing securities and keeping separate books. *Aldon Homes, Inc. v. Commr.,* 33 T.C. at 600. Further, a corporation is not treated as carrying on a business if its activities such as executing contracts and filing tax returns are merely "empty gestures" rather than substantial transactions. *Kimbrell v. Commr.*, 371 F.2d 897 (5th Cir. 1967). However, a corporation which in addition to engaging in corporate formalities holds itself out to unrelated third parties and engages in substantial business activities will be held to have carried on a business. *Skarda v. Commr.,* 250 F.2d 429 (10th Cir. 1957).

In *Visnapuu, Herk*, TC Memo 1987-354, the Tax Court utilized the following factors when classifying a corporation as a sham:

1. The corporation never paid salaries, wages, or officer's compensation to any individual. In fact the corporation had no employees;
2. The address for the corporation was the same as that of a related party, and the corporation did not maintain a telephone listing;
3. The owner, Visnapuu, never held himself out to third parties for services, rather his consulting fees billed by the sham corporation were exclusively billed to another corporation owned by Visnapuu;
4. Visnapuu controlled both entities.

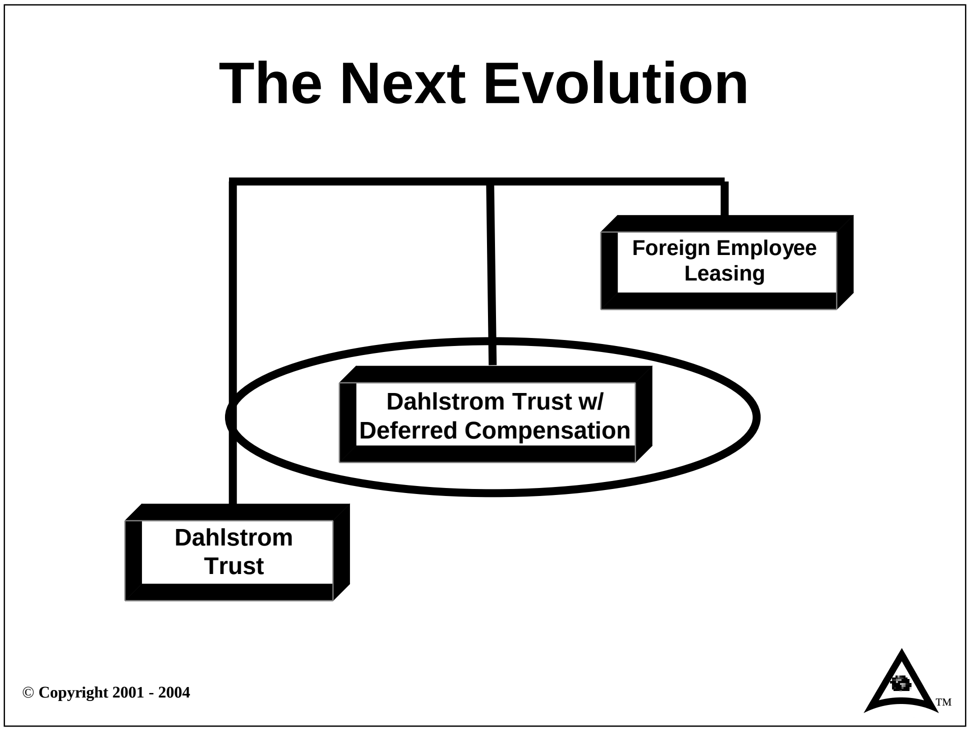
In *Zand, J.J.,* TC Memo 1996-19, a Bahamian corporation set up merely to receive commissions earned by the taxpayer, didn't engage in a business activity. It's only purpose was to hold funds in a tax haven jurisdiction.

III Sham Partnership

There are few cases regarding a partnership sham analysis. However, one of particular importance is *Merryman v. Commr.*, 873 F.2d 879 (5th Cir.), affd. TC Memo 1988-72. In this case, owners of a closely held corporation created a partnership, the closely held corporation sold an oil rig to the partnership, and then the closely held corporation leased the oil rig back to the partnership. The Fifth Circuit held that the partnership lacked economic substance and was merely an instrument used by the corporation to pass through losses and investment tax credits. In addition, the circular flow of money between the related entities with no alterations of economic position indicated that the partnership was a sham for tax purposes.

Penalties Under Sham Analysis

- Negligence Penalty 20%
- Substantial Understatement 20%
- Civil Fraud – 50%
- Possible Criminal Fraud –
  - Free Trip to Club Fed
- Failure to file form TDF 90.22-1
- Interest



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The second primary method to move money offshore is the use of a phony consulting deduction that is paid by the client's U.S. business to an offshore entity. The following three tax motivated structures have been utilized this way.

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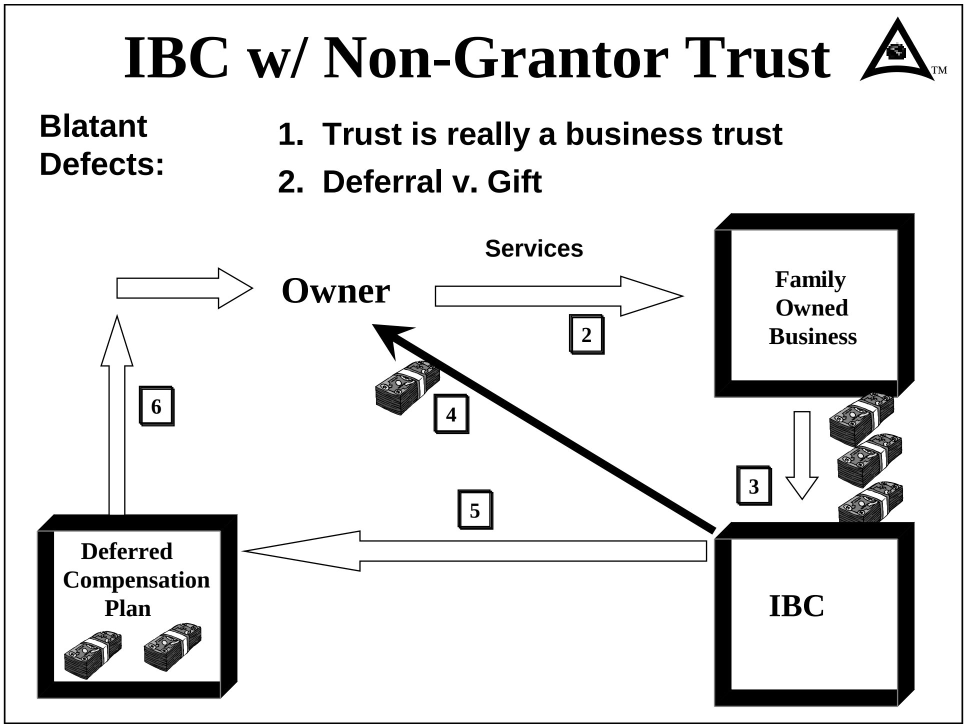


IBC W/ NON-GRANTOR TRUST

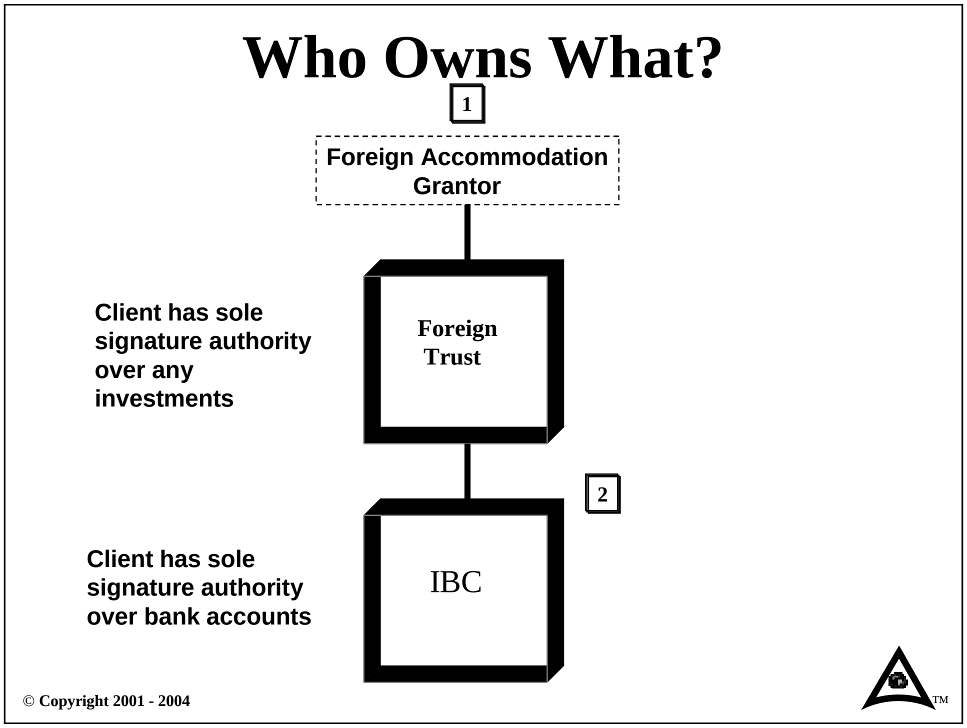
I Evolution of the Dahlstrom Trust

After the Dahlstrom Trust, the next evolutionary step was an attempt to correct some of the blatant defects. One of the fundamental mistakes in the Dahlstrom Trust structure was that the Dahlstrom Trusts were definitely business trusts. As such, they would be taxed either as a corporation or a partnership. Treas. Reg. 301.7701-2. Therefore, the next evolution attempted to correct this defect by adding an offshore deferred compensation plan and an International Business Company ("IBC").

Under this structure, rather than attempting to argue when the money was returned to the client that it was tax free, the new technique would be a tax deferral.

II Transaction Begins the Same

Similar to the Dahlstrom Trust, the transaction begins the same where the client claims to be now working for the offshore IBC and charges a management fee to the family owned business for "international business consulting services. However, pursuant to an agreement with the offshore IBC, almost all of the money transferred to the offshore IBC is set aside in a deferred compensation plan. Later, when the client "partially retires," the amounts are paid from the deferred compensation plan to the client. In this respect, the IBC and the deferred compensation plan act as a tax deferral.



WHO OWNS WHAT?

III Foreign Accommodation Grantor

In most situations, the client wishes to maintain control over the IBC. Therefore, a foreign accommodation grantor creates a foreign trust and funds the trust with a nominal amount – typically a couple of thousand of dollars. Then the foreign trust forms the IBC. The client is typically the investment manager of the trust with all voting control and usually signature authority over the IBC. The client also has the power to remove the offshore trustee without cause. Generally, the offshore trustee has no authority over any liquid assets in the structure.

IV The Names are Slightly Different, But the Objective Somewhat the Same

While the names have been changed, the objectives of the IBC combined w/ the non-grantor trust are similar to the Dahlstrom trust. Here, the client obtains a tax deferral through a completely phony management consulting deduction.

Penalties if Sham Transaction

- Negligence Penalty 20%
- Substantial Understatement 20%
- Civil Fraud – 50%
- Possible Criminal Fraud –
  - Free Trip to Club Fed
- Failure to file form TDF 90.22-1
- Interest

SERVICE COULD ARGUE SHAM, BUT WHY?

