STEERING INTO THE STORM: AMPLIFICATION OF CAPTIVE INSURANCE COMPANY COMPLIANCE ISSUES IN THE OFFSHORE TAX CRACKDOWN

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I. INTRODUCTION

A CIC is a corporation created to offer insurance to companies that are related parties to the CIC, either in a parent ("CIC") – subsidiary (insured) relationship or where the CIC owners also own the insured company (so called "brother-sister" CIC arrangements).[1] The non-tax benefits of a CIC include premium cost stabilization; elimination or reduction of brokerage commissions and marketing expenses; lower administrative costs;[2] the ability to provide niche coverage for a unique or specific risk that would not otherwise be transferable in the commercial insurance market; and the potential to control certain CIC investment decisions and portfolio management.[3] The tax benefits of an I.R.C. Section 831(b) CIC are extensive.[4] Premiums paid to a CIC by its insured shareholder are generally deductible, similar to the deductibility of premiums paid on commercial insurance.[5] I.R.C. Section 162(a) provides that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business,[6] and Treasury Regulation

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1. Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm (last visited Jun. 5, 2012) [hereinafter *Bad Financial Medicine*].

2. Julie Goosman& Christine Lug, *Captivating! Captive Insurance Arrangements are Alive and Well*, 35 J. CORP. TAX'N 25, 28 (2008) [hereinafter *Captivating! Captive Insurance Arrangements are Alive and Well*].

3. *See generally id.*

4. I.R.C. § 831 (2006).

5. *See* I.R.C. § 162(a) (2006); *See* Treas. Reg. § 1.162-1(a) (as amended in 1993).

6. I.R.C. § 162(a).

1.162-1(a) states that business expenses include insurance premiums on policies covering certain business losses.[7] I.R.C. Section 831(b) provides that certain electing insurance companies may receive tax-free annual premiums up to $1.2 million,[8] although the CIC would still be liable for tax on its investment earnings.[9] As such, the shareholder insured deducts the premium payments, the CIC receives the premium payments tax-free, and will not be taxed on the premiums until the CIC makes a dividend distribution or the CIC stock is sold – either of which would be at long-term capital gains rates (15%)[10] instead of ordinary income rates (35%).[11] However, to achieve these tax benefits, a CIC must be considered an "insurance company" and the arrangement must be considered an "insurance contract".[12]

To meet the above-referenced "insurance" requirements, each CIC with U.S. shareholders must use I.R.S. safe harbors or otherwise to both show: (i) that it has properly shifted the risk of economic loss ("risk shifting") from the insured to the insurer; and (ii) that the insurer has adequately distributed the risk among several insurance companies (or other unrelated entities) so that no particular insurance company (or entity) has all the risk for an economic loss.[13] The I.R.S. is also aware of certain less-prevalent I.R.C. Section 831(b) CIC tax-motivated compliance problems, that include: (i) the use of life insurance on the CIC owner's life as a major investment of the CIC; (ii) engaging in tax motivated loan back arrangements between the CIC and its owners; and (iii) structuring the CIC ownership in the name of a children's trust (or other entity) to avoid Federal Estate and Gift Taxes.[14] A CIC engaging in any of these compliance issues are likely to eventually come under significant

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7. Treas. Reg. § 1.162-1(a).

8. *See* I.R.C. § 831(b)(2).

9. *See* I.R.C. § 831(b)(1)(A), (b)(2).

10. CIC underwriting income that has been held by the CIC for at least one year would be taxed to the parent entity, upon distribution, at the long-term capital gains rate, which is currently 15%. *See* Rev. Proc. 2008-66, 2008-45 I.R.B. 1107.

11. *See* I.R.C. § 1201(a). *See* I.R.C. § 162; *See also* I.R.C. § 11(b) (2006).

12. *See* Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 838 (6th Cir. 1995) (explaining the Le Gierse test which explains the need for "risk shifting" and "risk distribution" in order to be insurance for the purposes of the Internal Revenue Code); Treas. Reg. § 1.162-1(a).

13. Humana, Inc. v. Comm'r, 881 F.2d 247, 251 (6th Cir. 1989) (citing Helvering v. Le Gierse, 312 U.S. 531, 539 (1941)).

14. *See* Phillip England et al., *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, J. OF PAYMENT SYSTEMS LAW 701, 701, 712 (June 2007), http://www.andersonkill.com/webpdfext/cic-riskfinancing.pdf[hereinafter *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*].

scrutiny by the I.R.S. and face serious consequences if done non-compliantly.

An important decision when forming an I.R.C. Section 831(b) CIC is whether to be governed by the laws of a U.S. state or a foreign jurisdiction. A CIC shareholder must review several factors before making this decision, including: (1) exposure to the U.S. tax system; (2) the capitalization burden at formation; (3) the investment flexibility afforded the CIC; and (4) the asset protection afforded the U.S. shareholders of the CIC.[15] As discussed below, these factors do not weigh in a significant way for U.S. taxpayers to choose to form in a foreign jurisdiction. However, any I.R.C. Section 831(b) CIC choosing to form offshore may end up compounding all the above-described potential compliance risks by virtue of ending up eventually in the middle of the ongoing I.R.S. offshore tax crackdown.

The I.R.S. and U.S. Department of Justice ("DOJ") have used various investigatory and compliance devices to gather significant information on offshore tax activities of U.S. taxpayers, including but not limited to: holding Congressional hearings; the VDI programs; the Qualified Intermediary regime; increased offshore audits; and international tax treaties.[16] The DOJ has used the information to launch civil and criminal tax cases against U.S. domestic and offshore clients, advisors, and banks - warning that U.S. tax avoidance overseas will receive serious scrutiny.[17] Negative consequences for non-compliance offshore may include large civil and criminal tax penalties, including indictments for tax evasion, conspiracy to defraud,

15. *See generally id.*at 709-10.

16. Staff of the Joint Comm. on Taxation, *Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities*, Mar. 30, 2009, 22, 34-35, 38, 61-62 (JCX-23-09) [hereinafter *Tax Compliance*].

17. *See generally* Jeremiah Coder & Lee A. Sheppard, *Banks Beware: IRS Criminal Investigations Expanding*, 2012 TAX NOTES TODAY 34-5 (2012) [hereinafter *Banks Beware: IRS Criminal Investigations Expanding*]; Robert Goulder, *U.S. Government Indicts Swiss Bank for Aiding Tax Fraud; Seizes Assets*, 134 TAX NOTES 634, 35-36 (2012); *Tax Compliance, supra* note 16; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-478T,TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE 1 (2009) [hereinafter TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE]; Rachel Armstrong & Chris Vellacott, *HSBC Case Alerts Asia Banks for U.S. Tax Probes*, REUTERS (Apr. 12, 2011, 8:33 AM), http://www.reuters.com/article/2011/04/12/tax-banks-idUSLDE73B14B20110412 [hereinafter *HSBC Case Alerts Asia Banks for U.S. Tax Probes*]; Marie Sapirie, *Practitioners Assess Offshore Initiative as Deadline Approaches*, 2011 TAX NOTES TODAY 157-1, 3 (Aug. 15, 2011)[hereinafter *Practitioners Assess Offshore Initiative as Deadline Approaches*].

money laundering, wire fraud, and violations of the RICO Act.[18] This I.R.S. and DOJ offshore tax crackdown appears as if it will continue to increase in size and scope for the foreseeable future. As the offshore tax enforcement push expands, compliance and audit costs for even a fully compliant foreign CIC may rise significantly. The fact that a tax beneficial entity (like a CIC) is formed and maintained in a foreign jurisdiction may end up making it a more attractive target for an I.R.S. audit, and the scrutiny received in such an I.R.S. audit may be significantly heightened by virtue of the anti-offshore bias derived from the current international enforcement push. Thus, the choice to be an offshore CIC may result in its compliance costs being prohibitive (if compliant) at best, or it may find itself the target of serious penalties (if non-compliant) at worst.

This article provides: (i) an overview of the benefits and requirements of an I.R.C. Section 831(b) CIC; (ii) the compliance issues surrounding such a CIC; (iii) a detailed discussion of the progression of the I.R.S. offshore crackdown; (iv) an analysis of the rationales for choosing an offshore jurisdiction for forming a CIC; and (v) a discussion of the I.R.S. crackdown's potential negative effect on the choice to utilize an offshore I.R.C. Section 831(b) CIC.

II. CAPTIVE INSURANCE COMPANIES

A. *In General*

A CIC is a corporation that insured parties related to the CIC, either in a parent–subsidiary or brother-sister relationship.[19] Most major U.S. corporations currently legitimately use a CIC for valid insurance purposes.[20] The organizational structure of a CIC is quite similar to a mutual insurance company for a very limited number of participants.[21] However, a CIC is subject to heightened I.R.S. regulations and scrutiny, due to the valuable preferential tax benefits afforded a CIC (addressed below) and the unusually close relationship that

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18. *See Banks Beware: IRS Criminal Investigations Expanding*, *supra* note 17; 18 U.S.C. §§ 1961-1962 (2006); 18 U.S.C. § 1956 (2006).

19. *Bad Financial Medicine*, *supra* note 1.

20*SeeTAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17, at 1.

21. William P. Elliott, *A Guide to Captive Insurance Companies (Part 1)*, 16 J. INT'L TAX'N 22, 25 (Apr. 2005).

generally exists between a CIC and the insured.[22] The I.R.S. may "challenge certain captive insurance transactions based on the 'facts and circumstances' of each case."[23] Revenue rulings issued in 2002 and 2005 subsequently provided guidance on what "facts and circumstances" the I.R.S. would scrutinize.[24]

This article discusses CIC arrangements that are covered by I.R.C. Section 831(b), so the reader should infer that all references below to a CIC are to an I.R.C. Section 831(b) CIC, unless otherwise noted.

B. *Captive Insurance Company Benefits*

1. Tax Benefits of a CIC

A parent corporation that wishes to self-insure against certain risks may face taxation on reserve investment income at the highest corporate rate.[25] In the corporate shareholder context, a CIC may operate as a subsidiary corporation formed to insure the risks of a parent corporation without incurring the income tax problems associated with self-insurance.[26] Of course, a CIC may also be set up with non-corporate shareholders, who may also be the shareholders of the insured entity.[27] Premiums paid to a CIC by its insured entity are generally deductible, similar to the deductibility of premiums paid on commercial insurance.[28] I.R.C. Section 162(a) provides "that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business."[29] Treasury Regulation 1.162-1(a) states that business expenses include insurance premiums on policies covering fire, storm, theft, accident, or similar losses in the course of business.[30] However, in order for premiums paid to a CIC to be considered tax-deductible under Treasury Regulation 1.162-1(a), a CIC must be considered an "insurance company"[31] and the arrangement must be considered an "insurance

22. Kimberly S. Bunting et al., *Possibilities and Pitfalls with Captive Insurance Companies*, 38 EST. PLAN.03, 03 (2011).

23. Rev. Rul. 2001-31, 2001-1 C.B. 1348 (2001).

24. Rev. Rul. 2002-89, 2002-2 C.B. 984 (2002); Rev. Rul. 2002-90, 2002-2 C.B. 985 (2002); Rev. Rul. 2005-40, 2005-2 C.B. 4 (2005).

25. *See* Richard M. Colombik, *Captive Insurance Companies*, INC. (Aug. 13, 2008), http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.

26. *See id.*

27. *See id.*

28. *See id.*; *see generally* I.R.C. § 162(a); *see generally* Treas. Reg. § 1.162-1(a).

29. I.R.C. § 162(a).

30. Treas. Reg. § 1.162-1(a).

31. *See Bad Financial Medicine*, *supra* note 1.

contract"[32] (See subsection below for a discussion of CIC requirements).[33]

I.R.C. Section 831(a) provides that tax shall be imposed under I.R.C. Section 11 on the taxable income of any insurance company other than life insurance companies.[34] However, I.R.C. Section 831(b) provides that a non-life or property and casualty insurance company, which receives annual premiums not to exceed $1.2 million, can elect to receive this premium tax-free.[35] Therefore, as long as a CIC maintains business operations that aggregate less than $1.2 million in annual premiums paid, the CIC would incur no tax on underwriting income earned on premiums paid.[36] The CIC would still be liable for tax on its investment earnings,[37] but the CIC could eliminate these taxes by investing in tax-free investments (such as municipal bonds).

