Company Profile

Contact Information

The John Marshall Law School
315 S. Plymouth CourtChicago, IL
60604
USA

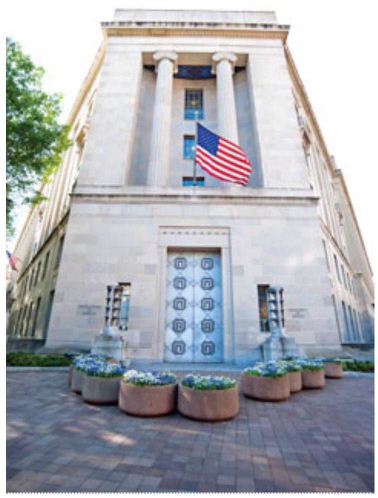
T: +1 (312) 386 2860
E: jkilborn@jmls.edu
W: http://home.comcast.net/~jasonkilborn

Risks posed by the IRS offshore crackdown and recent case law to international IRC § 831(b) captive insurance companies

TOPIC: Tax Column
By: Beckett G. Cantley
January 15, 2014

A− A+ Like 0 Tweet 0

> Comment on this story



It is no secret that the Internal Revenue Service and U.S. Department of Justice have been conducting a nearly decade-long crackdown on tax avoidance activities of U.S. citizens doing business internationally.

The offshore crackdown began with hearings conducted by the U.S. Senate Finance Committee, in which the Senate committee that controls IRS funding made it clear that it expected the IRS to get aggressive in international tax enforcement.

The IRS responded by making a big push to uncover undeclared foreign bank accounts of U.S. taxpayers, and punish the taxpayers, the foreign banks and the advisors who assisted their clients in setting up and maintaining the accounts. Congress also gave the IRS new enforcement tools, including Qualified Intermediary regime.
While the IRS used its administrative powers to gather U.S. taxpayer information and collect tax and penalties, the DOJ made use of the information to bring civil and criminal tax cases. Some of these cases included international banks, including but not limited to UBS, Wegelin, Credit Suisse and HSBC.

The U.S. government has made extensive use of its broad enforcement powers overseas to seize an individual or entity's U.S. assets, sometimes through an offshore bank's U.S. correspondent accounts. For example, in its case against Wegelin, the U.S. government seized roughly $16 million from UBS clients' correspondent accounts operated out of the UBS Stanford, Connecticut branch. Such seizures have put an enormous amount of pressure on the target offshore entities and individuals to reach an agreement with U.S. authorities.

The Swiss bank UBS settled claims of aiding and abetting U.S. tax evasion, forcing them to disclose U.S. taxpayer bank accounts after threatening the seizure of UBS's U.S. held assets and banking licenses. Using the Wegelin and UBS cases as a precedent, the IRS and DOJ have extended the offshore crackdown into numerous other jurisdictions, with this trend showing no signs of slowing.

Of course, the IRS and DOJ have not limited their offshore enforcement actions to overseas jurisdictions. Over the last few years, the DOJ has brought criminal cases in the U.S. against both U.S. and non-U.S. participants in offshore tax avoidance schemes. While many of the early cases were brought against U.S. taxpayers with undisclosed offshore bank accounts, the more recent cases have expanded the target activity.

The IRS and DOJ won a civil case, and separately brought a criminal case against the promoters of an offshore captive insurance company program. The development of these cases may be illustrative of how the IRS and DOJ plan to proceed in other offshore tax

CONTRIBUTOR BIO: AT A GLANCE

Prof. Beckett G. Cantley is an Associate Professor of Law at Atlanta's John Marshall Law School where his teaching focuses on tax law courses. He also teaches international taxation at Northeastern University. He is widely published and consults on numerous issues in tax law, including international tax enforcement, and captive insurance company law.

Beckett G. Cantley
Associate Professor of Law
Atlanta's John Marshall Law School
1422 W. Peachtree St. NW
Atlanta
GA 30309-2954

T: +1 (404) 502 6716
E: bgcantley@johnmarshall.edu
W: www.johnmarshall.edu
SSRN:

Related Articles

- A future of wealth confiscation?

- Almost five years on:
- AML/CFT audit: What is appropriate?
- Buyer beware: U.S. tax issues hidden in foreign trust inventories
- Cayman decision on tax information exchange:
- Cayman funds stand strong in new era of governance
- Commercial debt buyers, latent defects and aggravated insolvency risk
- Countries Represented among Member Jurisdictions: G20, FSB, Basel Committee on Banking Supervision
- FATCA: The G20 and the OECD – where are they?
- FSB Designations of Global Systemically Important Banks
- Global financial reform and the role of the IMF
- Grey matters
- How Cayman should benefit from the FATCA signing
- IFCs in the international financial architecture
- Notes
- Offshore trusts and private client confidentiality
- Portugal and life beyond the budget
- Post-crisis regulation and supervision of the biggest banks by the biggest countries:
- Quarterly review
- Repeal the anti-money laundering laws
- Risks posed by the IRS offshore crackdown and recent case law
- Shining a bright light on captive insurance
- STAR trusts: A world class structuring vehicle?
- StAR, asset recovery and the global toolbox against corruption
- Substance over form:
- The future of international financial centers
- The offshore as a black hole – fact or fiction?
- Thinking anew about information exchange and reporting
- Treasury's War:
- What does the future hold for IFCs?

cases may be illustrative of how the IRS and DOJ plan to proceed in other offshore tax avoidance schemes involving U.S. taxpayers.