V Sham Argument

With either the sham trust or sham transaction argument, the entire structure is disregarded.

VI What if the Service Argues the Trust is Valid, Except an Accommodation Grantor?

However, much greater penalties could be imposed if the Service could argue that the foreign trust was valid, just that the taxpayer should be deemed the grantor. In this case, the taxpayer would not have filed the proper foreign trust tax returns – Forms 3520 and 3520-A. The penalties for not filing the foreign trust reports, for not properly filing the payroll tax reports and the unreported U.S. source income would easily exceed the penalties under the sham theories of taxation.

Service Could Argue Sham, But Why?

- Failure to File Foreign Trust Returns
  - Form 3520 - 35% FMV
  - Form 3520-A - 5% FMV
  - Applies also to the deferred comp plan
- Tax at the Corp Level plus penalties
- Payroll withholding (941s) – 25 to 50%
- Tax at the Indiv Level if deferred comp fails
- TDF 90-22.1

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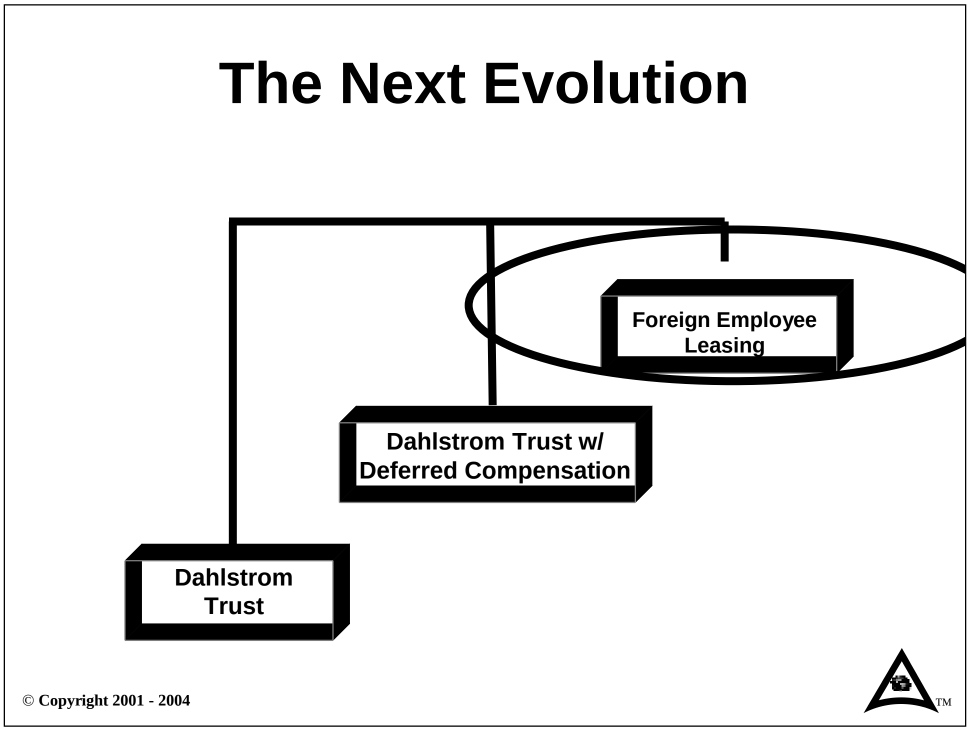

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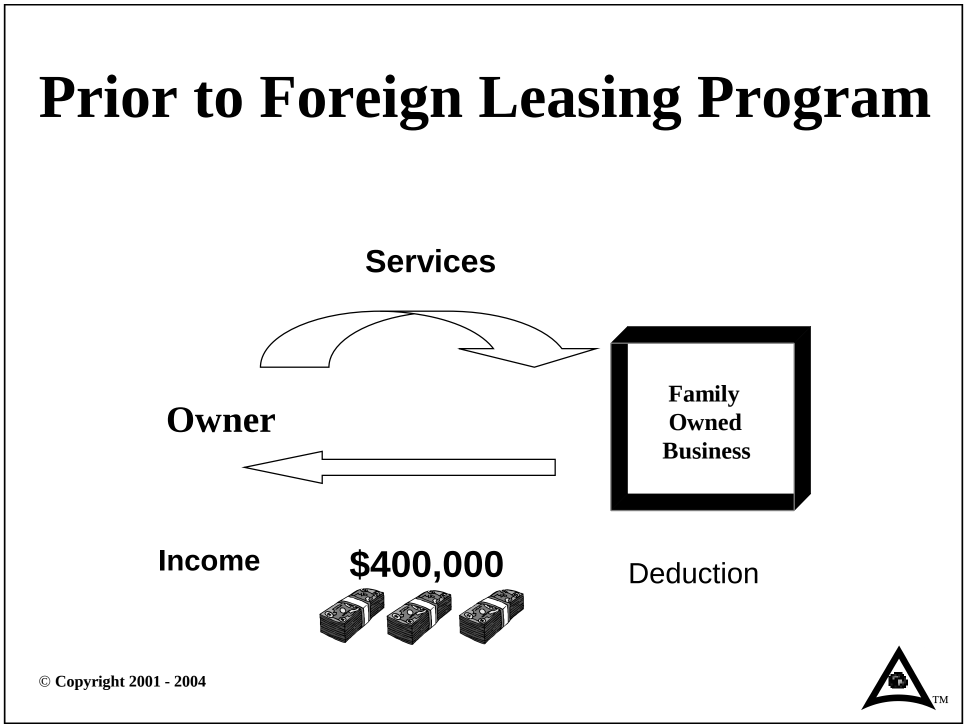


PRIOR TO THE FOREIGN LEASING PROGRAM

I Definition

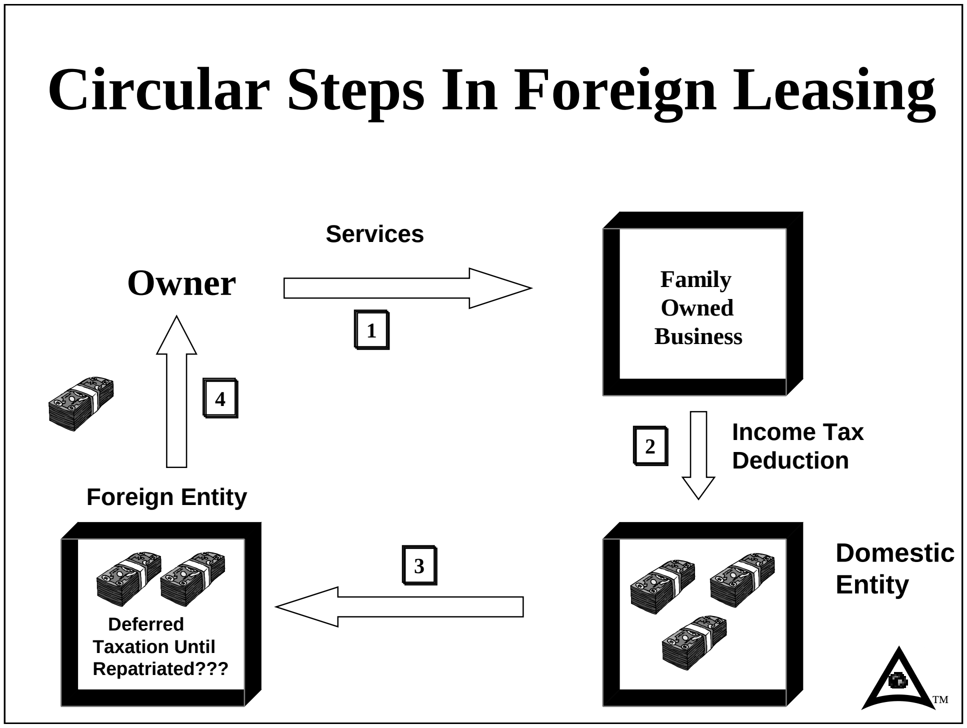
Prior to implementing the foreign leasing program, the owner is paid a salary for his services to the family owned business. The family owned business records an income tax deduction, and the owner pays income tax on such income. In the above example, the family owned business deducts the $400,000, and the owner pays income tax on the $400,000.

II Either the Owner or the Family Owned Business Pays Tax

Under this arrangement, either the owner or the family owned business pays tax, since both are domestic tax payers. In the event the owner's salary is reduced to $100,000, then the family owned business's income would be increased by the difference of $300,000, and the family owned business would pay the tax on the $300,000 difference.

III Foreign Employee Leasing

The foreign employee leasing program attempts to delay the imposition of tax by inserting a foreign entity into the equation.



CIRCULAR MOVEMENT OF MONEY

I. Objective of a Foreign Leasing Program

The objective of most foreign leasing programs is to defer the time when income is reported by a U.S. taxpayer. The entire question regarding the validity of a foreign leasing program begs the question, can a U.S. person enter into an arrangement with a series of entities, some of which are offshore,

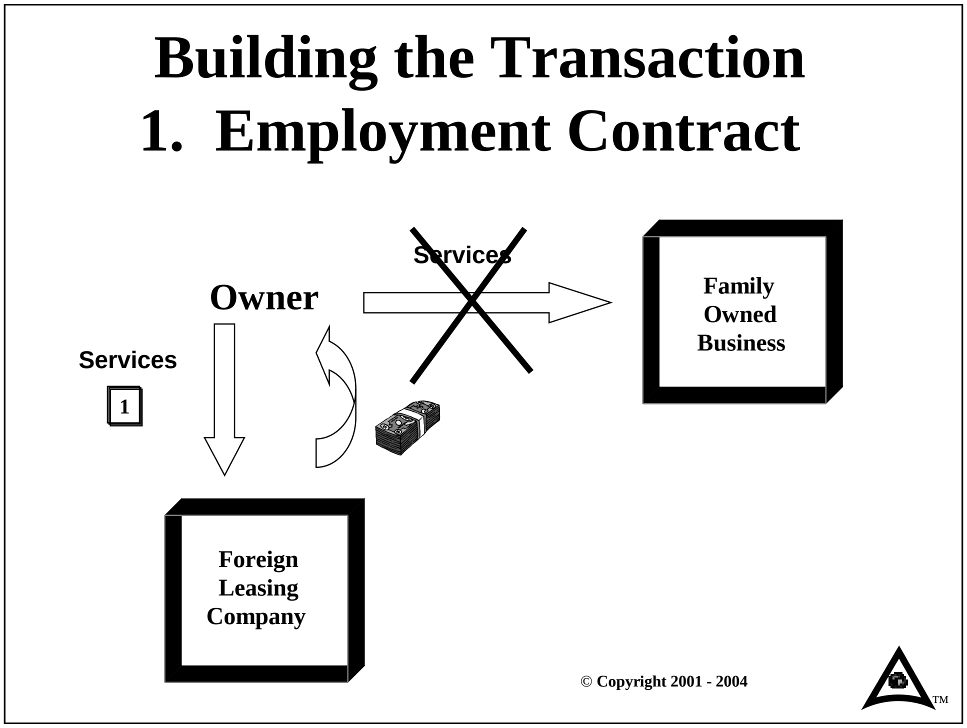
(1) take a deduction on his family business tax return (income tax benefit),
(2) move the money offshore (without incurring a tax);
(3) let the money (including the income tax benefit) grow tax free; and
(4) later have the compounded income tax free money returned and taxed when it is repatriated (returned) to the U.S.