In this scenario, the shareholder insured deducts the premium payments, the premium payments are received tax-free by the CIC, the CIC earns investment returns tax-free on pre-tax dollars, and is only taxed when either the CIC makes a dividend distribution or the CIC stock is sold. In either of these cases, the dividend or sale would be taxed at the long-term capital gains rates, under current law, rather than at the rate applicable to ordinary income.[38] Since the value of the premiums paid tax deduction to the parent is likely at least thirty-five percent (35%),[39] the fifteen percent (15%) rate[40] creates quite a large tax arbitrage.

Essentially, the use of a CIC may defer the realization of ordinary income and may even re-characterize ordinary income as capital gain to the parent corporation.[41] Also, a CIC may allow a company that self-insures to accelerate the tax deduction that would otherwise accrue at the time the self-insurance contingency occurs.[42] Obviously, these various tax breaks cumulatively act to create a significant tax reduction opportunity

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32. *See* Jay Adkisson, *Running a Captive Correctly*, RISSER ADKISSON LLP (Aug. 5, 2012), http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm (hereinafter *Running a Captive Correctly*).

33. *See* discussion *infra* Part II.C.1.

34. *See* I.R.C. § 831(b)(2); I.R.C. § 11(a).

35. *See* I.R.C. § 831(b)(2).

36. *See id.*

37. *See id.*; *see also Bad Financial Management*, *supra* note 1.

38. *See* I.R.C. § 1(h) (2006).

39. *See* I.R.C. § 11(b).

40. *See id.*

41. *See*I.R.C. § 831(b); *see* Colombik, *supra* note 25; *see Bad Financial Medicine*, *supra* note 1.

42. *See generally* I.R.C. § 162 (2006); Colombik, *supra* note 25.

for companies that have certain significant insurance needs that fit a CIC structure. In addition to these tax benefits, there are several financial and insurance benefits afforded a CIC that, in addition to the take benefits, make a CIC attractive to its owners (discussed immediately below).[43]

2. Other Benefits of a CIC

A CIC offers its owners many non-tax benefits.[44] For example, a CIC may be used as a means of cost stabilization for an insured that has grown tired of paying increased rates in the commercial insurance market. Furthermore, avoiding the commercial insurance market can eliminate or reduce brokerage commissions, marketing expenses, and administrative costs.[45] Administrative costs may include the cost savings from preventing litigation and controlling the claims review process to reduce incidents of insurance fraud. If the CIC has a positive claims experience, essentially "winning its gamble" with the insured, then the CIC stands to generate tremendous underwriting profit for the CIC owners, which would otherwise be lost to a commercial insurer.[46] In addition, a CIC can provide niche coverage for a unique or specific risk that would not otherwise be transferable in the commercial insurance market.[47]

Lastly, the premiums paid into a CIC may be invested, which may increase the surplus of funds in the CIC. Furthermore, the parent entity may generally exercise some control over the investment decisions and portfolio of the CIC.[48]All of these tax and non-tax benefits are available to I.R.C. Section 831(b) CIC owners, provided the statutory requirements are met, as discussed in the next section of this article.[49]

C. *I.R.C. § 831(b) CIC Requirements*

The premiums paid to a CIC are non-deductible and non-excludable from income under I.R.C. Section 831(b) where a CIC is not considered an "insurance company" or an arrangement is

43. *See* discussion *infra* Part II.C.2.

44. *See* Bunting et al., *supra* note 22, at 3-4.

45. *See id.*

46. *See id.*at3.

47. *Seeid.*at 4.

48. *See generally Captivating! Captive Insurance Arrangements are Alive and Well*, *supra* note 2, at 25.

49. *See infra* Part II.C.

not considered "insurance" for federal income tax purposes.[50] The I.R.S. will examine CIC arrangements closely and may attack a CIC based upon the individual facts and circumstances present.[51]

1. Operating as an Insurance Company

If a CIC does not meet the definition of an "insurance company," the entity will not be granted the favorable tax treatment allowed for insurance companies and may incur C-corporation double taxation on all of the entity's income.[52] In order for a CIC to be considered an insurance company, the CIC must be operated in a manner consistent with being primarily in the business of insurance.[53]

Treasury Regulation 1.801-3(a) provides that an insurance company is "a company whose primary and predominant business activity . . . is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies."[54] I.R.C. Section 816(a) defines "life insurance company" as any company more than half the total reserves of which is comprised of life insurance premiums, unpaid premiums and unpaid losses.[55]

A CIC will not be considered a bona fide insurance company where the CIC charges commercially unreasonable or non-arms length premiums.[56] The existence of underwriting and management fees payable to the CIC is indicative of the existence of a bona fide "insurance company."[57] However, arms length dealing and the existence of separate management and underwriting fees are not dispositive—the CIC must be operated as an insurance company in various other facets as well.[58] The CIC should employ licensed professionals to handle management, underwriting, accounting, and audit roles.[59] Furthermore, the CIC must meet local licensing and capital requirements for insurance companies.[60] These requirements vary by jurisdiction, but are oftentimes minimal in "offshore" jurisdictions, such as

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50. Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 838 (6th Cir. 1995); *Running a Captive Correctly*, supra note 32.

51. *See* Bunting et al., *supra* note 22, at 5.

52. *See Running a Captive Correctly*, *supra* note 32.

53. *See id.*

54. Treas. Reg. § 1.801-3(a) (as amended in 1972).

55. I.R.C. § 816(a) (2006).

56. *Running a Captive Correctly*, *supra* note 32.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

Bermuda or the Cayman Islands.[61] Of course, a CIC may be formed under the laws of any number of domestic State jurisdictions as well, including but not limited to Delaware, Vermont, Utah and South Carolina.[62]

In order for a CIC to be an "insurance company" it must issue "insurance" through "insurance contracts."[63] The I.R.C. does not define what constitutes "insurance" or an "insurance contract."[64] Generally, in order to be considered insurance for federal income tax purposes, an arrangement must transfer the risk of economic loss,[65] must contemplate the occurrence of a stated contingency,[66] and must constitute more than simply an investment or business risk.[67] The Supreme Court of the United States ("Supreme Court") has held, in *Helvering v. LeGierse*, that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present.[68]

In *Helvering*, an elderly taxpayer, who was uninsurable, purchased a life policy and a life-only annuity policy one month before the taxpayer's death.[69] By purchasing the annuity policy from the same insurer, the taxpayer effectively offset the insurer's risk.[70] The taxpayer's primary purpose for purchasing the life insurance policy was to obtain preferable estate tax advantages offered.[71] The Court decided that there was no risk shifting in this case because the life insurance policy and the life-only annuity contract offset one another.[72] As a result, the taxpayer was in the same economic position before and after purchasing the policies.[73] The *Helvering* case illustrates the need for risk shifting in a proper insurance policy, which is discussed next, below.

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61. *Id.*
62. *Running a Captive Correctly*, *supra* note 32.
63. I.R.C. § 816(a) (2006).
64. I.R.C. § 816.
65. Allied Fidelity Corp. v. Comm'r, 572 F.2d 1190, 1193 (7th Cir. 1978).
66. *See*Comm'r v. Treganowan, 183 F.2d 288, 290-91 (2nd Cir. 1950).
67. Helvering v. LeGierse, 312 U.S. 531, 542 (1941); Rev. Rul. 89-96, 1989-2 C.B. 114 (1989).
68. Helvering, 312 U.S. at 539.
69. *Id.* at 532.
70. *Id.* at 541.
71. *Id.*
72. *Id.*
73. *Id.*

2. Risk Shifting

Risk shifting must occur in any arrangement for the arrangement to be considered insurance.[74] Risk shifting occurs where a party facing the risk of a large economic loss transfers some (or all) of the financial consequences of such potential loss to the insured.[75]Risk shifting generally requires: enforceable written insurance contracts; premiums negotiated and actually paid at arms-length; and the insurance company to be a separate entity capable of meeting its obligations and formed under the laws of the applicable jurisdiction.[76] The test for risk shifting is whether the premium paying party has truly transferred risk of loss.[77]

In *Humana, Inc. v. Commissioner of Internal Revenue*,[78] the Supreme Court held that an arrangement solely between a parent company and a subsidiary insurance company did not constitute "insurance" for federal tax purposes because risk shifting was not present.[79] The *Humana* court noted that the comparison between an arrangement between a parent entity and a wholly owned CIC and a reserve for self-insurance could not be ignored.[80] The court further reasoned that the economic reality of the situation was that the parent entity did not truly transfer risk of loss to the CIC since any loss would be incurred by the parent entity as the only CIC owner.[81]

However, in *Humana*, the Supreme Court also held that an arrangement between a subsidiary insurance company and several dozen other subsidiaries of the parent corporation constituted insurance, since elements of risk shifting were present.[82] The *Humana* court reasoned that arrangements between a CIC subsidiary of a parent entity and other subsidiaries of a parent entity did not entail the same risk of loss arguments as does an arrangement directly between a CIC and

74. *Id.*at 539.

75. Bobbe Hirsh & Alan S. Lederman, *The Service Clarifies the Facts and Circumstances Approach to Captive Insurance Companies*, 100 J TAX'N168, 169 (Mar. 2004)[hereinafter *The Service Clarifies the Facts and Circumstances Approach to Captive Insurance Companies*].

76. *Id.*at 169.

77. Clougherty Packing Co. v. Comm'r, 84 T.C. 948 (1985), *decision aff'd*, 811 F.2d 1297, 1300 (9th Cir. 1987).

78. Humana, Inc. v. Comm'r, 881 F.2d 247, 251 (6th Cir. 1989).

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 252.

the parent entity.[83] The court implied that a loss suffered by the CIC would not necessarily translate into a loss suffered by the subsidiary insured since there would be other claims histories involved to counteract the effect of a CIC loss on the assets of the subsidiary insured.[84]

The *Humana* court noted that the doctrine of substance over form could be used to challenge the existence of separate and distinct entities, which are required to ensure the existence of risk shifting. [85] The *Humana* court noted, however, that this doctrine will only be applied where there exists no valid business purpose for the transactions or where there exists a clear Congressional intent to curtail the transactions in question.[86] The *Humana* court noted that Congress has not yet manifested an intent to disregard the separate corporate entity in the context of captive insurers.[87]

Furthermore, a CIC can almost always display a valid business purpose for maintaining separate entities with proper planning.[88] Therefore, the substance over form argument used to challenge the existence of risk shifting is generally fruitless, unless the transaction is found to be devoid of economic substance aside from mere tax benefits (discussed further below, *infra*).[89]

Since *Humana*, the I.R.S. has provided broad "safe harbor" rulings.[90] The main "safe harbor" provision is found in Revenue Ruling 2002-90.[91] In Revenue Ruling 2002-90, the I.R.S. explained that an arrangement of at least twelve subsidiaries paying premiums to an affiliated CIC constitutes effective risk shifting where each subsidiary has no more than 15% and no less than 5% of the total risk insured and none of the claimed twelve subsidiaries are disregarded entities.[92]

Following the promulgation of broad "safe harbor" provisions, the I.R.S. only appears eager to challenge a CIC on the grounds of risk shifting in the most egregious and abusive of

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83. *Id.*
84. *See id.* at 257.
85. *Id.* at 256.
86. *Id.* at 255-56.
87. *Id.* at 255.
88. *Id.* at 255.
89. *See* discussion *infra* Part II.C.2.
90. *E.g.*, Rev. Rul. 2002-90, 2002-2 C.B. 985.
91. Rev. Rul. 2002-90, 2002-2 C.B. 985.
92. Rev. Rul. 2005-40, 2005-2 C.B. 4.; Rev. Rul. 2002-90, 2002-2 C.B. 985.

circumstances.[93] Characteristics of risk shifting may also be lacking where guarantees exist to remove the presence of a CIC risk of loss and where contracts are not entered into at arms length.[94] Lastly, the I.R.S. may consider other factors in a risk shifting challenge, such as: whether the insured parties truly face hazard of economic risk in an amount which justifies premium payments made at commercially reasonable rates; whether the validity of claims was established before insurance claims were paid; and whether the CIC business operations and assets are kept segregated from the business operations and assets of the parent company.[95]

3. Risk Distribution

Risk distribution is also required for an arrangement to be considered insurance.[96] Risk distribution utilizes the law of large numbers.[97] The idea is that the risk that a single costly claim will exceed premium payments for a given time decreases over longer periods of time, and with a greater number of insureds in a given pool.[98]

Risk distribution involves the pooling of insurance premiums from separate entities so that the insured is not paying for a significant part of its own risks.[99]

The focus of a risk distribution analysis is broader than that of a risk shifting analysis.[100] A risk distribution analysis looks more to the insurer as to whether the risk insured against can be distributed over a larger group, rather than the relationship between the insurer and any single insured.[101] Unfortunately, there exists "little authority adequately discussing what constitutes risk distribution" if risk shifting is found to exist.[102] However, in *Humana*, the court found that an arrangement, in which a CIC insures multiple subsidiary insureds from a single affiliated group, constitutes valid risk distribution since the

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93. *See generally* Crawford Fitting Co. v. United States, 606 F. Supp. 136, 143 (N.D. Ohio 1985).