Both the civil case (Salty Brine v. U.S.) and the criminal case (U.S. v Crithfield, Donaldson, et. al.) derive from the same transaction facts. The promoters marketed and implemented a purported offshore captive insurance company structure through a series of controlled companies. The premiums were taken as tax deductions by the taxpayer when paid to the captive insurance company for a Business Protection Plan (BPP) policy, then created a system for refunding 85 percent of these funds to the taxpayer the next year.

The initial law firm that had blessed the transactions with a legal opinion letter later withdrew the letter, and a new opinion letter was acquired from a second law firm. The promoters recruited outside attorneys, CPAs and financial advisors to sell the BPP and allegedly paid them commissions through an offshore shell company.

The civil case ended with the taxpayer having its deductions reversed based on the transactions lacking in economic substance. In particular, the court determined that the structure was "merely a conduit" used to funnel tax-deducted income to offshore entities and subsequently permit the taxpayers to borrow the funds back. The court found that the taxpayers "owned and controlled the assets at issue before the transactions and after the transactions." As in many captive cases, the absence of real risk shifting was an issue in the civil case. In addition, the court determined that the insurance coverage was driven by a "predetermined premium, not a premium driven by predetermined coverages."

Lastly, the court determined that the taxpayer's tax advisors had a financial conflict of interest, among other problematic issues, and thus upheld the assessment of very severe civil tax penalties.

In the criminal case, the DOJ alleges that the promoters told a prospective BPP client not to file a claim, so the client could get a larger amount of premiums refunded. In addition, it is alleged that the promoters told a particular client not to file a claim because that was not the "real purpose" of the BPP policy. One promoter told his attorneys that no claims had been made under any of the 75 BPP policies and that no reserves for insurance losses were ever established. The DOJ alleges that a promoter told a client that an owner can "retitle" a salary or bonus as a BPP deduction and a year later, receive 85 percent of the premium back tax-free. The DOJ has a specific client that they allege did this exact thing.

What lessons can we learn from these cases? First, it is clear that, as in other high profile tax shelter cases, the IRS/DOJ will continue to argue a transaction is unsustainable (and potentially criminal) where the intent of the transaction does not appear to match its form. Note that I used the word "intent" rather than "substance" because "intent" is what triggers criminality. Where a captive is a pretext for a tax deduction, especially if the funds are cycled back to the client, then the IRS/DOJ may consider it to be a fraudulent transaction.

This may be true even where the form may have been proper under local law (i.e., a licensed captive with an actuarially determined premium payment), if the intent was to create a circular cash flow for the client that does not follow a traditional dividend issuance by a captive. Of course, even if the IRS deems the transaction to fall short of fraud, it is possible that certain methods of returning captive funds to a policyholder (i.e., other than dividends) may result in the IRS investigating the issue for lack of true risk shifting/distribution.

In addition, where there is evidence that the coverages were driven by the tax deduction desired rather than the risks to be insured, the IRS/DOJ are going to investigate it. Thirdly, the presence of no claims for several policies over a few years is clearly a fact that gives the IRS/DOJ the impression that the intent was not to create real insurance. Finally, if the marketers for such a captive product make use of the typical hallmarks of a tax shelter to obtain clients, it appears to trigger a red flag to the IRS/DOJ.

Such triggers may include the use of (1) a significant network of professionals to market the product; (2) a marketed opinion letter; and (3) cookie cutter policy structures and coverage mixes. The perception that these types of professionals are abusing the client's trust can clearly be a contributing factor in any case being elevated to the criminal level.

The BPP cases are not the end of the IRS/DOJ inquiry into captives. There are currently captive-participant IRC 6700 promoter investigations being undertaken by IRS. These are often the first step before a broad based coordinated attack on a transaction. There are also additional criminal warrants that have been issued to captive professionals who have not been referenced in the BPP cases.

This indicates that the DOJ may already have more promoters in sight for additional criminal cases. Given the heightened scrutiny that the IRS/DOJ has placed on the offshore financial world, these risks may be even more elevated. It may be a good time for captive professionals to take a hard look at the way they are marketing and operating their programs, and take extraordinary steps to avoid even the appearance of an activity that creates an unintentional red flag to the IRS.

It is always better to spend some money beefing up compliance now, rather than spending vastly more time and money dealing with the IRS later.

Share your Comment

We welcome your comments on our stories. Comments are submitted for possible publication on the condition that they may be edited and that your full name will be published with your comment.

IMPORTANT IDENTITY INFORMATION: Whilst we collect login information from you, this information will be kept confidential and only used to contact you directly, if required. We require a working email address - not for publication, but for verification. Your full name will be published with your comment. **Read our ethics policy**

Please login to comment on our stories. **LOG IN** | **REGISTER**

Site Map
Search
Disclaimer
TV Guide
Contact us
Letters to the Editor
Read our Ethics Policy

Stay informed
Our Digital Newspaper
Email - Breaking News & Alerts
RSS - Sign up today
E-Version
Video reports
Subscribe to our newspaper
Find us on Facebook
Follow us on Twitter
Find us on Google+

Advertise with us
Terms & Conditions
Place your advertisement
Advertise with us
Jobs at Cayman Free Press

Publications
Caymanian Compass
The Journal
Cayman Financial Review
Flava Cayman
This is Cayman
Key To Cayman
What's Hot
InsideOut
Precision Print
The Map
Hurricane Supplement