II. Taxation of a Domestic Transaction

If the transaction involves only U.S. (i.e., domestic) entities, the U.S. taxpayer will not be able to achieve any tax deferral. Either the U.S. taxpayer or the domestic entities involved in the transaction will pay the tax on the related income.

III. World-Wide Taxation

A. U.S. person is subject to world-wide taxation. If a U.S. person owned the foreign entity, no estate tax savings would be achieved due to the anti-deferral rules regarding service income.



EMPLOYMENT CONTRACT

I. Employment By the Foreign Leasing Company

The owner/employee severs his employment relationship with his family owned business. Instead, he enters into an “employment contract” with a foreign leasing company where the foreign leasing company has the right to lease the employee’s services on a world-wide basis.

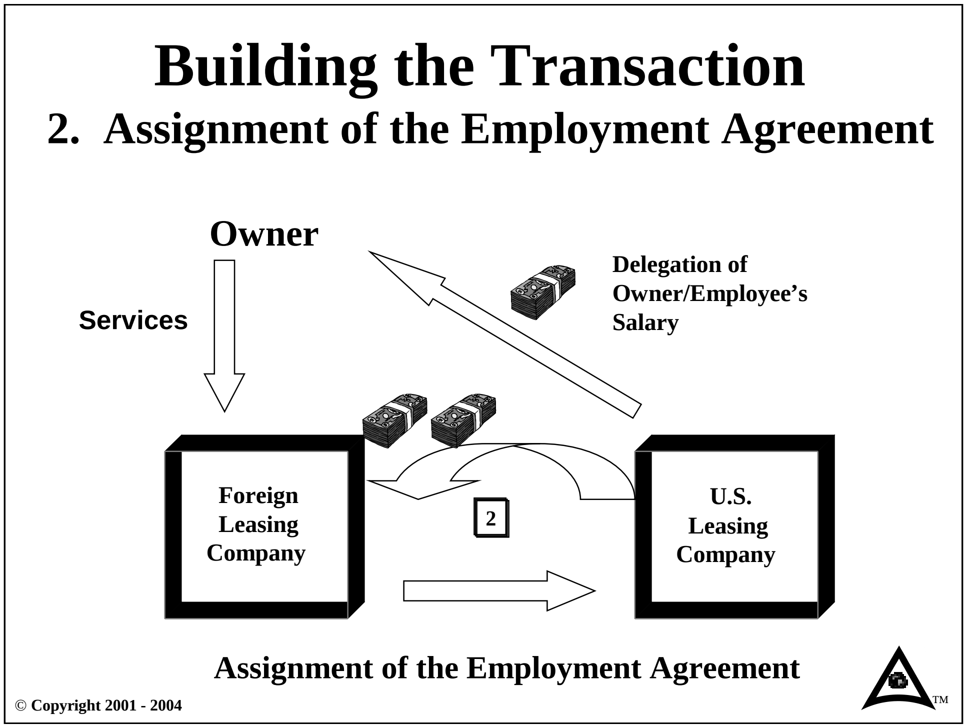
II. Terms of the Employment Contract

The employee typically receives the following benefits:

1. A nominal base salary when compared to the overall compensation that he was making with the family owned business;
2. A deferred compensation package that represents the difference between the nominal salary and the compensation the owner/employee was previously making with the family owned business;
3. life insurance, which would not be deductible had a domestic company purchased it on behalf of an owner; and
4. An international business credit card that is used for the employee to charge so called business expenses (some that would normally be partially non-deductible in the U.S. such as entertainment).

III. Deferred Compensation Agreement

Sometimes the deferred compensation agreement is a separate agreement that references the employment agreement. Other times, the deferred compensation agreement is embodied in the employment agreement. Some deferred compensation agreements do not tie the employee’s compensation to the net profits of the family owned business. Further, the deferred compensation agreement does not allow the employee the ability to determine when such compensation shall be paid.



ASSIGNMENT OF THE EMPLOYMENT AGREEMENT

I. Assignment or Sale of the Employment Agreement

Some foreign leasing programs refer to this part of the transaction as an assignment, other foreign leasing programs refer to it as a sale, finally some refer to this as a "loan-out" transaction. Regardless of the name assigned to the contract, in essence the foreign leasing company is selling all of its rights to the owner/employee domestic (i.e., U.S.) employment to a U.S. leasing company.

II. Terms of the Assignment of Employment Agreement

There are two primary parts to the assignment of employment agreement: (1) transfer of virtually all of the compensation of a business consultation agreement (discussed on the next page) to the foreign leasing company and (2) delegating the payment of the owner/employee's salary to the U.S. leasing company.

A. Transfer of All the Profit

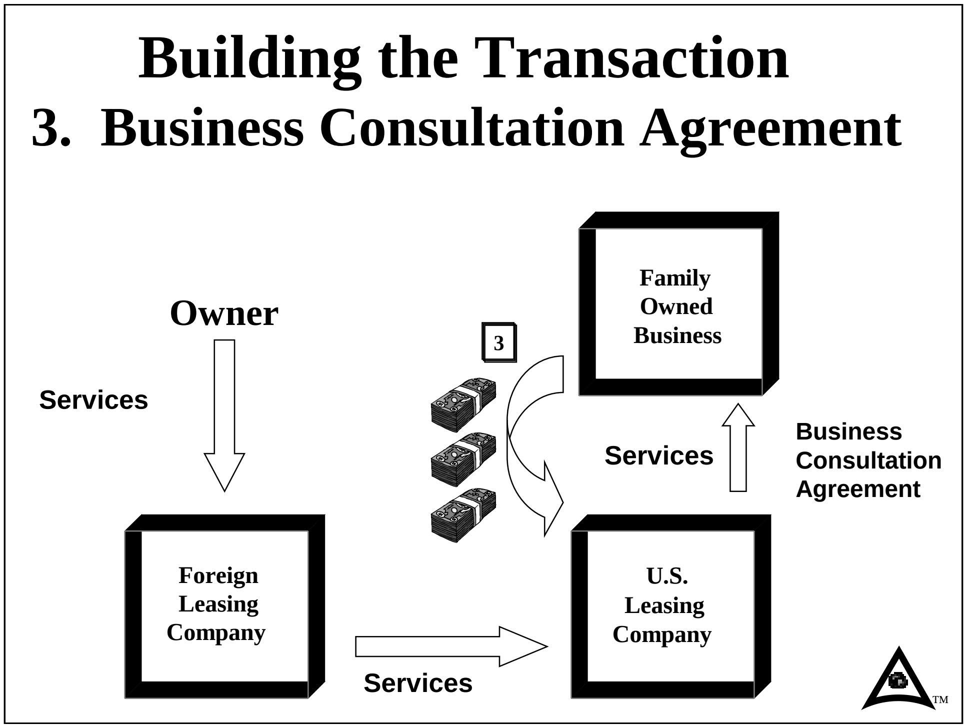
As noted before, the purpose of an offshore foreign leasing program is to move the money offshore, purportedly allow it to grow tax free, and defer the taxation on this income until it is returned to the U.S. Therefore, typically, the U.S. leasing company is guaranteed a profit equal to two to three percent of the total amount received under the business consulting agreement.

B. Payment of the Owner/Employee Salary

The U.S. leasing company also agrees to pay a modest salary to the owner/employee. Typically this amount is between one-quarter to one-half of what the owner employee previously received from the family owned business.

C. Taxation

The foreign leasing company claims it is not subject to U.S. taxation, because purportedly it is not engaged in a U.S. business.



BUSINESS CONSULTING AGREEMENT

I. Siphoning Out the Profits of the Family Owned Business

The family owned business is a domestic entity that is either subject to U.S. taxation (i.e., C corporation) or its owners are subject to tax on its income through a flow-through entity (i.e., partnership, S corporation, or disregarded entity). The purpose of the foreign leasing program is to create an income tax deduction on the family owned business, transfer the profits to the foreign leasing company, have the money grow offshore tax free, and return the money at a later point in time.

II. Terms of the Business Consulting Agreement

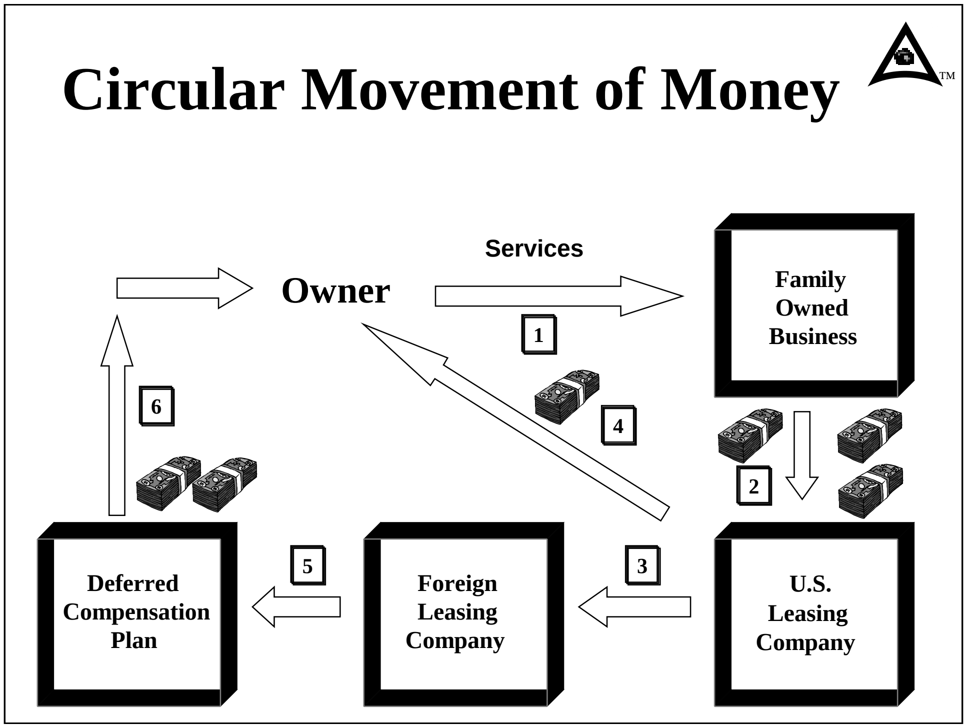
The terms of the business consulting agreement typically contain two compensation elements that are paid to the domestic leasing company: (1) a guaranteed amount plus (2) a profits amount.

A. Guaranteed Amount

The guaranteed amount is typically double to four times the amount the owner employee receives under the employment agreement with the foreign leasing company (discussed previously). Typically, the guaranteed amount is calculated so that it substantially reduces the profits of the family owned business. Some foreign leasing programs adjust this amount annually so that zeroing out the family owned business profits is almost assured. Other foreign leasing programs use a profits formula to help reduce the income of the family owned business.