94. *See* Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 840-41 (6th Cir. 1995); Rev. Rul. 2002-90, 2002-2 C.B. 985.

95. Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1151 (Fed. Cir. 1993).

96. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

97. Rev. Rul. 2002-90, 2002-2 C.B. 985.

98. Clougherty Packing Co. v. Comm'r, 811 F.2d 1297, 1300 (9th Cir. 1987).

99. Humana, Inc. v. Comm'r, 881 F.2d 247, 256 (6th Cir. 1989).

100. *Id.*

101. *Id.*

102. *Id.*

premiums paid by each insured may be used to offset the CIC losses as a whole.[103] The courts have never established a floor for sufficient unrelated business to constitute risk distribution, but the courts have ruled that 2% is insufficient and that 30% is sufficient.[104]

The benefits of a CIC are clear. I.R.S. safe harbors provide formation and operational compliance guidance.[105] Next, this article provides an overview of some of the compliance issues that are brewing for every I.R.C. Section 831(b), although this list is in no way exhaustive. The reason for outlining these compliance risks is to illustrate examples of things that may be compounded by making use of an offshore jurisdiction for a CIC. As the compliance hot button list grows, even a fully compliant CIC may see its compliance and audit costs rise substantially when it is located in a foreign jurisdiction by virtue of the I.R.S.' current bias against U.S. taxpayers doing tax avoidance transactions outside of the U.S.

D. *Current I.R.C. § 831(b) CIC Compliance Risks*

In addition to the above risk shifting and risk distribution requirements applicable to every CIC, there are currently a few specific CIC activities that are of particular interest as compliance issues to the I.R.S. While most I.R.C. Section 831(b) CIC arrangements avoid these compliance issues, a growing number of CICs are either exposed to or undertake these problematic additions to their CIC planning.[106] One of these compliance issues involves the use of life insurance on the CIC owner's life as a major investment of the CIC (discussed immediately below).[107]

1. CIC Investments in Life Insurance

The life insurance industry has, numerous times, attempted to construct an arrangement to garner tax-deductible life insurance premiums or to provide tax-deductible financing for

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103. *Id.* at 257.

104. *See* Gulf Oil Corp. v. Comm'r, 89 T.C. 1010, 1025-28 (1987); Sears, Roebuck, and Co. v. Comm'r, 972 F.2d 858, 863 (7th Cir. 1992); Amerco, Inc. v. Comm'r, 979 F.2d 162, 168 (9th Cir. 1992); Harper Group v. Comm'r, 979 F.2d 1341, 1342 (9th Cir. 1992).

105. *See generally* Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-90, 2002-2 C.B. 985; Rev. Rul. 2002-91, 2002-2 C.B. 991; Rev. Rul. 2005-40, 2005-2 C.B. 4; Rev. Proc. 2002-75, 2002-2 C.B. 997.

106. *See* Jay Adkisson, *Life Insurance and Captives*, http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm (last visited Sept. 6, 2012) (hereinafter *Life Insurance and Captives*).

107. *See* discussion *infra* Part II.D.1.

the purpose of purchasing life insurance.[108] These arrangements have included but not been limited to Company Owned Life Insurance ("COLI") plans;[109] I.R.C. Section 419 plans;[110] I.R.C. Section 412(i) plans;[111] and Producer Owned Reinsurance Companies ("PORCs").[112] However, in each of these arrangements, the I.R.S. has quickly closed the tax loopholes by designating these transactions as "listed transactions."[113] The end result for taxpayer participants in such arrangements has been expensive litigation, generally unfavorable results, and even accuracy-related taxpayer penalties.[114]

The life insurance industry's latest attempt to provide an income tax incentive for the purchase of life insurance is setting up an I.R.C. Section 831(b) CIC and having the CIC invest in life insurance on the CIC/business owner's life.[115] The theory behind this arrangement is that the small business owner's funding of the CIC may be treated as an ordinary and necessary business expense under I.R.C. Section 162. An ordinary and necessary business expense is tax deductible, so the CIC premiums are made tax-free.[116]In the context of an I.R.C. Section 831(b) CIC, such business-risk insurance premiums may be deductible up to $1.2 million per year, and these premiums are also not included in the taxable income of the CIC.[117] Theoretically, the CIC could then purchase life insurance on the small business owner's life with pre-tax dollars as an investment.[118] Although these separate steps each meet the formalities of the I.R.C., the I.R.S. may still attack these arrangements as a whole under various judicial doctrines designed to combat abusive tax structures.[119] These judicial doctrines include, but are not limited to, the "sham transaction doctrine;" the "economic substance doctrine;" the

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108. *See generally* Winn-Dixie, Inc. v. Comm'r, 113 T.C. 254; Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43 (2000); Curcio v. Comm'r, T.C. Memo 2010-115 (2010); Zarella v. Pacific Life Ins. Co., 2010 WL 4663296 (S.D. Fl. 2010).

109. *See* I.R.C. § 101(j) (2006).

110. *See* I.R.C. § 419A (2006).

111. *See* I.R.C. § 412 (2006); Treas. Reg. § 1.412(i)-1.

112. *See* I.R.S. Notice 2002-70.

113. *See* Sherwin P. Simmons & Stephan R. Leimberg, *Prop. Regs. Address Abusive Transactions Involving Life Insurance in Qualified Plans*, 31 EST. PLAN.163, 165-69 (2004).

114. I.R.S. Announcement 2002-96, 2002-2 C.B. 756; *see* Neonatology Associates, P.A., 115 T.C. at 51.

115. *See Bad Financial Medicine, supra* note 1.

116. *Bad Financial Medicine, supra* note 1.

117. I.R.C. § 831(b).

118. *Bad Financial Medicine, supra* note 1.

119. *Id.*

"step transaction doctrine," and the doctrine of "substance over form."[120]

Congress intended that premiums paid on personal life insurance be non-deductible.[121] Life insurance purchased by a small-business owner's CIC may appear to be for business purposes, but this insurance likely would not benefit anyone other than the small-business owner and their family, which makes the premium expense arguably personal in nature.[122] The I.R.S. has a long history of successfully attacking life insurance arrangements that alter the form of transactions for the purpose of garnering tax benefits, and small business owners would be wise to take notice of the inherent risks involved with participation in such an arrangement.[123]

This author has explored this subject matter in a previous article, discussing: (i) the history and purpose of income tax benefits for the purchase of life insurance; (ii) the life insurance industry's historical attempts to provide additional income tax incentives for the purchase of life insurance; (iii) the level of I.R.S. scrutiny received, as well as the general results obtained, under these historical attempts to provide additional income tax incentives; and (iv) the likely level of I.R.S. scrutiny and general

120. *See generally* Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43, 88-90 (2000); Winn-Dixie, Inc. v. Comm'r, 113 T.C. 254, 290 (1999); In re C.M. Holdings, Inc., 254 B.R. 578, 621 (D.Del. 2000); Am. Elec. Power, Inc. v. United States, 136 F. Supp. 2d 762, 786-87 (S.D. Ohio 2001); I.R.S. Notice 2002-70; Security Industrial Ins. Co., 702 F.2d 1234, 1244 (5th Cir. 1983).

121. Howard Zaritsky& Stephan Leimberg, *Deductibility of Life Insurance Premiums*, Tax Planning with Life Insurance: Analysis with Forms § 2.08 (2011).

122. A small business owner's purchase of life insurance through a CIC would likely only benefit the small business owner and their family since most small businesses are closely held, with only the business owner and family having any equity interest in the entity. *See Closely Held Corporations*, Inc.com (2012),http://www.inc.com/encyclopedia/closely-held-corporations.html. Life insurance could potentially benefit creditors and employees by enabling an insolvent entity to meet its obligations. Insolvency, by definition, means that the entity is unable to meet existing obligations as they come due. *See Definition of Insolvency*, Investopedia *(2012)*, http://www.investopedia.com/terms/i/insolvency.asp#axzz27h1c2H6U. Solvency, on the other hand, means "financial soundness of an entity that allows it to discharge its monetary obligations as they fall due." *See Definition of Solvency*, BusinessDictionary.com (2012), http://www.businessdictionary.com/definition/solvency.html. Since a solvent entity is, by definition, able to meet all debt obligations as they come due, only holders of equity interests in a solvent entity would benefit from the payment of life insurance benefits to the entity. *See generally Definition of Solvency*, BusinessDictionary.com (2012), http://www.businessdictionary.com/definition/solvency.html.

123. *See generally* Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43, 90 (2000); Curcio v. Comm'r, T.C. Memo 2010-115 (2010); I.R.S. Notice 2002-70; Donald Arthur Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79, 86 (1990); Elliott, *supra* note 21.

results that would be received upon the current use of CIC as such as income tax incentivized program for the sale of life insurance.[124] While the life insurance issue is a significant CIC compliance issue, it is not the only one. The CIC "loan back" problem is discussed immediately below.

2. Loan Backs to CIC Shareholder and/or Insured

Some aggressive planners may attempt to engage in tax motivated loan back arrangements between an I.R.C. Section 831(b) CIC and the CIC owners. In such an arrangement, the owners would find loan backs from a CIC beneficial because the owners could make use of the funds while enjoying a deferral of the realization of insurance underwriting income. The I.R.S. and the DOJ have historically challenged schemes wherein a taxpayer engages in non-taxable loan back transactions from a tax-deferred investment vehicle, viewing such an arrangement as inherently fraudulent.[125] If a shareholder of the CIC is able to make use of the funds while enjoying tax benefits Congressionally intended only for certain true investment vehicles, the I.R.S. and DOJ may assert that the arrangement is solely a tax-motivated transaction. I.R.C. Sections 6662 and 6663 impose accuracy-related penalties of between 20% and 75% of the underpayment amount of income tax where one or more of certain factors are present, including where the transaction lacks economic substance or is deemed fraudulent.[126] Of course, the DOJ may also bring criminal charges of defrauding the U.S. and/or conspiracy to defraud the U.S. of tax revenue where the arrangement is found to constitute fraudulent tax evasion.[127]

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124. Beckett G. Cantley, *Repeat as Necessary: Historical IRS Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance*, 12 U.C. DAVIS BUS. L.J. (forthcoming December 2012).

125. *See* Steven Meyerowitz, *Court Finds 'HedgeLoan' Transactions Were Taxable Stock Sales Disguised As Loans*, FINANCIAL FRAUD LAW (June 16, 2011), http://www.financialfraudlaw.com/lawblog/court-finds-'hedgeloan'-transactions-were-taxable-stock-sales-disguised-loans/2426; William D. Hartsock, *Six Defendants Convicted in $120 Million International Tax Shelter Case* (2009), http://www.taxlawfirm.net/audit-international/international_tax_shelter.htm.

126. I.R.C. § 6662(a) (2006); I.R.C. § 6663(a) (2006).A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 150% or more of the amount determined to be the correct amount of the value or adjusted basis. I.R.C. § 6662(e)(1).

127. *See* Hartsock, *supra* note 125; Shannon P. Duffy, *Attorney Indicted for Helping Clients Avoid $4.6M in Taxes*, THE LEGAL INTELLIGENCER (Nov. 29, 2007), http://www.judicialaccountability.org/articles/lawyersinthenewsthree.htm; Press Release, U.S. Dep't of Justice, Tax Division, Office of Public Affairs, *Utah-Based Tax Shelter Operators Plead Guilty in $200 Million Tax Fraud* (Oct. 26, 2009), http://www.justice.gov/opa/pr/2009/October/09-tax-1155.html [hereinafter Utah-Based Tax Shelter]; Jonathan D. Glater, *Former Banker Pleads Guilty in Tax Shelter Case*, NEW

Thus, it is important for taxpayers to be aware under what circumstances the I.R.S. and DOJ may assert that a loan back arrangement is actually, in substance a tax-motivated or fraudulent transaction.