B. Profits Amount

With many of the foreign leasing programs, the domestic leasing company also receives a profits amount. The profits amount is typically equal to 50% to 90% of the family owned business. Again, this part of the compensation element is designed to substantially reduce any possible profit of the family owned business.



CIRCULAR MOVEMENT OF MONEY

I Services

After implementation of the foreign leasing program, the owner/employee is still performing services for the family owned business. However, rather than directly contracting with the family owned business, the owner/employee's services are provided under the Business Consulting Agreement.

II Income Siphoned From the Family Owned Business to the Domestic Leasing Company

As previously discussed, most of the profit of the family owned business and the prior owner's compensation is transferred to the domestic leasing company under the Business Consulting Agreement. The family owned business takes an income tax deduction for all amounts paid to the domestic leasing company.

III Income Siphoned From the Domestic Leasing Company to the Foreign Leasing Company

Under the terms of the Assignment Agreement, by formula, almost all of the profits of the domestic leasing company are siphoned to the offshore leasing company. The foreign leasing entity typically retains a two to four percent fee.

IV Payment of a Modest Salary

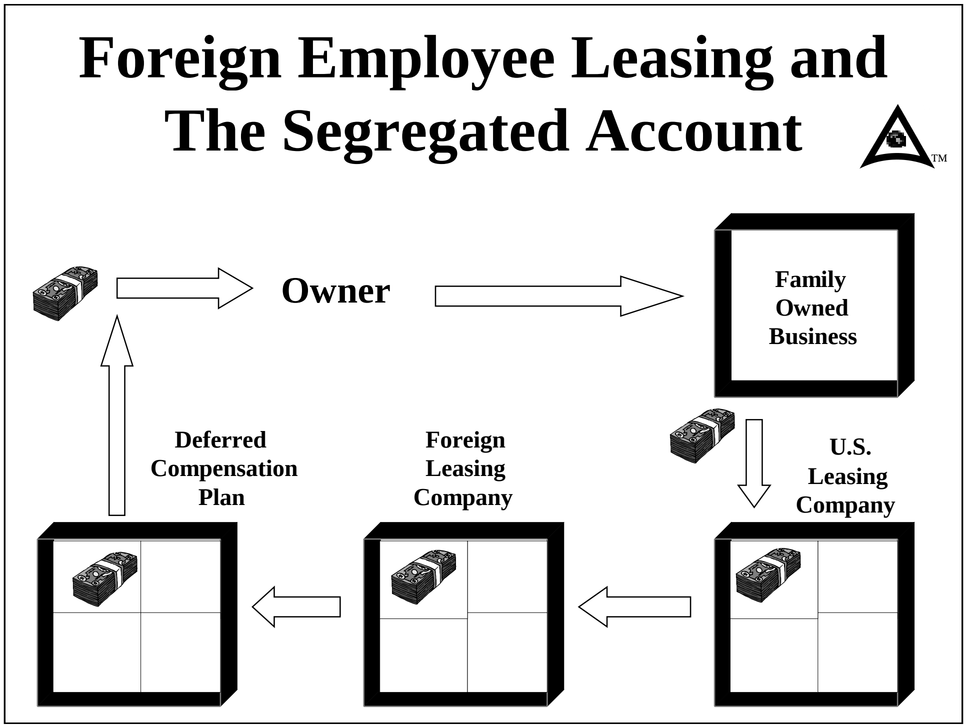
Pursuant to the Assignment Agreement, the offshore leasing company pays a modest salary to the owner/employee.

V Deferred Compensation Program

After the foreign leasing company takes a two to five percent fee, the remainder of the funds (i.e., the difference between the amount siphoned from the family business and the modest salary) is placed in a deferred compensation program for the benefit of the owner/employee.

VI Repatriation

At sometime in the future, usually retirement or by mutual agreement, the deferred compensation is reported by the owner/employee as ordinary income.



THE SEGREGATED ACCOUNT

I Services

After implementation of the foreign leasing program, the owner/employee is still performing services for the family owned business. However, rather than directly contracting with the family owned business, the owner/employee's services are provided under the Business Consulting Agreement.

II Income Siphoned From the Family Owned Business to the Domestic Leasing Company

As previously discussed, most of the profit of the family owned business and the prior owner's compensation is transferred to the domestic leasing company under the Business Consulting Agreement. The family owned business takes an income tax deduction for all amounts paid to the domestic leasing company.

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IV Payment of a Modest Salary

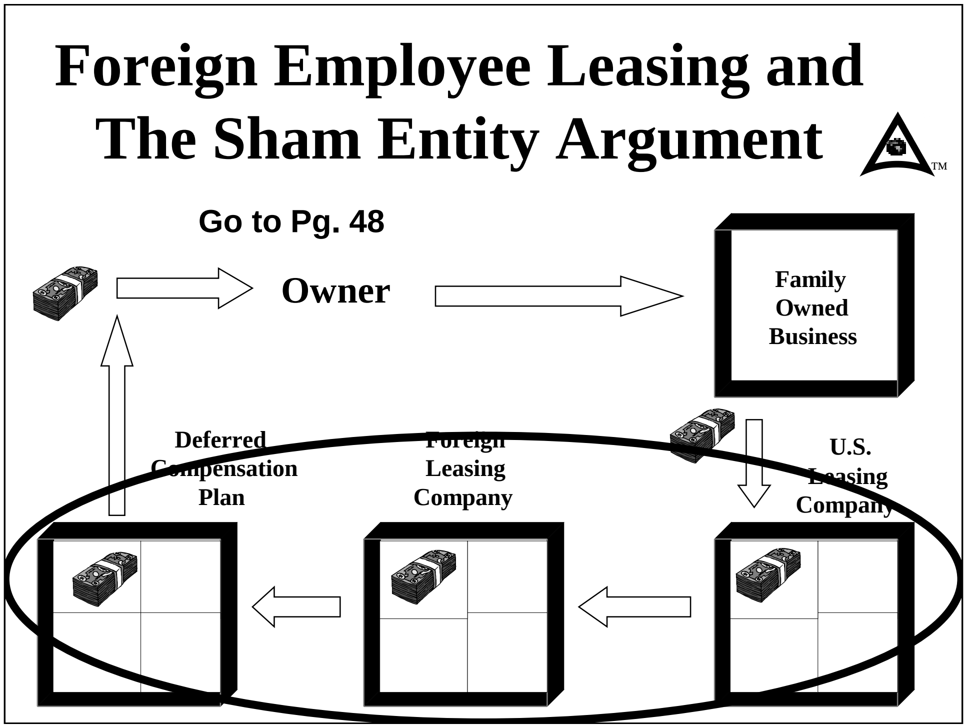
Pursuant to the Assignment Agreement, the offshore leasing company pays a modest salary to the owner/employee.

V Deferred Compensation Program

After the foreign leasing company takes a two to five percent fee, the remainder of the funds (i.e., the difference between the amount siphoned from the family business and the modest salary) is placed in a deferred compensation program for the benefit of the owner/employee – in a segregated account.

VI Repatriation

At sometime in the future, usually retirement or by mutual agreement, the deferred compensation is reported by the owner/employee as ordinary income.



THE SHAM ENTITY ARGUMENT

I Compared to a Dahlstrom Trust

In essence, the foreign leasing program attempts to adapt the Dahlstrom trust circular movement of money with a few key differences. First, the owner of the family business does not own either the domestic leasing company or the foreign leasing company. Second, the owner of the family leasing business does not directly control the operations of either the domestic leasing company or the foreign leasing company (however, as discussed below, there is quite a bit of indirect control with the Hunter/Chatzky structure), and third the income is not returned tax free as a gift, rather the transaction is a tax deferral.

II Ownership

In the sham entity analysis, ownership of the entities is not a primary factor that the courts emphasize. Rather, the courts are more concerned with has any relationship changed after the structure has been implemented. *Markosian v. Commr.*, 73 TC 1235 (1980). As applied to the foreign leasing program, the owner was an employee of the family owned busines ("the Company") before the foreign leasing program, he still performs the exact same services after implementation of the foreign employee leasing program. Nothing has changed regarding the owner's relationship to the Company.

III Control

Control is a factor that the Court's consider. Under the foreign leasing program, one might argue that the owner of the family owned business is not a director or officer of either the domestic or foreign leasing corporation. Therefore, the taxpayer does not control these entities. The issue of control is not entirely dependent on whether the taxpayer is an officer or director. Rather, the issue is whether the officers of the foreign leasing company will follow the directions of the taxpayer. In particular, can the owner direct the return of his share of the deferred compensation plan or could can he direct the investments of the deferred compensation plan?

Summary of the Sham Entity Theory

- **Foreign Employee Leasing Program Properly Operated Most Likely Fails the Sham Entity Test**
- **Implied Agreements Definitely Fail the Sham Entity Test**
- **Ability to Demand Money is Constructive Receipt and the Program Fails**
- **The Single Purpose Domestic Leasing Structure Fails in Itself**

SUMMARY OF SHAM ENTITY

When summarizing the Dahlstrom Trust, the Tax Court noted that it was "nothing more than a device used to siphon funds from Dale Sandvall's business through another entity before those funds made their way back to the petitioner, all in disregard of the most fundamental rules of Federal income taxation. {Emphasis Added}" Sandavall v. Commissioner, 57 T.C.M. (CCH) 238 (1989)

As noted before, the foreign employee leasing program is a variation of the Dahlstrom Trust with a few key differences. Unfortunately, the differences of removing a degree of control (and possibly ownership) from the taxpayer are not significant enough to remove it from the sham entity theory. Even with a properly implemented structure, it is most likely that the Service would prevail under a sham entity argument.

Sham Transaction Theory

- **Business Purpose** – Usually a subjective test, did the business owner plan on making a profit
- **Economic Profit** – Usually based on the following criteria:
  - – Circular Movement of Money
  - – Lack of an Arm's Length Arrangement
  - – Economic Profit – Absent the Tax Affect
- 4th Circuit Requires Both;
- 11th Circuit Either;
- 9th, 8th, 6th – Pornography Test

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SHAM TRANSACTION THEORY

I General

The sham transaction theory is a separate and distinct argument that the Service may utilize other than the sham entity theory. While both sham theories concentrate on whether there was a business purpose and/or economic substance to the transaction, the sham transaction theory attacks the entire transaction. The sham entity theory attacks the specific entity.

II Test

In *Lyons v. U.S.*, 435 U.S. 561 (1978), the Supreme Court utilized a two prong test to determine whether a transaction would be classified as a sham. Under the two prong test, the taxpayer must have a business purpose and the transaction must have economic substance.

The Circuits are split over how exactly this is applied. The Fourth circuit has held that both prongs of the test must be satisfied in order for a transaction to be classified as a sham. *Rice's Toyota World Inc. v. Com.*, 752 F2d 89 (4th Cir. 1985). The Eleventh circuit has held that if either prong of the two prong test is satisfied, the transaction is a sham. *Winn-Dixie Stores, Inc. & Subsidiaries v. Com.*, 254 F. 3d 1313 (11th Cir. 2001). Other Circuits, while acknowledging the usefulness of the two-pronged test, have held that the application of the test should not be a rigid two step analysis. *Sochin v. Commr.*, 843 F2d 351 (9th Cir. 1988), cert den. 488 US 824 (1988); *Hutchinson v. U.S.*, 67 AFTR 2d 91-502 (DC Or 1990); *Shriver v. Comm.* 899 F2d 724 (8th Cir. 1990); *Rose v. Comm.*, 868 F2d 851 (6th Cir. 1989). At this point, the 10th Circuit has not ruled whether one prong, both prongs, or a list of factors should be utilized to determine whether a transaction is a "sham" transaction.

TEST CONTINUED

A. Business Purpose

The business purpose test is a subjective test, but a factual analysis, often involving an analysis of the taxpayer's motives in making the transaction. ***Hutchinson v. U.S.***, 67 AFTR 2d 91-502 (9th Cir. 1990). It involves consideration of whether the taxpayer had an "actual and honest" profit objective. ***Shriver v. Commr.***, 899 F.2d 724 (8th Cir. 1987); ***Rasmussen, Tommie***, TC Memo 1992-212.

1. Marketing or consulting company a sham. It had no employees, no telephone listings, the same address as the corporation. ***Visnapuu, Herk***, TC Memo 1987-354.
2. Bahamian corporation set up merely to receive commissions lacked a business purpose. The corporation didn't engage in any business activity and its only purpose was to hold funds in a tax haven jurisdiction. ***Zand, J.J.,*** TC Memo 1996-19, affd. 143 F.3d 1393 (11th Cir. 1988).
3. In *Able Co.,* TC Memo 1990-500, the Petitioner admitted that the Dahlstrom trust had no business function other than the generation of tax deductions. Therefore, the Tax Court found the foreign business trust organizations to be sham entities without any economic purpose.

Similar to the Dahlstrom trust, a foreign employee leasing program has no business purpose other than a generation of the tax deductions. For this reason, it is most likely that a foreign employee leasing program will fail the business purpose test. However, an interesting point of analysis has been brought out in the Eleventh Circuit court's recent case of *United Parcel Service v. Comm.,* 87 AFTR 2d 2001-2565 (11th Cir. 2001)..

In *United Parcel Service,* in a two to one decision, the Eleventh Circuit has said that the requirement that a transaction have economic effect and a business purpose will be satisfied where the transaction involves the structure of a bona fide profitable business. After the restructuring, UPS paid the EVCs (Excess Value Contracts) it collected from customers to an unrelated domestic insurer (D) as insurance premiums, and D paid the EVC's, minus a fee, to taxpayer's Bermuda reinsurance subsidiary, to reinsure D's risks. The Bermuda reinsurance company was owned by the same shareholders that own UPS. The transaction had economic effect because: (1) it created a genuine obligation enforceable by an unrelated party, i.e., the insurance policy between taxpayer and D; and (2) the second business entity was an independent profitable taxable entity. The Eleventh Circuit viewed the transaction as simply altering the form of the taxpayer's existing, bona fide business.

It should be noted that the Eleventh Circuit Court distinguished the UPS tranasaction from the Dahlstrom Trust type of cases where an individual meant to "evade taxes on income probably destined for personal consumption." Further, the foreign employee leasing program may be distinguished from the UPS reinsurance arrangement. First, as noted by the 11th Circuit, in the UPS transaction, the unrelated domestic insurer did have a risk of loss (even though it was a small risk of loss). This is not the case with foreign leasing programs; they do not insure against any risk of loss. Rather, they merely collect a percentage fee to generate a tax deduction that would not be available domestically. Second, the Bermuda reinsurance company in the UPS case was a profitable business due to an income stream lost by UPS. The foreign employee leasing program involves only creation of a deduction with the promoters charging a service fee. Therefore, it is unlikely that the UPS case will materially affect the sham transaction nature of a foreign leasing company transaction.

B. Economic Profit

The economic substance test for determining if a transaction is a sham involves a determination of whether, from an objective standpoint, the transaction is likely to produce economic benefits aside from a tax deduction. ***Casebeer, Harvey***, 909 F.2d 1360 (9th Cir. 1990). A realistic potential for profit exists when the transaction is carefully conceived and planned in accordance with standards applicable to the relevant industry, so that a reasonable businessman, using those standards, would make the investment. ***Cherin, Ralph***, 89 TC 986 (1986). Factors considered by the courts in determining whether a transaction had economic substance are:

Whether the transaction involves the circular movement of money;

Whether the transaction is at arms-length;

Whether the taxpayer controls the transaction.

1. Circular Movement of Money

One of the key factors the Tax Court has used to identify a sham transaction is the circular movement of money. The Tax Court noted that the "circular flow has consistently been regarded by this Court as compelling evidence that arrangements involving multiple trusts lack economic substance." ***Professional Services v. Commr.***, 79 TC at 928; ***Denali Dental Services***, TC Memo 1989-482; ***Tatum v. Commr.***, TC Memo 1990-119; ***Akland v. Commr.***, TC Memo 1983-249; ***Anderson v. Commr.***, TC Memo 1994-366, 103 F3d 406 (9th Cir. 1997). As detailed throughout this outline, the core design of the foreign leasing program is the circular movement of money.

2. Arms-Length Transaction

In order for a tax motivated structure to work, the profits of the family owned business must be siphoned offshore through a tax deduction. Generally, since the owner's salary is insufficient to accomplish this objective, it must be inflated by using a profits formula as an additional compensation element. With most foreign leasing programs (including the Hunter/Chatzky foreign leasing program), a reasonable compensation analysis or study of the owner is not performed. Rather, the owner's salary is an artificially inflated salary designed to siphon out the income of the family owned business. The Tax Court's review of the following cases regarding similar types of transactions resulted in the following holdings:

Tax court held the management agreement was a sham based on both an excessive agency commission and the arbitrary cap on fees at one million dollars. ***Portermain, Neill***, TC Memo 1989-539.

Where taxpayer's business premises were leased to a Dahstrom type trust at twice the market price, the transaction was not arms-length and the foreign trust was nothing more than a device to siphon profits out of a business and later return them to the taxpayer. ***Sandvall, Dale K.***., TC Memo 1989-189; ***Professional Services v. Commr.***, 79 TC 888 (1982).

Where goods were sold by a Dahlstrom type trust to the taxpayer's domestic business at an artificially high purchase price, the effect was to siphon the profit out of the domestic business. There was no arms-length agreement. ***Akland, et. al. v. Comm.***, 767 F.2d 618 (9th Cir. 1985).

3. Control

As discussed before under the sham entity analysis, the client holds enough control over the structure to constitute a sham entity.

Summary of the Sham Transaction Theory

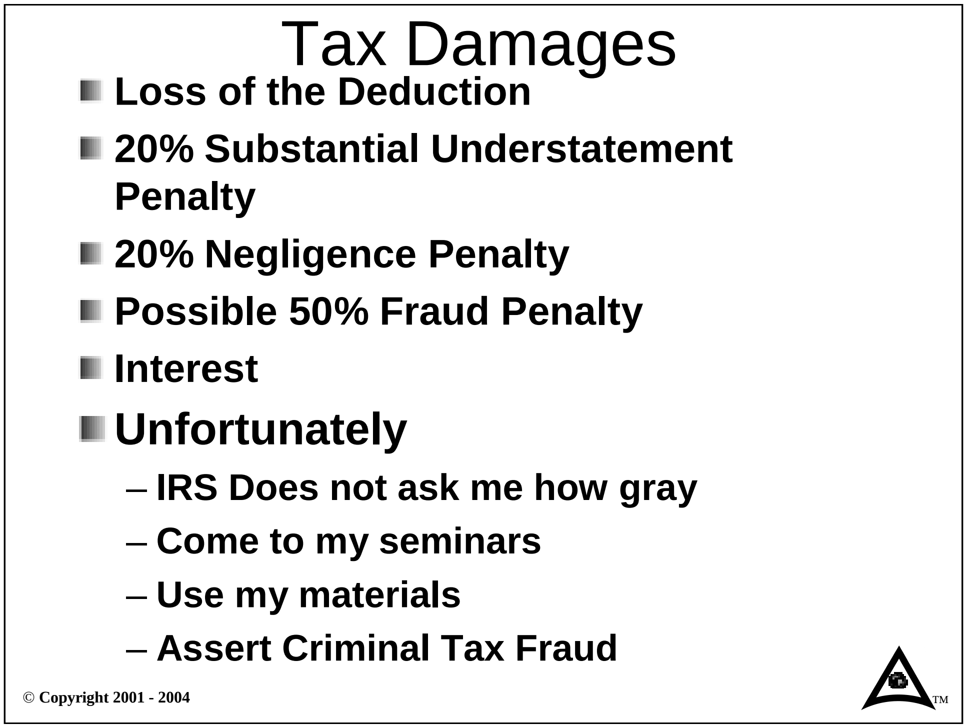
- **Foreign Employee Leasing Program Has No Business Purpose Other Than Generate Deductions**
- **Foreign Employee Leasing Program Has No Economic Profit Other Than The Tax Deduction**
  – Circular Movement of Money Designed to Siphon The Profits Out of the Business
  – No Arm's Length Transaction
  – Indirect Control Over the Receipt of Funds

SUMMARY OF SHAM TRANSACTION THEORY

Under the subjective business purpose test, as to the owner and the Company., the only purpose of the foreign leasing transaction is to reduce taxes. Neither the owner nor the Company have any foreign operations. Further, neither the owner nor the Company has created any offshore profitable business.

Under the economic profit test, the entire purpose of the foreign leasing program is to create a circular movement of money that siphons the profits out of Dawson Resources, Inc. No independent study was done to determine whether the transaction was arms length, and the owner typically has the power to demand the return of the deferred compensation at anytime. Based on these facts, there is no economic profit in a foreign leasing program.

Since the foreign leasing program fails both prongs of the two-prong test as well as the factors that are frequently cited by the circuit courts, it really does not matter in which circuit the case is decided. In any circuit, it is most likely that the foreign leasing program will constitute a sham transaction.



TAX DAMAGES

I. Loss of Tax Deduction

Under the sham theories, the entity or transaction is completely disregarded. Therefore, the Company would be taxed on the entire amount remitted through the foreign leasing program.

II Double Tax Issue

One might think that the damages would be merely the loss of the tax deduction. However, in the Company's case, the corporation is a C-corporation, subject to a double taxation issue. While the foreign leasing program is not responsible for the entity selection of the Company, it is responsible for documenting an artificially low salary that will result in a double tax issue.

III Substantial Understatement Penalty

Under Section 6662(b)(2), there is a 20% penalty if the amount of tax is understated by 10% or more of the amount shown on the return. In all the years in question, the foreign leasing program reduced the amount of tax well in excess of the 10% amount. Therefore, the substantial understatement penalty will be imposed.