The government has yet to specifically address the validity of CIC loan back arrangements either civilly or criminally.[128] As such, reviewing the historical non-CIC loan back and fraudulent related party loan cases currently provide the best guide for predicting how the I.R.S. and DOJ may view CIC loan back transactions. The structures in several of these prior cases are factually and legally very similar to a CIC loan back arrangement, so the legal attacks and consequences are likely a fair analogy to how a CIC loan back case would proceed. The most common judicial and codified doctrines, as exemplified in the analogous loan cases discussed immediately above, that the I.R.S. and DOJ utilize to argue a transaction is a tax scheme are (i) the lack of bona fide indebtedness; (ii) the sham transaction doctrine; and (iii) the economic substance doctrine.[129] In some cases, the facts of the transaction may lead to an argument that the arrangement additionally constitutes criminal fraud.[130] A less problematic, but still complicating addition to certain CIC arrangements, is the use of a children's trust to own the CIC shares for estate planning purposes (discussed below).

3. Estate Planning Ownership Structures

Another CIC compliance issue that is likely to become a source of focus at the I.R.S. is the recent growth in utilizing a CIC for avoiding Federal transfer taxes. In particular, the planning community is arguing that by having the CIC owned ab initio by a trust (or other entity) that benefits the descendants of the person who owns the premium paying insured entity, the resulting transfer of premium into the CIC will shift the CIC profits to the next generation without liability for Federal Estate or Gift Taxes.[131]

YORK TIMES (Aug. 12, 2005), http://www.nytimes.com/2005/08/12/business/12tax.html?pagewanted=all; I.R.S. Notice 97-24, 1997-1 C.B. 409.

128. *See generally* Bunting et al., *supra* note 22.

129. *See generally* U.S. v. HedgeLender, LLC, 2011 WL 2686279 (E.D.Va. 2011); Schrott v. Comm'r, T.C. Memo. 1989-346 (1989); *Malone and Hyde, Inc.*, 62 F.3d 835, 840; Goldstein v. Comm'r, 364 F.2d 734, 740 (2d Cir. 1966); I.R.C. § 7701(o).

130. *See* Utah-Based Tax Shelters, *supra* note 127, at 127.

131. *See* Gordon A. Schaller and Scott A. Harshman, *Use of Captive Insurance Companies in Estate Planning*, 33 ACTEC J. 252, 259-61 (Spring 2008).

While this transaction likely is technically compliant with the Federal Estate and Gift Tax provisions of the I.R.C., it may run afoul of the judicial and codified doctrines. Specifically, it may be difficult to explain the business purpose for having a business owner's children be the beneficial owners of an insurance company that insures the business of the father-owner. A court may have a difficult time finding that a father would actually shift real risk to his children's trust, which may make the court determine that the likelihood of a good faith insurance claim being made seem remote. In addition, a court may also determine that the real purpose of the arrangement was primarily to transfer wealth in a tax efficient manner to the next generation, not the insurance of business risks. Thus, it seems relatively certain that the I.R.S. and DOJ may put the parties in interest in the difficult position of reconciling the seemingly contradictory goals of obtaining a real insurance policy for serious business risks, and the preservation of wealth for your children's beneficial interest.

Now that this article has discussed several of the potential special compliance issues relevant to certain I.R.C. Section 831(b) CIC arrangements, the next section describes the broad I.R.S. attack on offshore tax and financial arrangements.

III. THE I.R.S. OFFSHORE ATTACK

Senator Carl Levin has been leading investigations of offshore tax evasion for several years, in his role as Chairman of the U.S. Senate Permanent Subcommittee on Investigations ("PSI").[132] The PSI has heard testimony that these offshore schemes drastically reduce the U.S. government's ability to monitor its citizens' financial situations, and significantly add to the "tax gap" that exists between what tax is collected and what tax is actually owed.[133] As such, the U.S. government has a strong interest in uncovering these schemes to collect the billions in lost in tax revenue.[134] According to Senator Levin, these tax schemes shift the tax burden from high-income individuals and

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132. *See* Senator Carl Levin, Chairman, Permanent Subcommittee on Investigations, *Statement Introducing the Stop Tax Haven Abuse Act, Part 1* (Feb. 17, 2007), *in* Tax Analysts (Doc. 2007-4503), Feb. 12, 2007, at 36 [hereinafter *Statement Introducing the Stop Haven Abuse Act, Part I*].

133. *TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17.

134. *See* Statement Introducing the Stop Haven Abuse Act, Part 1, *supra* note 132.

large companies onto the backs of middle and working class families.[135]

Additionally, certain countries (such as Switzerland) have strict offshore secrecy rules that can assist unscrupulous taxpayers in committing illicit activity with little fear of getting caught.[136] These laws are often used as shields for foreign banks to conceal the identities and financial information of U.S. taxpayer accounts from U.S. regulatory authorities.[137] Countries such as the United Kingdom, France, and Germany also seek to pressure worldwide financial centers to modify bank secrecy laws.[138]

This part of the article will focus on the United States' reasons for exerting such pressure, including the billionaire brothers whose scheme gave credence to the concerns outlined in the 2006 PSI investigation,[139] the government's attempt to reign in tax evaders through various versions of the Voluntary Disclosure Initiative ("VDI"),[140] other offshore enforcement issues,[141] and non-filers with foreign bank accounts.[142] This section of the article covers a great deal of ground and detail. The point of this extensive discussion on the offshore crackdown is to provide a picture of the history and direction of the offshore crackdown and to provide perspective on how broad the scope of the government's activities are, and will likely continue to be, in this area.

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135. *See Statement Introducing the Stop Haven Abuse Act, Part I, supra* note 132.

136. *Id.* at 36-37.

137. *Id.* at 37.

138. Alan W. Granwell et al., *IRS Issues Voluntary Disclosure Guidance for Unreported Offshore Accounts and Entities*, PRACTICAL U.S./DOMESTIC TAX STRATEGIES, Apr. 2009, at 2, http://www.dlapiper.com/files/Publication/95e03d3b-7060-4562-b72d-a46fea0aa4b5/Presentation/PublicationAttachment/5e2a2645-f236-4863-8e9e-c85fec262f48/DomTax0409.pdf [hereinafter *IRS Issues Voluntary Disclosure Guidance for Unreported Offshore Accounts and Entities*].

139. *See* Norm Coleman, Chairman, U.S. Senate Permanent Subcommittee on Investigations, *Tax Haven Abuses: The Enablers, The Tools, and Secrecy*, Minority & Majority Staff Report, 113-15, Aug.1, 2006, http://www.levin.senate.gov/imo/media/doc/supporting/2006/PSI.taxhavenabuses.080106.pdf (releasing in conjunction with the Permanent Subcommittee on Investigations Aug. 1, 2006 Hearing) [hereinafter *Tax Haven Abuses: The Enablers, The Tools, and Secrecy*].

140. *See* Kristen A. Parillo, *IRS Streamlines Offshore Disclosure Process*, 124 TAX NOTES 415, 415 (2009) [hereinafter *IRS Streamlines Offshore Disclosure Process*].

141. *See TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17, at 7-11.

142. Internal Revenue Service, *FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) - Financial Accounts* (June 29, 2012), http://www.irs.gov/businesses/small/article/0,,id=210249,00.html.

A. *The Wyly Brothers' Senate Hearing*

In 2005 and 2006, federal and state agencies investigated brothers Samuel and Charles Wyly for tax evasion.[143] The 2006 PSI report described a potential tax evasion scheme of the Wylys involving fifty-eight unreported offshore trusts and corporations.[144] The Wylys transferred over $190 million in stock options they had received from several U.S. publicly traded companies to the offshore entities.[145] The brothers claimed that the options were not currently taxed because the option transfers were made in a proper exchange for future deferred private annuity payments to be paid by the offshore entities to the Wylys.[146] In the interim, the brothers proceeded to direct the offshore entities to cash in stock options and start investing the money.[147] These offshore stock transactions were not disclosed to the U.S. SEC despite the brothers' positions as directors and major shareholders in the relevant companies.[148] The PSI was able to trace more than $700 million in untaxed stock option proceeds that Sam and Charles Wyly invested in the various ventures they controlled, including two hedge funds, an energy company, and an offshore insurance firm.[149]

The Wyly brothers ostensibly got away with these avoidant and arguably manipulative tax maneuvers because of the offshore country's secrecy laws.[150] Although the funds were offshore, the brothers controlled all of the accounts and assets by communicating their directives to a "trust protector," who relayed directions to offshore trustees.[151] The PSI investigations revealed that these trustees never once rejected a Wyly order and

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143. Democratic National Committee, *Another Bad Batch of Bush Money* (June 6, 2012), http://www.democraticunderground.com/discuss/duboard.php?az=view_all&address=132x1836592; Eric Torbenson & Brendan M. Case, *SEC Accuses Sam, Charles Wyly of Secrecy, Insider Trading* (July 30, 2012), http://www.dallasnews.com/business/headlines/20100729-SEC-accuses-Sam-Charles-Wyly-3129.ece (stating that the brothers are being investigated by the SEC, a grand jury in Dallas, and a grand jury in New York).

144. *See Statement Introducing the Stop Haven Abuse Act, Part I*, *supra* note 132, at 3.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*; *SeeTax Haven Abuses: The Enablers, The Tools, and Secrecy*, *supra* note 139, at 118.

150. *Id.*

151. *See Statement Introducing the Stop Haven Abuse Act, Part I*, *supra* note 132, at 3-4.

never initiated an action without direct Wyly approval.[152] Senator Levin explained how simple it was for these billionaire brothers to take advantage of a practice dubbed the "Foreign Trust Loophole."[153] The PSI called the Wyly brothers in 2006, and they each invoked their Fifth Amendment right and were never asked to testify.[154] Regardless, the damage was done—the Wyly brothers' activities had been the ignition spark for a six-year (and counting) extensive offshore tax evasion crackdown.[155] The first wave of the crackdown would be giving U.S. taxpayers a chance to come clean by voluntarily revealing their illegal activities—the VDI.[156]

B. *The Voluntary Disclosure Initiatives*

On March 23, 2009, the I.R.S. introduced the first Voluntary Disclosure Initiative ("2009 VDI").[157] The 2009 VDI lowered penalties for individuals and companies that voluntarily disclosed previously unreported offshore accounts.[158] Taxpayers with legal sources of income that made timely and accurate disclosures and paid (or made arrangements to pay) taxes due qualified for the 2009 VDI.[159] By introducing the 2009 VDI, the

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152. *Id.* at 4.

153. *Id.* at 8-9; Nebraska Democrats, *Taxes? We Don't Need to Pay No Stinkin' Taxes!* (June 8, 2012),
http://www.dallasnews.com/

> (First a public company grants stock options to a senior executive. The executive then transfers the options to a trust or partnership controlled by the executive's family. The parties then structure the transfer as a 'sale' and the trust then 'pays' the executive for the options with a long-term or deferred note. . .Shortly after then options are transferred, the trust exercises the stock options and sells the stock in an open market. The executive then takes the position that tax is not owed until the date of the deferred payment . . .although the executive has access to the partnership assets.).

154. *See* David Cay Johnston, *Tax Cheats Called Out of Control* (Aug. 1, 2012), http://www.nytimes.com/2006/08/01/business/01tax.html.

155. *Id.*

156. *Id.*

157. *IRS Streamlines Offshore Disclosure Process*, *supra* note 140.