IV Negligence Penalty

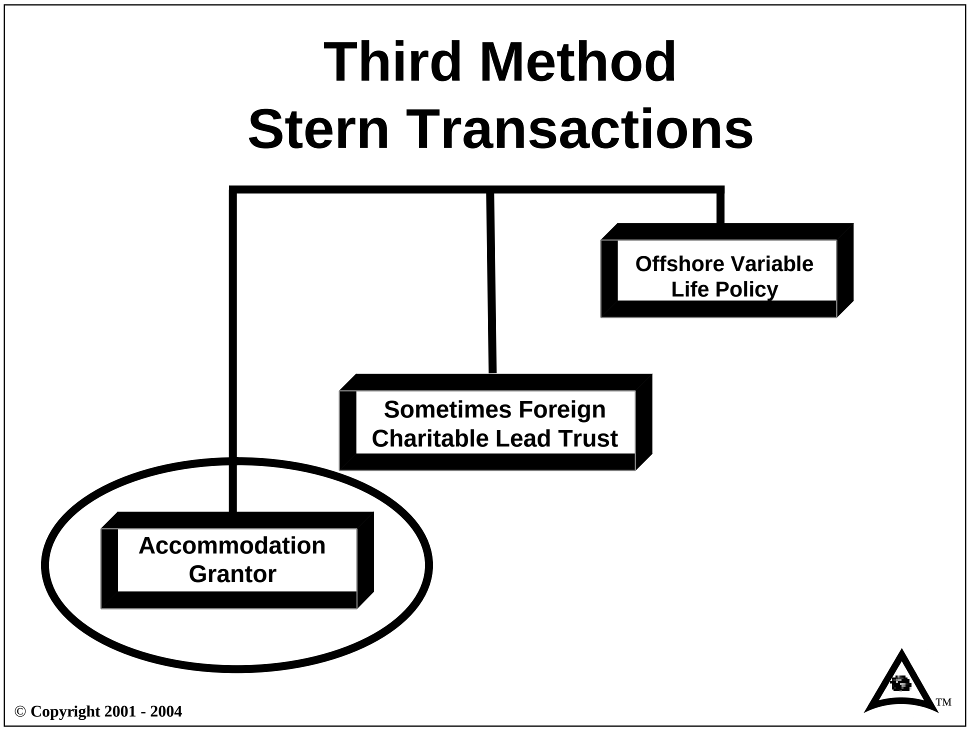
In almost all of the cases that the Service won under the sham entity or sham transaction theory, the Service also was able to impose a 20% negligence penalty under Section 6662(b)(1). The facts under the Hunter/Chatzky leasing program are similar. Therefore, it is most-likely the Service will prevail under this argument.

V Possible Civil Tax Fraud

It is probable that the Service will assert civil tax fraud and there is the possibility the Service will be successful with the argument.

VI Interest

Interest would be compounded at three points above the applicable federal tax rate on all amounts due.

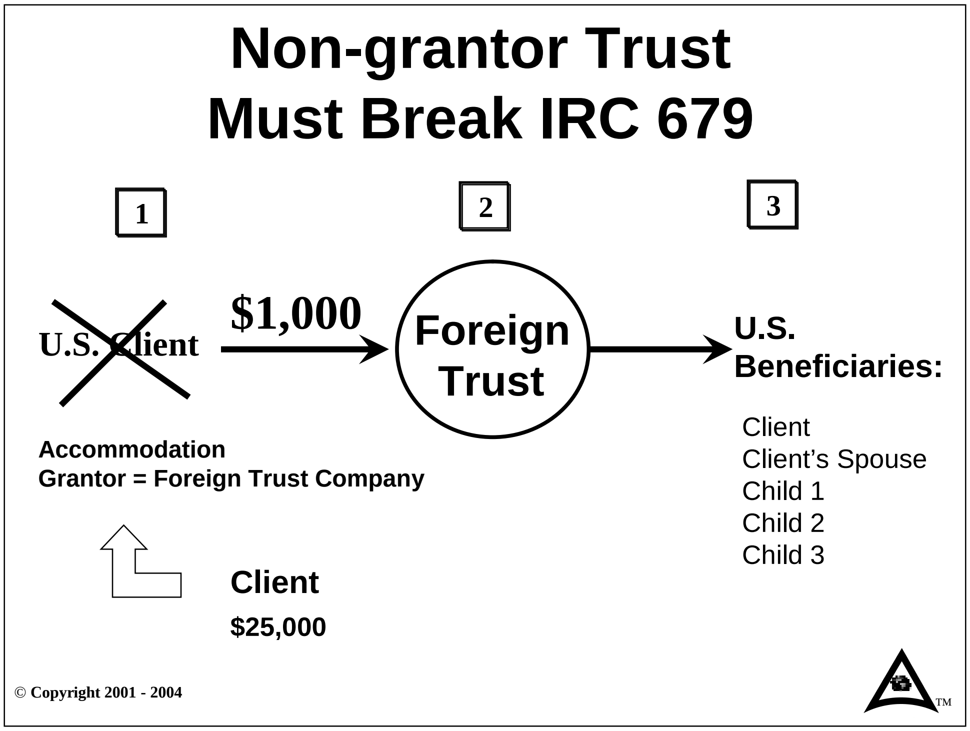


STERN TRANSACTIONS

The last common method to move money offshore into foreign trust is known as a "Stern transaction." The Stern transaction is named after the case *Stern v. Commr.*, 747 F.2d 555 (9th Cir. 1984). With a Stern transaction, a client uses either a private annuity, installment sale, or even a self canceling installment note to transfer highly appreciated property to an offshore trust.

The following three offshore tax motivated structures use the stern transaction to move money offshore:

1. Accommodation Grantor;
2. Foreign Charitable Lead Trust;
3. Offshore Variable Life Policy.



MUST BREAK IRC 679

I Three Elements

As previously noted, a trust is classified as a grantor trust if the following three prong test is met: (1) U.S. client, (2) transfers property to a foreign trust, and (3) there are any U.S. beneficiaries.

II Breaking the First Prong

Some promoters have argued that the first prong of the equation may be broken by having an accommodation grantor create the foreign trust. In the past, how the transaction was structured is as follows:

1. Client pays the offshore trust company (or offshore attorney) $25,000 (or more) to create the offshore trust.
2. The offshore trust company settles the foreign trust for the benefit of the client, the client's spouse, and the client's children.
3. The offshore trust company funds the offshore trust with $1,000.

At first glance, many people would say that this transaction is nothing more than a "farce." The transaction is merely a simple substance over form issue. It only takes a few of seconds to realize that the true grantor behind the transaction, is actually the client.

However, believe it or not, until 1996, a split actually developed in the courts over the issue. The Tax Court held in *Bixby v. Commr.,* 58 TC 757 (1972) that the offshore trust company was an obvious accommodation grantor. In *Stern v. Commr.,* 747 F.2d 555 (1984) the Ninth Circuit held for the taxpayer.

Bixby v. Commr., 58 TC 757 (1972)

- Funded seven trusts with $1,000
- Advisory committed with veto power controlled by Bixby
- Bixby could be appointed to vote closely held stock held by the corporation
- Bixby's investment advice followed

BIXBY v. COMMR., 58 T.C. 757 (1972)

I First Tax Court Case

With the first Tax Court case directly on point, the Tax Court sided with the Service that the offshore settlor was no more than an accommodation grantor. As such, Bixby was the true settlor of the offshore trust.

II Facts

An offshore trust company funded seven offshore trusts with $1,000 each for the benefit of Bixby, his spouse, and his children. There was an advisory committee that had the power to veto any decisions of the trustee. The advisory committee was composed of four persons: a related family member, a Vice President that was employed by Bixby, Bixby's domestic lawyer, and an unrelated third person. Bixby retained the power to remove and replace any member of the advisory committee without cause. The offshore trusts allowed Bixby to be appointed as a voting trustee over any closely held securities owned by the trust. Finally, the offshore trustees almost always followed Bixby's suggestions regarding investments.

III Bixby Controlled the Trust

Based on the above facts, the Tax Court held that Bixby retained control over the offshore trusts. Of particular concern to the Tax Court was the offshore trustee repetitively followed almost all of Bixby's suggestions regarding investments held by the trust. This bad fact coupled with Bixby's control over the advisory committee as well as the fact that he potentially had the power to vote any closely held securities owned by the offshore trust, resulted in the fatal outcome.

IV From 1972 to 1984

After *Bixby*, there was considerable question whether an accommodation grantor trust worked. Some argued that *Bixby* was an obvious "bad facts" make bad law case. Others argued that the transaction was an obvious violation of substance over form.

Stern v. Commr., 747 F.2d 555 (9th Cir. 1984)

- Canadian attorney funded a foreign trust with $500
- Stern could only change trustee to a "qualified successor trustee"
- Investment manager was subject to Stern's approval (veto power)
- Stern's recommendations were repetitively declined

STERN V. COMMR., 747 F.2d 555 (9th Cir. 1984)

I Facts

Stern paid a Canadian attorney $5,000 to create an offshore trust for the benefit of Stern, his spouse, and children. The Canadian attorney settled and funded the trust with $500. Shortly after the trust was settled, the trust entered into a private annuity with Stern in exchange for Stern's highly appreciated U.S. property.

II Court Decided the Case on Whether Stern "Controlled the Trust"

A. Removal/ Replacement Power

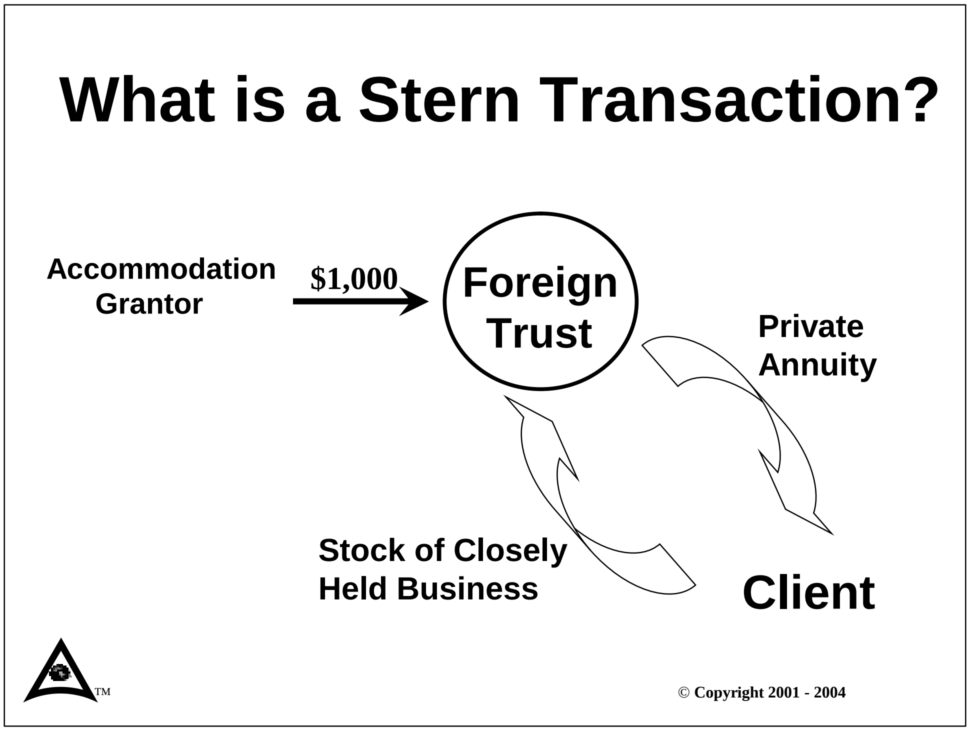
Stern had the power to remove and replace a trustee. However, the trustee needed to be a qualified corporate trustee. At the time the Stern case was tried, the issue of whether a removal/replacement power could be held by the trustee had not been addressed by the court. However, as determined in the 1990's, Stern's removal power was similar to the cases where the Service lost. *Estate of Wall*, 101 T.C. 300 (1993); 1st National Bank of Denver v. U.S. 81-1 USTC 13408; Estate of Vak 973 F.2d 1409 (8th Cir. 1992).