158. *See id.*

159. *IRS Issues Voluntary Disclosure Guidance for Unreported Offshore Accounts and Entities*, *supra* note 138; I.R.M. § 9.5.11.9 (West 2009)

> ((3) A voluntary disclosure occurs when the communication is truthful, timely, complete, and when: (a) a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability. (b) The taxpayer makes good faith arrangements with the IRS to pay in full, the tax, the interest, and any penalties determined by the IRS to be applicable. (4) A disclosure is timely if it received before: (a) The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified taxpayer it intends to commence such an examination. (b) The IRS has received information from a [3rd] party (e.g. informant, other governmental agency, or the

I.R.S. hoped to create an incentive for noncompliant taxpayers to become compliant by setting forth a circumscribed and favorable penalty framework.[160] The I.R.S. also hoped to recover lost tax revenue.[161]

The I.R.S. policy goals for the 2009 VDI included creating a mechanism for dealing with a large group of noncompliant taxpayers using offshore accounts.[162] The I.R.S. hoped to reduce or eliminate the difficulties of obtaining information from offshore banking countries, and to satisfy the requests for certainty from practicing tax attorneys and accountants.[163] I.R.S. personnel applied the penalty framework to voluntary disclosure requests for previously unreported offshore accounts.[164] Under the 2009 VDI, taxpayers were required to file or amend all returns for the prior six years, and as well as an I.R.S. form called Reports on Foreign Bank and Financial Accounts ("FBAR").[165] The I.R.S. agreed to only assess a penalty of 20% of the amount in foreign bank accounts or entities in the year with the highest aggregate account or asset value.[166] The penalty could be reduced to 5% in the case of certain inherited accounts.[167] While the program did not guarantee immunity from prosecution, it was the most effective way to avoid criminal penalties.[168] I.R.S. stated policy is that agents will pursue the maximum for both criminal and civil penalties for taxpayer cases of offshore income not reported to the I.R.S. via the 2009 VDI.[169]

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media) alerting the IRS to the specific taxpayer's noncompliance. (c) IRS has initiated a civil examination or criminal investigation, which is directly related to the specific liability of the taxpayer. (d) The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g. search warrant, grand jury subpoena).).

160. *See IRS Issues Voluntary Disclosure Guidance for Unreported Offshore Accounts and Entities*, *supra* note 138.

161. *Id.*

162. *Id.*

163. *See id.*

164. *Id.*

165. *Id.* (providing an exception where an account or entity was formed or acquired within the six-year "look back" period. In these cases, the taxes and interest will be assessed starting with the earliest year in which the account was created or acquired, or the entity was formed.).

166. *Id.*

167. *Id.* at 9 (providing the requisite conditions are satisfied before qualifying for a reduction, including "(1) the taxpayer did not open or cause any accounts to be opened or entities to be formed; (2) there has been no activity in any account or entity; and (3) all applicable U.S. taxes have been paid on the funds deposited in the accounts or transferred to the entities (except for taxes on income or earnings or the account of entity)").

168. *See id.* at 8; I.R.M § 9.5.11.9(2) (This does not apply to a taxpayer with illegal income source).

169. Internal Revenue Service, Press Release, *Statement From IRS Comm'r Douglas Shulman on Offshore Income* (Mar. 26, 2009) http://www.irs.gov/uac/Statement-from-IRS-

The 2009 VDI led to about 15,000 voluntary disclosures and about 3,000 more after the deadline had passed.[170] The I.R.S. has seen closures of about 95% of the cases from the 2009 VDI program.[171]

In 2011, The I.R.S. introduced a second VDI ("2011 VDI").[172] Just as in the 2009 VDI, the 2011 VDI created an incentive to come forward with disclosures in order to avoid penalties enforced as a result of I.R.S. detection.[173] However, the 2011 VDI included several changes to the 2009 initiative.[174] Mainly, the penalties for the 2011 VDI were higher than the penalties in 2009 VDI, because the I.R.S. did not want to reward taxpayers for waiting to disclose information.[175] Since the close of the 2011 VDI last September, hundreds of taxpayers have come forward.[176] The combination of the 2009 VDI and 2011 VDI produced a total of 33,000 disclosures.[177]

The I.R.S. announced this month that it plans to introduce a third VDI ("2012 VDI").[178] The overall penalty structure is vey similar to the 2011 VDI,[179] but taxpayers in the highest penalty category will pay a higher penalty (27.5%, up from 25% in 2011).[180] Another difference between the 2012 VDI and the 2011 VDI is that the new program does not have a set deadline for taxpayers to apply.[181] Additionally, the I.R.S. has stated that

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Commissioner-Doug-Shulman-on-Offshore-Income ("Those who truly come in voluntarily will pay back taxes, interest, and a significant penalty, but can avoid jail time.").

170. Internal Revenue Service, Press Release, *IRS Shows Continued Progress on International Tax Evasion* (Sept. 15, 2011), http://www.irs.gov/uac/IRS-Shows-Continued-Progress-on-International-Tax-Evasion; Internal Revenue Service, Press Release, *Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 Deadline* (Feb. 8, 2011) http://www.irs.gov/newsroom/article/0,,id=235695,00.html.

171. *See* Internal Revenue Service, Press Release, *IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens* (updated Jan. 9, 2012) http://www.irs.gov/newsroom/article/0,,id=252162,00.html.

172. *Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 Deadline*, *supra* note 170.

173. *Id.*

174. *Id.*

175. *See id.*

176. *IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens*, *supra* note 171.

177. *IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens*, *supra* note 171.

178. *IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens*, *supra* note 171.

179. *Id.*; *Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 deadline*, *supra* note 170.

180. *IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens*, *supra* note 171.

181. *Id.*

they reserve the right to change the 2012 VDI at any moment going forward and plan to keep the 2012 VDI very open-ended.[182]

The I.R.S. is taking a carrot-and-stick approach to enforcement.[183] The "stick" is the increased I.R.S. enforcement for those who hide their money offshore and do not report it.[184] The "carrot" is the reduced penalty for those who come forward.[185] The I.R.S. is dedicated to increasing the penalty with each new VDI, as seen from the changes in the initiatives from 2009 to 2011 and 2011 to the new 2012 initiative.[186] The "stick" also includes the new open-ended nature of the 2012 VDI mentioned above.[187] Jeffrey A. Neiman ("Neiman"), Assistant U.S. Attorney who led the prosecution of UBS, stated the open-ended deadlines "puts pressure on American with oversees accounts to come in now."[188]

The fact that the I.R.S. has undertaken three separate VDI programs, each with a more draconian penalty regime,[189] shows how seriously the I.R.S. is invested in its offshore crackdown. The amount of time and resources necessary to implement these programs is extensive, and is very likely the precursor to an even more serious enforcement push against non-compliant taxpayers who have not taken part in any of the VDI programs.[190]

C. *The Qualified Intermediary Regime*

The I.R.S. understands that tax evasion involving offshore entities is difficult to detect and prosecute.[191] Abusive and evasive offshore tax schemes present many challenges to tax enforcement[192]including the time constraint the I.R.S. faces conducting examinations of offshore tax issues.[193] A 2009 U.S. Government Accountability Office ("GAO") report shows offshore

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182. *Id.*

183. *See* Thomas Zehnle, *Rethinking the Approach to Voluntary Disclosures,* 134 TAX NOTES 575, 575 (Jan. 30, 2012), *available at* http://www.millerchevalier.com/Publications/PublishedArticles?find=73302.

184. *Id.*

185. *Id.*

186. *Id.*

187. *See* Marie Sapirie, *IRS Announces Open-Ended Third Offshore Voluntary Disclosure Program,* 2012 TAX NOTES TODAY 6-1, para. 10 (Jan. 10, 2012), *available* at http://www.journalofaccountancy.com/Web/20124984.html.

188. *Id.*

189. *Id.*

190. *See id.*

191. *TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE, supra* note 17, at 7.

192. *Id.* at 1.

193. *Id.* at 9.

examinations can take an average of 500 more calendar days to investigate than domestic audits, due to complexity and difficulty accessing information from offshore sources.[194] Additionally, the three-year statute of limitations, which is the same as domestic investigations, limits the I.R.S. from assessing taxes or penalties from offshore investigations.[195] The result is that the I.R.S. is deterred from opening examinations or forced to end examinations early – despite evidence of likely noncompliance.[196] The U.S. is currently taking several actions to make the best use of the three-year statute of limitations period, including increasing the amount of information available to the I.R.S..[197] One such newly enacted legislation passed to improve on the information available to the I.R.S. from offshore activity is the Qualified Intermediary ("QI") program.[198]

The QI program requires that certain offshore financial institutions report income to the I.R.S..[199] However, a low percentage of U.S. source income sent offshore flows through a QI.[200] The U.S. source income that does not flow through any QI flows through U.S. withholding agents, who are permitted to accept account owners' self-certification of their identities at face value - leading to a greater chance of improper withholding due to misinformation or fraud.[201] Irrespective of the holes inherent in the QI reporting regime, the fact that Congress has deemed it necessary to enact and implement an entirely new set of

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194. *Id.* at ii.

195. *Id.* at 8.

196. *Id.*

197. *Id.* at 8-9.

198. *See* TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE, *supra* note 17, at 10; *Tax Compliance*, *supra* note 16, at 22-25

> (A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, which has entered into a withholding and reporting agreement ('QI agreement') with the IRS. In exchange for entering into a QI agreement, the QI is able to shield the identities of its customers from the IRS and other intermediaries in certain circumstances and is subject to reduced information reporting duties compared to those that would be imposed in the absence of the agreement. This ability to shield customer information is limited, however, with respect to U.S. persons, because the QI is required to furnish Forms 1099 to its U.S. customers if it has assumed primary withholdings responsibility for these accounts, or to provide Forms W-9 to the withholding agent in cases in which the QI has not assumed such responsibility.).

199. *Tax Compliance*, *supra* note 16, at 22-25.

200. *Id. at 25.*

201. *Id.* at 31 (stating the UBS cases – discussed later in this paper – demonstrate how QIs are insufficient in eliminating offshore tax evasion).

reporting requirements for foreign financial institutions[202] is indicative of the seriousness attached to the offshore tax- evasion crackdown underway.

D. *Proposed Legislation*

Congress continues to propose new legislation to aid the I.R.S. in its battle with offshore tax evasion.[203] For example, Senator Levin has introduced the *Stop Tax Havens Abuse Act,* a comprehensive bill to combat offshore abuses, for the fifth time in the 112th Congress.[204] In addition, legislators have introduced the *Foreign Account Compliance Act* ("FACTA") that imposes both (i) new filing requirements for taxpayers with foreign accounts, and (ii) new penalties on foreign financial institutions that do not disclose holdings by U.S. citizens.[205] Moreover,

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202. *See id.*at 22.

203. S. 344, 111th Cong. (2009); S. 1973, 110th Cong. (2007); *See generally* Senator Carl Levin, Chairman, Permanent Subcommittee on Investigations, *Summary of the Stop Tax Haven Abuse Act* (July 12, 2011), http://levin.senate.gov/newsroom/press/release/summary-of-the-stop-tax-haven-abuse-act-of-2011/?section=alltypes; *See* Comm. On Finance, Press Release, U.S. Congress, *Baucus, Rangel, Kerry, Neal Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties* (Oct. 27, 2009), http://finance.senate.gov/newsroom/chairman /release/?id=c661a192-81e8-4bdf-8502-242615963f71; Jeremy Scott, *News Analysis: Republicans Demand Taxpayers receive 'Geithner Deal'*, 125 TAX NOTES 1057, 1058 (2009); Joann M. Weiner, *News Analysis: Trouble Brewing Offshore with New U.S. Lending Initiative*, 122 TAX NOTES 1062, 1062 (2009).

204. *See generally* Senator Carl Levin, Chairman, Permanent Subcommittee on Investigations, Summary of the Stop Tax Haven Abuse Act (July 12, 2011), http://levin.senate.gov/newsroom/press/release/summary-of-the-stop-tax-haven-abuse-act-of-2011/?section=alltypes (Senate Bill 1346 and House Bill 2669, proposing to (1) allow the Department of Treasury to impose the same penalties used when an institution, foreign jurisdiction, or individual is found to be laundering money to any transaction or entity that the Treasury finds to be impeding on U.S. tax enforcement; (2) authorizing the Secretary of the Treasury to add or remove countries from the list of offshore secrecy jurisdictions, which are viewed as having secrecy laws or practices that unreasonably restrict U.S. tax authorities from obtaining necessary information; (3) cause certain non-U.S. corporations, which are managed and controlled within the U.S., to be treated as domestic corporations and liable for U.S. corporate income tax; and (4) apply withholding tax to payments with respect to stock of U.S. corporations to non-U.S. persons of dividend equivalent amounts and substituted dividends, which are, arguably, not subject to the 30% withholding tax on dividends paid to non-U.S. investors).