B. Investment Manager Subject to Veto Power

By itself, this is not a major power. However, based on other cases in the area of offshore variable life insurance products, it was <u>not</u> prudent for Stern to hold this power. Fortunately, the Court tended to negate the effect of holding this power.

C. Stern's Recommendations Were Repetitively Declined

The major factor that the Ninth Circuit seemed to rely on was that over the life of the trust, Stern had made repetitive suggestions for the offshore trustee to make certain investments. However, for the most part, the offshore trustee declined to follow Stern's requests. This fact indicated to the Court, Stern did not control the offshore trust; and therefore, the Canadian attorney who settled the offshore trust was not an accommodation grantor.



WHAT IS A STERN TRANSACTION?

I Seed Money is Trivia

With an accommodation grantor trust, the trust is settled with an insignificant amount of money - $500 or $1,000. This amount of money represents part of the legal fees charged to create the structure. Naturally, the amount that might be deferred on such an insignificant sum is trivia. Therefore, the real question is how does the accommodation grantor trust save a U.S. taxpayer income tax?

II The Stern Transaction

What has come to be known as a "Stern transaction," is an <u>exchange</u> transaction where highly appreciated assets are transferred to a foreign person (i.e., foreign trust, international business corporation, or offshore variable life insurance policy) and in exchange the U.S. client receives a tax deferred debt instrument. The tax deferred debt instrument is usually a private annuity. However, it could be an installment note or even a self canceling installment note.

III Playing With the Taxation Advantages of a Foreign Person

The essence of the accommodation grantor trust as a tax motivated tool is the ability of the tool to take advantage of the favorable tax treatment received by a foreign person. As noted in the U.S. Taxation of a Foreign Person Outline, a foreign person does not pay any capital gain tax on the sale of U.S. securities. This is true regardless of whether or not the stock held by the foreign person is closely held stock in a corporation. Therefore, shortly after the highly appreciated assets are transferred to the offshore trust, the offshore trust sells the securities and pays no capital gain tax on the transaction. At the same time, the U.S. client pays a deferred income tax over the term of the private annuity (or installment sale, as the case may be).

What Has Been Accomplished?

- **Income Tax Side:**
  - Client's gain is deferred through the private annuity
  - Non-grantor trust sells the highly appreciated securities tax free
  - Future growth during the client's life, income tax free
- **Estate Tax Side:**
  - Estate Freeze
  - Client was also a beneficiary of the trust

WHAT HAS BEEN ACCOMPLISHED?

I Income Tax Side

The client's gain from the sale is deferred through either the private annuity or the installment sale. On the other hand, since the offshore non-grantor trust is classified as a foreign person for U.S. tax purposes, no gain is recognized on the sale of the client's highly appreciated assets. Further, assuming that the sales proceeds are invested in non-dividend paying stocks or debt instruments, the trust assets will continue go grow tax free.

II Estate Tax Side

From an estate tax perspective the transaction is an estate tax freeze. While the private annuity or the installment note is part of the client's estate, all future appreciation on the assets are part of the trust. Further, the client may receive the benefit of these assets, because he or she is a beneficiary of the trust. Finally, it is not even considered a self-settled trust. Because under the Ninth Circuit decision – the Canadian attorney was <u>not</u> held to be an accommodation grantor.

End of the Accommodation Grantor

- **From 1984 – 1996**
  - – Using an accommodation grantor was a questionable practice
- **Small Business Job Protection Act 1996**
  - – Legislative Regulation Authority Granted to the Treasury Department
  - – Final Reg. 1.671-2(e)(3)
  - – Eliminated the accommodation grantor technique

ACCOMMODATION GRANTOR DEFINED

I From 1984 to 1996

For years, many offshore planners differed whether the doctrine under *Bixby* or the doctrine under *Stern* would be determine the outcome of an accommodation grantor. However, in 1996, the Small Business Job Protection Act gave the Service legislative authority to promulgate regulations in this area.

II Final Reg. 1.671-2(e)

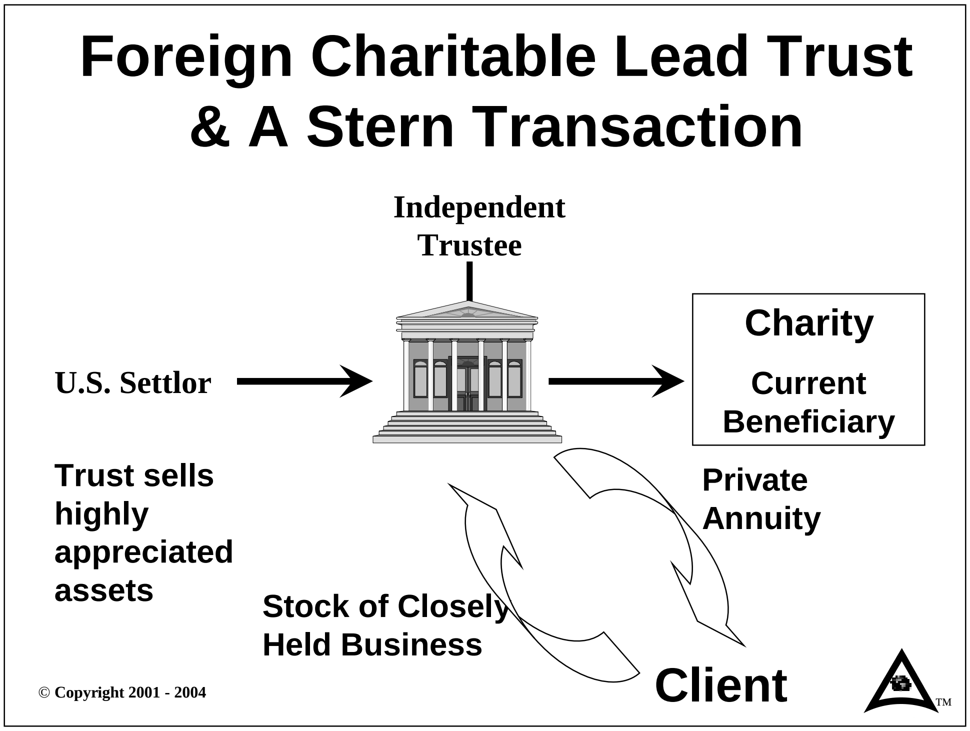
In early 1997, the Service promulgated Proposed Reg. 1.671-2(e)(3). The proposed regulation became a final regulation and provides as follows:

> *If one person creates or funds a trust (or a portion of a trust) as an accommodation for another person, the other person shall be treated as the grantor of the trust (or portion of the trust).*

To add insult to injury, Example 3 of the final regulation is the fact pattern of Stern, and the preamble to the regulations specifically mentions *Stern.*

III Elimination of the Accommodation Grantor Technique

Since the promulgation of the final regulations regarding an accommodation grantor, most offshore planners have come to the conclusion breaking the first prong of IRC 679 is no longer an option.



FOREIGN CHARITABLE LEAD TRUST

I Non-Grantor Trust

As previously, it is highly questionable the foreign charitable lead trust will be classified as a non-grantor trust, because its design conflicts directly with the legislative intent behind IRC 679(c).

II Private Annuity – Stern Transaction

In addition to gifting property directly to the foreign charitable trust, more property may be transferred to the foreign charitable lead trust by adding the Stern transaction.

Is the Stern Transaction Dead?

- **Non-Grantor Trust Options:**
  - Accommodation Grantor – Gone
  - Foreign Charitable Lead Trust – Highly Questionable
- **Foreign Corporation?**
  - CFC Rules; PFIC Rules
- **What About a Tax Blessed Product?**
  - Offshore Variable Life Insurance
  - Could it do a Stern Transaction?

TM

IS THE STERN TRANSACTION DEAD?

I Non-Grantor Trust?

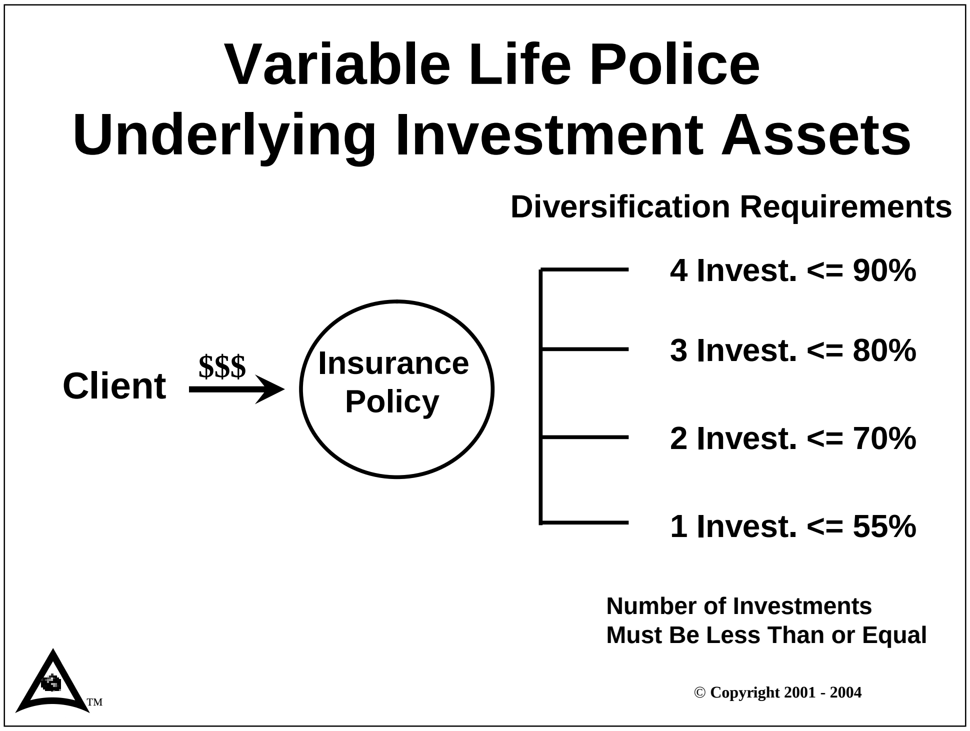
Since the publication of Treas. Reg. 1.671-2(e)(3), breaking the first prong of the three prong test of IRC 679 does not appear to be an option. As previously discussed, a foreign trust (i.e., non-grantor) would be required to achieve any tax savings. Therefore, the second prong is not an option. Finally, as previously mentioned, using the foreign charitable lead trust to break the third prong of the IRC 679 is a highly questionable technique. Therefore, at present, it does not appear that creating a non-grantor trust is a viable option for a tax motivated structure.

II Foreign Corporation?

As discussed in the U.S. Person and World Wide Taxation Outline and the Offshore Mutual Fund Outline, using a foreign corporation will not break work when designing a tax motivated structure.

II What About Using a Tax Blessed Product?

As noted at the beginning of this outline, offshore tax motivated structures used either a foreign non-grantor trust, a foreign corporation, or an offshore tax blessed product. Therefore, could an offshore variable life insurance policy possibly structure a Stern transaction?



UNDERLYING INVESTMENT ASSETS

Whether an offshore life insurance policy could consummate a Stern transaction would depend on the permissible investments that were held by the life insurance policy.

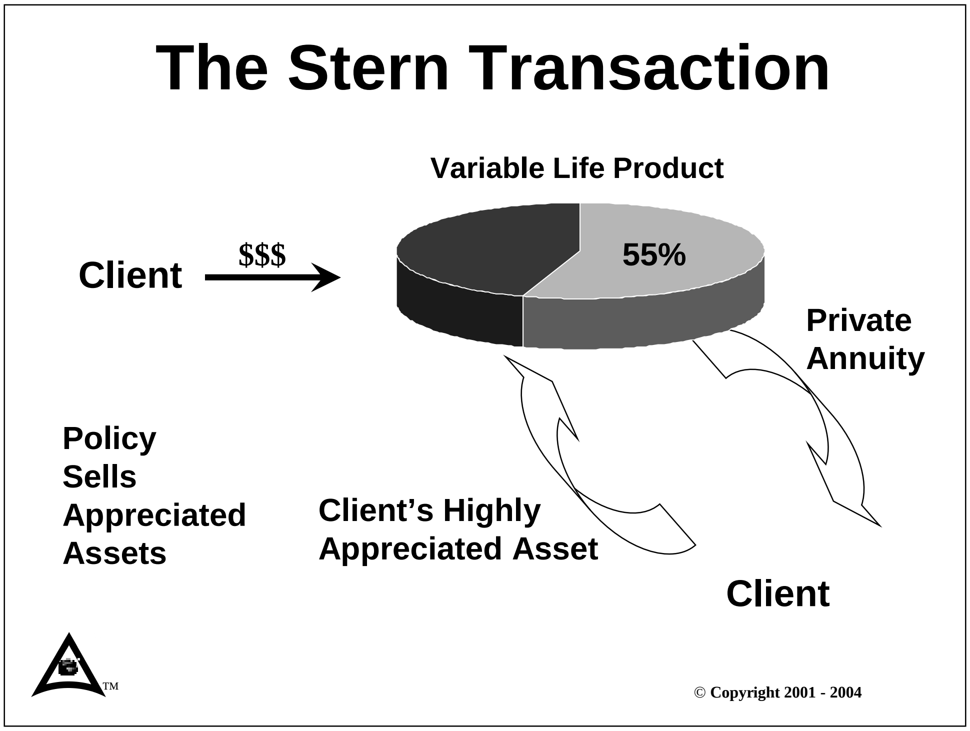
I Variable Life Insurance Policy

The idea behind a Stern transaction is that a client's appreciated securities, which most likely represent stock in a closely held business, will be transferred into the cash surrender value of a life insurance policy (directly or indirectly) owned by the client. Therefore, only a variable life insurance policy will work, because a variable insurance policy directly owns the underlying assets. With a whole life or universal life policy, there is a pool of assets owned by the insurance company, rather than direct ownership by the policy.

II Diversification Requirements

Under Treas. Reg. 1.817-5(b)(1)(i), the underlying assets of a variable life insurance policy must be diversified as follows:

(1) Four investments do not constitute more than 90% of the underlying investment account;
(2) Three investments do not constitute more than 80% of the underlying investment account;
(3) Two investments do not constitute more than 70% of the underlying investment account; and
(4) One investment does not constitute more than 55% of the underlying account.



STERN TRANSACTION

I Underlying Account Value

Pursuant to the diversification requirements, one investment asset may represent up to 55% of the underlying account value. Therefore, promoters of this tax motivated structure claim that 55% of the underlying value may be used to support either a private annuity transaction or an installment sale with the client's highly appreciated assets.

II Stern Transaction

Assume the client transfers $500,000 to a variable life insurance product, if after the commissions, $250,000 becomes the 55% of the underlying account, this amount may be used to support the private annuity or installment sale transaction. After the exchange transaction, the variable life insurance policy owns the highly appreciated assets. Shortly after the exchange, the variable life insurance policy sells the highly appreciated assets. Since insurance is a tax blessed product, no gain is reported on the sale by the variable life insurance policy, since it is a tax blessed product.

In essence, the client has accomplished the same income tax results that was achieved by Stern when he utilized a non-grantor trust. Estate tax benefits may also be present if the client settled an offshore life insurance trust to hold the offshore insurance policy (which is generally the case when this tax motivated structure is used).

Why Will No U.S. Insurance Company Do a Stern Transaction?

- **Tax Benefits Do Not Depend on Being Offshore**
- **Investor Control**
  - Rev. Rul. 77-85
    - If purchaser selects and controls the investments, treated as owner
  - *Investment Annuity v. Blumenthal -1979*
    - D.C. Cir. invalidated the Rev. Rul.

WHY WILL NO U.S. COMPANY DO A STERN TRANSACTION?

I Tax Benefit Does Not Depend on Going Offshore

The tax benefit of using a variable life insurance policy to create a Stearn transaction does not depend on whether or not the variable life insurance policy is a domestic policy or an offshore policy. In other words, if a domestic life insurance company was willing to participate in a Stern transaction, the same tax benefits would be available offshore as onshore. However, no domestic insurance company is willing to participate in a Stern transaction, because they do not think the transaction does not work – due to purchaser control.

II Rev. Rul. 77-85

The purchaser of the annuity had the power to select the underlying investments held by the variable annuity. The Service held the purchaser control caused the contract to fail.

III *Investment Annuity v. Blumenthal*, 442 F. Supp. 681 (D.D.C. 1977)

The District Court held in favor of the Service and invalidated the Revenue Ruling. When invalidating the Revenue Ruling, the court noted that it was invalidating a revenue ruling based on the standard of review for a revenue ruling. Since that point in time, the Revenue Ruling has been added to the final regulations. It is uncertain if the District Court would still invalidate the Treasury Regulation with the higher standard of review.

Investor Control

– Rev. Rul. 80-274
  - Prearranged plan to wrap CDs with annuity deemed control
– Rev. Rul. 82-54
  - Investment in different mutual funds with different investment objectives allowed
– *Christoffersen* – 1984 – Mirror Image Fund
– Services Position – PLRs 200248021; 200244001; 9851044; 9536016; 9433030; 9437027; 8835059; 8403014

WHY WILL NO U.S. COMPANY DO A STERN TRANSACTION?

I Rev. Rul. 80-274

Under the facts of this revenue ruling, through a prearranged plan, a bank offered annuities where the underlying investment would be CDs. When the CD matured, the bank would purchase another CD as the underlying investment. The Service held that the prearrange plan to purchase a CD constituted control of the underlying investment.

II Rev. Rul. 82-54

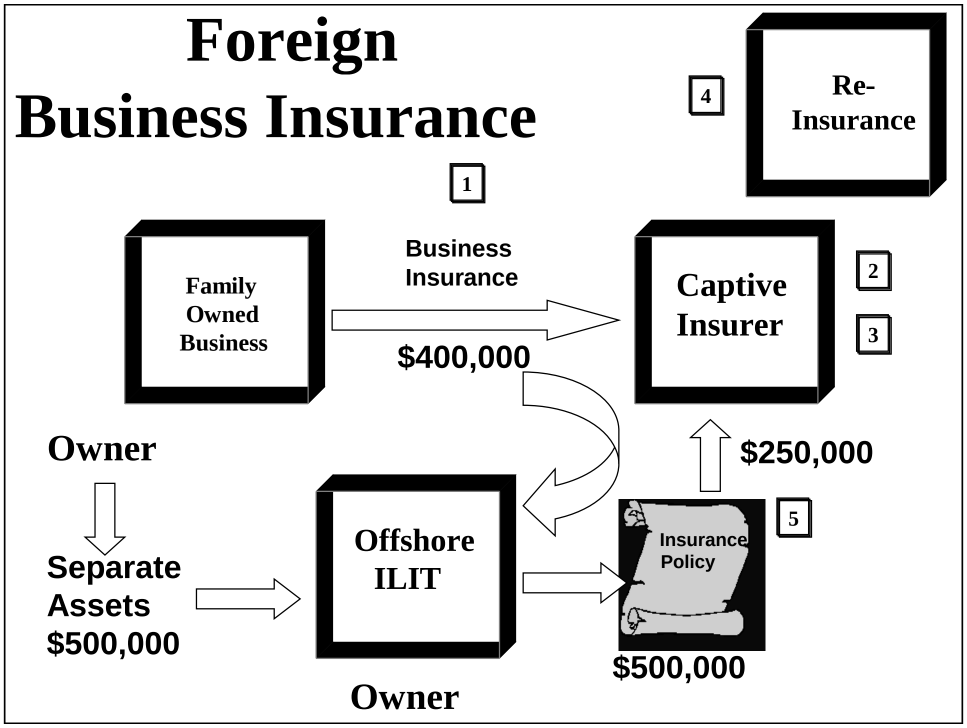
The purchaser of the annuity had the power to select the underlying investments held by the variable annuity. The Service held the purchaser control caused the contract to fail.

III *Christoffersen v. U.S.*, 578 F. Supp. 398 (8th Cir. 1984)

The 8th Circuit Court refused to follow *Investment Annuity, Inc. v. Blumenthal* when holding that the taxpayers ability to direct the investment account between six different public mutual funds (which were publicly traded) constituted investor control.

IV Service Position

The Service position has remained consistent since the creation of variable life products. A variable life product will not fail the tax blessed status if the purchaser has the option to invest in different mutual funds, and these mutual funds are not available for purchase by the public. On the other hand, if the purchaser controls the specific policy investments through a prearranged plan, the Service argues that the insurance contract will fail. If this is the case, how can a prearranged plan to purchase the client's highly appreciated assets as part of the account value, <u>not</u> constitute control? [Please note that if the client has the power direct the specific underlying investment by the terms of the life insurance contract, the life insurance contract will also fail the diversification requirements under Treas. Reg. 1.817-5(e).]


Foreign
Business Insurance
1
2
3
4
5
Re-
Insurance
Family
Owned
Business
Business
Insurance
$400,000
Captive
Insurer
Owner
$250,000
Separate
Assets
$500,000
Offshore
ILIT
Insurance
Policy
$500,000
Owner

Dos and Don'ts

- **Almost Every Tax Scam Had an Opinion Letter**
  - Most from a "NY" or "Chicago" Law Firm
  - Most were 45-80 pgs. after covering facts
  - One was 1 pg. after 9 pgs of facts on an insignificant portion transaction
- No One Had a Private Letter Ruling
- Independent Opinion Outside of Promoter
  - May not get you out of negligence penalties
- Review Before You Sell - $15k to $20k of time
- Promoter Liability Many Times Greater Than Investor
  - Will not back down on criminal fraud
  - Suits by investors
- Do Not Let Your Client Become One of My Clients in This Area