205. *See* Comm. On Finance, Press Release, U.S. Congress, Baucus, Rangel, Kerry, Neal Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties (Oct. 27, 2009), http://finance.senate.gov/newsroom/chairman/release/?id=c661a192-81e8-4bdf-8502-242615963f71

> (. . . [t]he Foreign Account Tax Compliance Act would force foreign financial institutions, foreign trusts, and foreign corporations to provide information about their U.S. accountholders, grantors, and owners, respectively. The nonpartisan Joint Committee on Taxation has estimated the provisions of the

Congress proposed the *Geithner Penalty Waiver Act* that sought to alter the penalty for VDI disclosures.[206] Senator Levin and other legislators have also introduced the *Hedge Fund Transparency Act of 2009*, seeking to increase the transparency of the offshore operations of U.S.-based hedge funds.[207] Lastly, the Senate proposed *Senate Bill 73*, to modify the statute of limitations period for investigations involving offshore secrecy jurisdictions.[208] These numerous Congressional offshore crackdown proposals have been introduced since the original Wyly brothers' hearings in 2006.[209] The scope and frequency of offshore crackdown legislation is unlikely to abate any time soon, and taxpayers who choose to make use of foreign jurisdictions in their tax planning should count on dealing with an ever-changing and perilous compliance burden. This is especially true, given the increase in I.R.S. audits involving international entities,[210] discussed below.

Foreign Account Tax Compliance Act would prevent U.S. individuals from evading $8.5 billion in U.S. tax over the next ten years.).

206. Jeremy Scott, *News Analysis: Republicans Demand Taxpayers receive 'Geithner Deal'*, 125 TAX NOTES 1057, 1058 (2009)(". . . [t]axpayers who avoided tax obligations on overseas accounts for years could come forward and pay only back taxes and interest . . . ").

207. Joann M. Weiner, *News Analysis: Trouble Brewing Offshore with New U.S. Lending Initiative*, 122 TAX NOTES 1062, 1062 (2009); *See* S. 344, 111th Cong. (2009).

208. *See* S. 1973, 110th Cong. (2007).

209. *See generally* Democratic National Committee, *Another Bad Batch of Bush Money* (June 6, 2012), http://www.democraticunderground.com/discuss/duboard.php?az=view_all&address=132x1836592; Eric Torbenson & Brendan M. Case, *SEC Accuses Sam, Charles Wyly of Secrecy, Insider Trading* (July 30, 2012), http://www.dallasnews.com/business/headlines/20100729-SEC-accuses-Sam-Charles-Wyly-3129.ece; *Statement Introducing the Stop Haven Abuse Act, Part I, supra* note 132, at 3; Senator Carl Levin, Chairman, Permanent Subcommittee on Investigations, Summary of the Stop Tax Haven Abuse Act (July 12, 2011), http://levin.senate.gov/newsroom/press/release/summary-of-the-stop-tax-haven-abuse-act-of-2011/?section=alltypes; S. 344, 111th Cong. (2009); S. 1973, 110th Cong. (2007);Comm. On Finance, Press Release, U.S. Congress, Baucus, Rangel, Kerry, Neal Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties (Oct. 27, 2009), http://finance.senate.gov/newsroom/chairman/release/?id=c661a192-81e8-4bdf-8502-242615963f71; Jeremy Scott, *News Analysis: Republicans Demand Taxpayers receive 'Geithner Deal'*, 125 TAX NOTES 1057, 1058 (2009); Joann M. Weiner, *News Analysis: Trouble Brewing Offshore with New U.S. Lending Initiative*, 122 TAX NOTES 1062, 1062 (2009);S. 1973, 110th Cong. (2007).

210. Doug Shulman, Comm'r, Internal Revenue Service, *Testimony before the Senate Finance Committee on Tax Issues Related to Ponzi Schemes and an Update on Offshore Evasion Legislation* (Mar. 17, 2009), http://finance.senate.gov/hearings/hearing/?id=d82f4597-e246-be50-240b-6056c6a2a678.

E. *Increased Offshore Audits*

The I.R.S. has increased the number of audits involving international entities since November 2008 and prioritized the stepped-up hiring of international experts and investigators.[211] The I.R.S. is also looking for ways to improve information reporting and sharing in this area.[212] In 2011, the I.R.S. audited one out of every eight millionaires, about 12.5% of taxpayers earning $1 million dollars or more.[213] This was the highest enforcement rate since 2004.[214] The I.R.S. claims the increase in audits can be attributed to the offshore crackdown.[215] It is also evident that the I.R.S. will make good use of the information gathered through the new QI program in these audits, and will continue to look closely at how to improve the QI program for these purposes.[216] One major target of these audits is clearly the uncovering of unreported foreign bank accounts,[217] as outlined in detail below.

F. *Unreported Foreign Bank Accounts*

The reporting requirements for U.S. taxpayers with foreign bank accounts are extensive.[218] If one or more of a taxpayer's foreign bank accounts reach an aggregate balance of over $10,000 within the year, the taxpayer is obligated to file a report with the United States Department of Treasury listing all foreign accounts, Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts).[219] This includes a citizen or resident of the U.S., a domestic partnership, a domestic corporation, or a

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211. *Id.*

212. *See id.*

213. Blake Ellis, *IRS audited 1 in 8 millionaires*, CNN MONEY (Jan. 5, 2012), http://money.cnn.com/2012/01/05/pf/taxes/irs_audit/index.htm.

214. *Id.*

215. *Id.*

216. Doug Shulman, Comm'r, Internal Revenue Service, *Testimony before the Senate Finance Committee on Tax Issues Related to Ponzi Schemes and an Update on Offshore Evasion Legislation* (Mar. 17, 2009), http://finance.senate.gov/hearings/hearing/?id=d82f4597-e246-be50-240b-6056c6a2a678 (stating these enhancements include expanding information reporting requirements to include sources of income for U.S. persons with accounts at QI banks, strengthening documentation rules to ensure that the program is delivering on its original intent, and requiring withholding accounts with documentation that is considered insufficient).

217. Ellis, *supra* note 213.

218. *See generally* Memorandum, Internal Revenue Service, *Report on Foreign Bank and Financial Accounts* (June 30, 2009) (on file with the agency), *available at* http://www.irs.gov/irm/part4/irm_04-026-016.htm (describing numerous filing requirements for U.S. taxpayers with foreign bank accounts).

219. *Id.* at § 4.26.16.1

domestic estate or trust.[220] "Financial accounts" include bank accounts[221], security/brokerage accounts, mutual funds, securities, derivatives, financial instrument accounts, debit and prepaid credit cards maintained with a financial institution, and certain types of annuities or pension accounts.[222] U.S. investors in offshore hedge funds and private equity funds are also required to file a FBAR.[223]

The failure to file an FBAR or disclose foreign accounts can lead to significant civil and criminal penalties.[224] Civil penalties can be $10,000 for non-willful noncompliance and $100,000 or 50% of the amount of the underlying account's balance at the time of the violation if the I.R.S. determines the noncompliance to be willful.[225] Criminal penalties can include a $250,000 fine and imprisonment for five years or, if the taxpayer violated another U.S. law in addition to failure to file a FBAR (or disclose foreign accounts), the individual will be fined $500,000 and imprisoned for ten years.[226] The penalties are also applicable if a

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220. *Id.* at § 4.26.16.3.1.1; William Pomierski, *Recent Developments Encourage Voluntary Correction of Foreign Financial Account Reporting Violations*, MCDERMOTT NEWSLETTER, McDermott Will & Emery LLP, Int'l.,(Apr. 14, 2009) http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/6eb0672c-de23-4242-9312-888af6760b4b.cfm (stating that a U.S. person has financial interest in each account for which each person is the owner of record or has legal title, regardless of whether the account is maintained for the persons' own benefit or for the benefit of others, including non U.S. persons. Instructions on Form TD F 90-22.1 now provide that the owner of record or holder of legal title includes a corporation in which the U.S. person directly or indirectly owns more than fifty percent of the total value or more than fifty percent of the voting power of all shares of stock, and a partnership in which the U.S. person owns an interest in more than fifty percent of the profits or more than fifty percent of the capital of the partnership.).

221. Pomierski, *supra* note 220 (stating this includes savings, demand, checking, deposit, or any other account maintained with a financial institution); *See id.* (stating that individual bonds, notes or stock certificates and an unsecured loan to a foreign trade or business that is not a financial institution are not financial accounts. Correspondent or "nostro" accounts – international interbank transfer accounts – maintained by banks that are used solely for the purpose of bank-to-bank settlement are also not financial accounts.).

222. *Id.*

223. Kristen A. Parillo, *Hedge Fund Investors Must File FBAR, IRS Confirms*, 124 TAX NOTES 18, 19 (2009) (stating there has been confusion over the rules in recent years).

224. Dan Meehan & Bill Morrow, *Foreign Account Disclosure – Possible June 30 Filing Obligation for Certain Funds and LPs*, COOLEY ALERT!, Cooley Godward Kronish LLP, Int'l., (June 2009), http://www.cooley.com/62717.

225. Memorandum, Internal Revenue Service, *Report on Foreign Bank and Financial Accounts* (June 30, 2009) (on file with the agency), *available at* http://www.irs.gov/irm/part4/irm_04-026-016.htm.

226. Internal Revenue Service, *Voluntary Disclosure: Questions and Answers* (Feb. 1, 2012), http://www.irs.gov/newsroom/article/0,,id=210027,00.html.

U.S. person supplies false information or if information is omitted.[227]

The I.R.S. appears to be in a continuous process of revising and increasing the compliance requirements for doing business offshore. These changes are not limited to the U.S. reporting requirements discussed above, but also include changes to U.S. treaties with foreign countries (as outlined below).[228]Therefore, taxpayers considering doing business overseas, especially with a foreign entity or bank account, likely will have to operate compliantly and stay focused on how these laws are revised. Otherwise, taxpayers will risk serious penalties or criminal charges for non-compliance.

G. *The U.S.-Swiss Tax Information Exchange Agreement Revisions*

Even before the Senate Wyly brothers hearing kicked off the current offshore tax evasion crackdown, the I.R.S. had seen the potential for non-compliance inherent in the Swiss bank secrecy laws.[229] In an attempt to neutralize this possibility, the U.S. sought changes to the U.S.-Swiss Tax Information Exchange Agreement ("TIEA") to enhance tax enforcement cooperation between the two countries.[230] A TIEA is a bilateral agreement between two sovereign countries governing the mutual exchange of information.[231] The U.S. initiated a tax information exchange program to assure accurate assessment and collection of taxes, to prevent fraud and evasion and to improve sources for tax matters.[232] The U.S. and Switzerland entered a TIEA, U.S.-Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income ("Convention") in 1997.[233]

The Convention required the exchange of tax information, for both criminal and civil matters, as is necessary for the "prevention of tax fraud or the like in relation to the taxes . . . "[234]

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227. *Id.* (discussing 31 U.S.C. §§ 7206(1), 7203).

228. *See id.*; STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., TAX COMPLIANCE & ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS & ENTITIES 2 (Comm. Print 2009) [hereinafter TAX COMPLIANCE & ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS & ENTITIES].

229. *See* TAX COMPLIANCE & ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS & ENTITIES, *supra* note 228.

230. *See id.* at 31.

231. *Id.* at 54.

232. *See id.* at 55.

233. *See* Convention Between The United States of America and The Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, U.S.-Switz., at V, Oct. 2, 1996, S. TREATY DOC. NO. 105-8.

234. *Id.* at 84.

However, the U.S. and Switzerland differ with respect to the definition of fraud.[235] Swiss law generally defines tax fraud as the use of forged or falsified documents or a scheme of lies to deceive tax authorities.[236] However, the U.S. definition has the more liberal view that non-filing or the omission of certain income from tax returns constitutes tax fraud.[237] The changes made in 2003 to the mutual agreement favor the more liberal American view.[238]

In 2003, a mutual agreement between the U.S. and Swiss authorities established new guidelines on implementing the Convention.[239] The new guidelines were to clarify the behaviors constituting "tax fraud" through a short list of hypothetical situations where recognized tax fraud occurs.[240] This list was meant to be non-exhaustive and was to only provide basic guidelines.[241] The countries also agreed upon renewed efforts to work together to support the tax administration of both countries and application of the requesting party's statute of limitations.[242] Additionally, the countries agreed upon the understanding that information may be requested for both criminal and civil penalties, and information may be requested if it is believed or suspected that there is tax fraud being committed.[243] Finally, the countries agreed to the understanding that the preceding

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235. *See id.* at VII.

236. *See id.* at 101.

237. *See id.*

238. *See id.* at 101-02; Mutual Agreement of Jan. 23, 2003, Regarding Administration of Article 26 (Exchange of Information) of the Swiss-U.S. Income Tax Convention of Oct. 2, 1996, U.S.-Switz., 4(a)-(c) (Jan. 23, 2003), http://www.taxjustice.net/cms/upload/pdf/ch_us_convention.pdf.

239. *See* Press Release, U.S. Dep't of Treas., Office of Public Affairs, *Treasury Announces Mutual Agreement with Switzerland Regarding Tax Information Exchange* (Jan. 24, 2003)(on file with department), *available at* http://www.treasury.gov/press-center/press-releases/Pages/kd3795.aspx [hereinafter *Treasury Announces Mutual Agreement with Switzerland Regarding Tax Information Exchange*].

240. *See* Mutual Agreement of Jan. 23, 2003, Regarding Administration of Article 26 (Exchange of Information) of the Swiss-U.S. Income Tax Convention of Oct. 2, 1996, *supra* note 238, at app. 3-10.

241. *See id.* at 6; *Treasury Announces Mutual Agreement with Switzerland Regarding Tax Information Exchange, supra* note 239.

242. *See* Mutual Agreement of Jan. 23, 2003, Regarding Administration of Article 26 (Exchange of Information) of the Swiss-U.S. Income Tax Convention of Oct. 2, 1996, *supra* note 238, at paras. 1-2.

243. *See id.* at paras. 3-4(Examples include (1) conduct established to defraud individuals or companies, even though the aim of the behavior may not be to commit tax fraud; (2) conduct that involves destruction or non-production of records, or the failure to prepare or maintain correct and complete records; and (3) conduct by a person subject to tax in the requesting State that involves the failure to file a tax return that such person is under a legal duty to file, or an affirmative act that has the effect of deceiving the tax authorities.).

examples will constitute tax fraud under Article 26 of the Convention.[244]

A TIEA is advantageous[245] because many countries (including the U.S.) believe that Switzerland is prone to abusive tax avoidance, and Swiss secrecy laws present issues for countries attempting to combat tax fraud.[246] Rather than prosecuting offshore fund holders, updates to the mutual agreement can create a renewed faith in the Swiss banking system and allow Switzerland to maintain its status quo as an epicenter of banking.[247] The updates to the Convention can help the U.S. increase its surveillance abilities, potentially eliminate the tax gap, and recover lost tax revenue.[248] The 2003 changes to the TIEA set the table for the first serious extension of the offshore tax crackdown to a sovereign foreign country's internal bank secrecy laws – the case against the Swiss bank UBS AG.[249]

H. *The UBS Case*

UBS AG ("UBS"), one of the largest financial institutions in the world, voluntarily entered into a QI agreement with the I.R.S. in 2001.[250] The QI Agreement required UBS to disclose its U.S. client names to the I.R.S., withhold their U.S. client taxes, and maintain related records on U.S. clients.[251] In 2008, a John Doe summons, which was sought the names of roughly 20,000 UBS clients with U.S. citizenship, was issued by a Federal district court in Florida.[252]

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244. *See id.*at 1.

245. *See Treasury Announces Mutual Agreement with Switzerland Regarding Tax Information Exchange, supra* note 239.

246. *See* Andrea Coombes, *Offshore Tax Havens Under Fire*, MARKETWATCH.COM (July 11, 2009, 10:48 AM),
http://www.marketwatch.com/story/ubs-case-could-be-major-victory-for-irs.

247. *See id.*

248. *See id.*

249. *See id.*

250. *See* TAX COMPLIANCE & ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS & ENTITIES, *supra* note 228, at2, 31;*TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17, at 10-11.

251. *See* TAX COMPLIANCE & ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS & ENTITIES, *supra* note 228, at 31.

252. *See Statement Introducing the Stop Haven Abuse Act, Part I, supra* note 132, at 18-19 (explaining a John Doe summons is a tool used by the I.R.S. in recent years to uncover taxpayers in offshore tax schemes). It is an administrative I.R.S. summons used to request information in cases where the identity of the taxpayer is unknown. *See id.* To obtain approval of the summons, due to the I.R.S.'s inability to serve the taxpayer, the I.R.S. must show the court, in public filings to be resolved in open court, that: (1) the summons relates to a particular person or ascertainable class of persons, (2) there is a reasonable basis for concluding that there is a tax compliance issue involving that person

To avoid possible criminal conspiracy and fraud liability for its U.S. client activity,[253] UBS agreed to pay $780 million in fines, penalties, interest and restitution by way of a Deferred Prosecution Agreement ("DPA") with the DOJ.[254] To facilitate this disclosure, the Swiss Financial Markets Supervisor Authority broke with its banking secrecy tradition by disclosing about 250 U.S. UBS clients to the U.S. government, including the client identities and account information.[255] However, ending the criminal liability did not end UBS' problems, because the U.S. retained the ability to pursue UBS in a civil court matter.[256] The day after the U.S. entered into the DPA, the U.S. filed a civil conspiracy and fraud suit against UBS to force disclosure of all the remaining undisclosed 52,000 U.S. customers.[257] The civil lawsuit alleged conspiracy between the bank and the customers to defraud the I.R.S. and the U.S. Federal Government of legitimately owed tax revenue.[258] In addition to the suit, the U.S. requested enforcement of the John Doe summons.[259] UBS claimed that the I.R.S.'s summons sought information protected by Swiss financial privacy laws.[260] In order to comply with the John Doe Summons, Swiss UBS employees would have to violate domestic law because breaching confidentiality is against the law in Switzerland.[261] In response to the summons, the Swiss'

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or class of persons, and (3) the information sought is not readily available from other sources. *See id.*

253. *See Tax Haven Banks and U.S. Tax Compliance – Obtaining the Names of U.S. Clients with Swiss Accounts: Statement Before the Permanent S. Subcomm. on Investigations on Homeland Sec. and Governmental Affairs*, 111th Cong. 4 (2009) (statement of John DiCicco, Acting Asst. Att'y Gen., Tax Division, U. S. Dept. of Justice).

254. *See TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17, at 10; Deferred Prosecution Agreement, U.S. v. UBS AG, No. 09-600333-CR-COHN. (S.D.Fla. Feb. 18, 2009) at 3; Press Release, U.S. Dep't of Justice, Office of Public Affairs, *UBS Enters into Deferred Prosecution Agreement* (Feb. 18, 2009) (on file with the DOJ), *available* atwww.usdoj.gov/opa/pr/2009/February/09-tax-136.html [hereinafter *UBS Enters into Deferred Prosecution Agreement*].

255. *See UBS Enters into Deferred Prosecution Agreement*, *supra* note 254; DEALB%K, *U.S. Sues UBS to Disclose Customer,* N.Y. TIMES (Feb. 19, 2009 2:42 PM), http://dealbook.blogs.nytimes.com/2009/02/19/us-sues-ubs-to-disclose-customer-names/ [hereinafter *U.S. Sues UBS to Disclose Customer Names].*

256. *See UBS Enters into Deferred Prosecution Agreement*, *supra* note 254.

257. *U.S. Sues UBS to Disclose Customer Names*, *supra* note 255.

258. *See id.*

259. *See* UBS AG's Opposition to U.S.'s Motion to Strike Declaration.of Charles W. Lawrence of Alixpartners and Report of Alixpartners at 1, U.S. v. UBS AG, (2009) (No. 1:09-CV-20423-ASG).

260. *Id.*

261. *See id.*; Katharina Bart, *Swiss Meet on UBS Tax Case,* WALL ST. J.(Aug.11, 2009) http://online.wsj.com/article/SB124989702337219011.html.

People's Party called for retaliation against the U.S."[262] This did not prevent the U.S. from continuing to seek information from UBS.[263]

"The Swiss Financial Market Supervisory Authority, or Finma, 'proceeded on the assumption that if this data hadn't been disclosed, the U.S. Department of Justice would have filed an indictment against UBS, which would arguably have caused the bank's ruin and consequently have had serious repercussions for the Swiss economy . . . '"[264] On August 12, 2009, the U.S. and UBS negotiators came to a substantive agreement.[265] Over time, the settlement could end up disclosing more than 10,000 names of American clients suspected of using offshore accounts to evade taxes.[266] Additionally, the agreement carved out an exception for fraud to the Swiss secrecy laws allowing bank authorities to disclose the names of investors without breaking the law.[267] Ultimately, UBS avoided Swiss secrecy laws in order to comply with the U.S.'s requests.[268] Of course, obtaining the taxpayer names from UBS was only the first step in the U.S. prosecutorial process of undisclosed offshore account holders[269] – the next step is discussed below.

I. *U.S. Taxpayer Criminal Prosecutions*

The information derived from the UBS case led to several criminal prosecutions of UBS offshore account holders,[270] including the recent indictment by the DOJ of three former UBS clients on charges of hiding millions of dollars from the I.R.S. in

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262. Emma Thomasson, *Swiss Party Wants to Punish U.S. for UBS Probe*, REUTERS (Feb. 21, 2009), http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSTHO1501 7420090221.

263. *See* Lynnley Browning, *U.S. Extends Its Inquiry of Offshore Tax Fraud*, N.Y. TIMES (Mar. 18, 2009), www.nytimes.com/2009/03/19/business/19tax.html.

264. David Voreacos, *Credit Suisse May Settle U.S. Probe by Admitting Wrongdoing, Paying Fine*, BLOOMBERG (Aug. 15, 2011), http://www.bloomberg.com/news/2011-08-15/credit-suisse-likely-to-settle-u-s-probe-than-risk-charges-lawyers-say.html (quoting the Swiss Federal Supreme Court).

265. *See* Pascal Fletcher & Lisa Jucca, *UBS, U.S. Settle Tax Evasion Case*, REUTERS (Aug. 12, 2009), http://www.reuters.com/article/2009/08/12/us-ubs-tax-idUSTRE57B2CF20090812.

266. *See id.*

267. *See id.*

268. *See* Fletcher & Jucca, *supra* note 265.

269. *See id.*

270. *See* Charles Gnaedinger, *U.S. Seeks More John Doe Summonses*, 123 TAX NOTES 507, 527-28 (2009).

offshore accounts.[271] These UBS clients are obviously not the first the I.R.S. has indicted and definitely will not be the last.[272] In addition to the UBS data, the VDI programs have generated a "gold mine of data" regarding undisclosed offshore accounts for the I.R.S. Criminal Investigation Division and the DOJ.[273] The list of names and account information derived from the various VDI programs are compiled in a database ("VDI Database"), which may be used by the DOJ as a powerful tool against offshore account holders and banks.[274] The I.R.S. has used this information (and continues to use it) to take criminal action against U.S. taxpayers with offshore accounts used to evade taxes.[275] Within the past few years, the I.R.S. indicted more than 40 U.S. taxpayers, and has several unreported individuals that are still under investigation.[276]

While the UBS and VDI matters have resulted in the disclosure of many taxpayer offshore account holder names, the I.R.S. continues to pursue more information from additional financial institutions in multiple foreign jurisdictions.[277] Since the initial disclosure of names by UBS, the U.S. has opened new investigations seeking U.S. taxpayer offshore account holders from Swiss banks Wegelin & Co. and Credit Suisse, as well as seeking U.S. account holders with accounts in India from HSBC.[278] The I.R.S. and DOJ show no sign of abating these types of investigations as the offshore tax crackdown continues.[279] These investigations have also led to criminal investigations and deferred prosecution agreements with some of these financial institutions,[280] as outlined in the next section of this article.

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271. Darrin Mish, *Three Indicted of Tax Evasion Using UBS*, JDSUPRA (Feb. 3, 2012), http://www.jdsupra.com/post/documentViewer.aspx?fid=ed381d4c-0792-4911-a4ef-62a3ffef3064.

272. *Id.*

273. *Practitioners Assess Offshore Initiative as Deadline Approaches*, *supra* note 17, at664 (referring to VDI as OVDP).

274. *See id.*at 665.

275. *See generally* Gnaedinger, *supra* note 270.

276. Charles P. Rettig, *Evaluation of an IRS Undisclosed Offshore Accounts*,133 TAX NOTES 759, 760 (2011).

277. Asher Rubinstein, *The IRS Offensive Against Offshore Accounts: New Attacks and New Relief*, 62 TAX NOTES INT'L 293, 293-94 (2011).

278. *See Practitioners Assess Offshore Initiative as Deadline Approaches*, *supra* note 17, at 665.

279. *Id.* at 293.

280. *Id.*

J. *Foreign Bank Criminal Deferred Prosecution Agreements*

Following its success with UBS, the U.S. has opened criminal investigations into the activities of several additional offshore banks.[281] Unlike UBS, there is no guarantee that these investigations will be settled without a criminal conviction of the targeted banks. The I.R.S. seems to more vehemently attack and prosecute arrangements in which intermediary entities, such as foreign trusts and corporations, are used in order to obscure the true beneficial ownership of the underlying foreign bank account.[282] The I.R.S. has attacked these noncompliant foreign arrangements, large and small banks and accounts alike, for transaction amounts as low as $200,000.[283] Large banks, like UBS for instance, were forced to settle the tax fraud charges because the alternative was to face seizure of U.S. held assets and banking licenses.[284] Smaller banks that do not have a substantial U.S. presence are not as vulnerable to U.S. prosecution because the U.S. may not threaten seizure of assets and licenses and may not otherwise be susceptible to U.S. jurisdiction and court orders.[285]

1. Credit Suisse

In the case of Swiss bank Credit Suisse, the DOJ threatened to indict the bank if the DOJ did not receive proper cooperation with U.S. disclosure requests.[286] If Credit Suisse were to be indicted, the bank could be forced to forfeit the U.S. located bank assets and the bank's U.S. banking license.[287] The DOJ seemed likely to see anything short of disclosing names of U.S. taxpayers as insufficient cooperation.[288] Since Credit Suisse Group AG faced U.S. indictment for aiding in tax evasion, it moved to enter into a deferred prosecution agreement with DOJ prosecutors.[289] The deal called for admitting wrongdoing and paying a penalty in excess of $1 billion, as reported by Bloomberg.[290] Commentators

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281. *Id.*
282. Rubinstein, *supra* note 277, at 293.
283. *Id.* at 293-94.
284. *Id.* at 294.
285. *See id.*
286. *Practitioners Assess Offshore Initiative as Deadline Approaches*, *supra* note 17, at 665.
287. Voreacos, *supra* note 264.
288. *Practitioners Assess Offshore Initiative as Deadline Approaches*, *supra* note 17, at 664-65.
289. Voreacos, *supra* note 264.
290. *Id.*

opined that Credit Suisse AG simply had "too much to lose by fighting the [DOJ] and risking indictment[s]."[291]

"[T]he U.S. also filed a [civil] lawsuit seeking data on another 52,000 secret [Swiss] accounts," mostly from Credit Suisse account-holders.[292] "The Swiss and U.S. governments negotiated an agreement for the bank to surrender the names of 4,450 clients."[293] "The Swiss Parliament later ratified that agreement," demonstrating the high-stakes game of poker occurring between the U.S. and Switzerland, with Credit Suisse in the middle of it all and Swiss banking secrecy hanging in the balance.[294]

2. Wegelin

In the wake of ongoing investigations, the DOJ suspects that UBS lost business directly to other offshore banks, including Wegelin and HSBC.[295] Wegelin and HSBC likely assured customers they would not disclose information to the U.S. government and claimed they were less vulnerable to investigation than UBS.[296] However, the assurances may not pan out since the DOJ has indicted Wegelin, a private Swiss bank, for conspiracy to conceal assets and evade taxes.[297]The Wegelin indictment marked the first time the U.S. government has indicted a foreign bank for facilitating criminal tax fraud.[298]If found guilty, Wegelin faces a fine of $500,000 or twice the gross monetary gain derived from the offense, whichever is greater.[299]

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291. *Id.*

292. *Id.*

293. *Id.*

294. *Id.*

295. *See* Dep't of Justice, *DOJ Announces Tax Indictment Against Swiss Bank* (Feb. 2, 2012), www.justice.gov, 1;Dep't of Justice, *HSBC India Client Indicted for Tax Evasion and Failing to Report Foreign Bank Accounts* (Nov. 17, 2011) http://www.justice.gov/opa/pr/2011/November/11-tax-1504.html; Stephanie Song Johnston, *HSBC India Client Indicted for U.S. Tax Evasion*, 2011 TAX NOTES TODAY 224-7, 2 (Nov.21, 2011) [hereinafter *HSBC India Client Indicted for U.S. Tax Evasion*].

296. *See DOJ Announces Tax Indictment Against Swiss Bank*, *supra* note 295; Bruce Zagaris, *International Tax Enforcement Continues to Rise*, SPECIAL REPORTS, Nov. 28, 2011, at 661-62; *see also* David D. Stewart, *U.S. Offshore Enforcement Likely to Focus on Asia, Practitioners Say*, WORLDWIDE TAX DAILY, Apr. 5, 2010 ("bankers . . . considered their financial institutions to be insulated from the controversies taking place with banks in Switzerland and Liechtenstein . . . ").

297. Kevin McCoy, *Swiss Bank Indictment Details Tax Evasion Ploys*, USA TODAY (Feb. 3, 2012), http://www.usatoday.com/money/industries/banking/story/2012-02-03/swiss-bank-charged-wegelin/52953452/1; Goulder, *supra* note 17.

298. Goulder, *supra* note 17.

299. *Id.*

Wegelin, Switzerland's oldest bank, is alleged to have conspired to hide more than $1.2 billion in secret accounts in order to evade U.S. income taxation on any resulting income derived therefrom.[300] As of the end of 2010, the bank held $25 billion in assets under management, but operated no branches outside of Switzerland.[301] Even though Wegelin does not operate branches outside of Switzerland, Wegelin can access the U.S. banking system via correspondent accounts.[302] U.S. law enforcement authorities seized roughly $16 million from a correspondent account operated out of the UBS Stanford, Connecticut branch.[303] This forfeiture complaint to seize Wegelin correspondent accounts demonstrates that the U.S. does have some remedies even against institutions that have no physical presence in the United States.[304]

3. HSBC and Asia

Following the erosion of Swiss bank secrecy, funds flowed quickly into other jurisdictions such as Singapore.[305] The DOJ followed the money from Europe to Asia amid the Swiss banking crackdown and appears intent on staging similar crackdowns upon new-found Asian tax havens.[306] In 2010, the DOJ began investigating HSBC and account holders in HSBC for criminal tax fraud in relation to accounts held in India and Singapore.[307] The DOJ used the same "John Doe" summons strategy against HSBC India as the DOJ used against UBS.[308] The DOJ also used the same investigation strategy of going through all U.S. citizen accounts above $10,000 and further investigating any accounts that have not made a FBAR filing.[309] After a court trial, a father and son were convicted and sentenced to ten years in prison.[310] The DOJ has threatened indictments of HSBC India and appear prepared to seek a similar criminal deferred prosecution agreement as entered into with Credit Suisse AG.[311] The DOJ threatened the seizure of HSBC's U.S. based assets and licenses

300. *Id.*
301. *Id.*
302. *Id.*
303. *Id.*
304. Goulder, *supra* note 17.
305. *See HSBC Case Alerts Asia Banks for U.S. Tax Probes*, *supra* note 17.
306. *See HSBC Case Alerts Asia Banks for U.S. Tax Probes*, *supra* note 17.
307. *See* Rubinstein, *supra* note 277.
308. *HSBC Case Alerts Asia Banks for U.S. Tax Probes*, *supra* note 17.
309. *See id.*
310. Rubinstein, *supra* note 277.
311. *See id.*

in order to pressure HSBC for a settlement and the turnover of client identities.[312]

Following the DOJ's investigation into HSBC India, private banks across Asia have braced for similar investigations into the concealment of assets for U.S. taxpayers.[313] These crackdowns have caused several large private banks in Singapore to refuse all U.S. clients, due to the high risk of becoming involved in similar investigations.[314]The summonses placed pressure on the banks and HSBC decided to suspend private offshore banking services to U.S. customers, fearing HSBC and its customers would face additional criminal charges.[315] The HSBC U.S. Branch is now the branch serving U.S. residents.[316]The large Asian banks that continue to take U.S. clients generally impose tight restrictions on the types of products that can be sold to U.S. clients.[317] Singapore has also taken steps to become more financially transparent and to enter into a double-taxation treaty with the U.S.[318]

HSBC specifically targeted Indian-American clients and offered offshore banking services in India and Singapore, which will assuredly warrant heightened scrutiny.[319] However, the information DOJ has in the HSBC India probe is clearly deeper than what it had at the outset of the UBS probe.[320] In the UBS probe, UBS advised its American clients that the I.R.S. might scrutinize their accounts.[321] However, Americans with accounts at HSBC in India received letters directly from the DOJ in 2010 - prior to any HSBC communications.[322] Thus, it is clear that the DOJ already had their names.[323] It appears that some stolen Liechtenstein Global Trust ("LGT") bank data purchased by the German government was also shared with the government of India.[324] In 2010, India was in the process of negotiating tax treaties with 65 countries.[325] But even in the absence of such a treaty, the LGT information is almost certainly already in the

312. *HSBC Case Alerts Asia Banks for U.S. Tax Probes, supra* note 17.

313. *Id.*

314. *Id.*

315. *See HSBC India Client Indicted for U.S. Tax Evasion, supra* note 295.

316. *Practitioners Assess Offshore Initiative as Deadline Approaches, supra* note 17.

317. *HSBC Case Alerts Asia Banks for U.S. Tax Probes, supra* note 17, at 1.

318. Rubinstein, *supra* note 277.

319. *Id.*

320. *Id.*

321. *Id.*

322. *Id.*

323. *Id.*

324. Rubinstein, *supra* note 277.

325. *Id.*

possession of the I.R.S. as well and may lead to future prosecutions of account holders.[326]

4. Israeli Banks

The DOJ is likely to heavily scrutinize many other offshore financial institutions, including, but not limited to, institutions in Israel.[327] If settlement agreements similar to the 2009 agreement between the U.S. government and UBS do not pan out, it is likely these financial institutions will face criminal charges.[328]

"Some Americans feel mistakenly comfortable not disclosing their Israeli bank accounts to the I.R.S. because of Israel's close ties with the U.S."[329] Israel is in a unique situation because of ties between Israel and Jews around the world, including Jews who have inherited "Holocaust accounts."[330] The original "Holocaust account" was established in Switzerland by European Jews prior to the Holocaust, to protect their assets from the rise of Nazi Germany.[331] Holocaust survivors established another type of "Holocaust account" after World War II to receive German reparation payments.[332] In both of these cases, there existed no tax avoidance motive for creating the accounts.[333] Now, many Holocaust account descendants who have inherited these accounts are unintentionally in non-compliance because of their unawareness of the necessity to annually report these accounts to the Treasury Department.[334] That being said, it is highly unlikely that the I.R.S. and DOJ are specifically targeting "Holocaust accounts."[335] For example, the I.R.S. offered a lower Voluntary Disclosure penalty of merely 5% on "Holocaust accounts."[336]

Pursuing undisclosed accounts in Israel will not require nearly as much cost and effort as historically required when pursuing information on undisclosed accounts in Switzerland.[337]

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326. *Id.*

327. *Id.*

328. Randall Jackson, *U.S. Offers 11 Swiss Banks Deal to End Tax Evasion Investigation*, 2011 TAX NOTES TODAY 245-2, 2 (Dec. 21, 2011).

329. Rubinstein, *supra* note 277.

330. *Id.*

331. *Id.*

332. *Id.*

333. *Id.*

334. *Id.*

335. Rubinstein, *supra* note 277.

336. *Id.*

337. *Id.*

An existing tax treaty between the U.S. and Israel enables the two countries to "exchange such information as is pertinent to [prosecute] . . . fraud or fiscal evasion in relation to the taxes."[338] According to the Israeli Ministry of Justice, "the [Israeli Government] has cooperated with requests from U.S. law enforcement in matters of financial crime."[339] The Israeli Minister of Justice's statement refers to Israel's fight against money laundering; however, it is likely that the Ministry would cooperate with requests from the I.R.S. in matters related to undisclosed bank accounts.[340] Furthermore, the U.S. and Israel give each other legal assistance via a Mutual Legal Assistance Treaty ("MLAT"), which expressly applies to criminal tax offenses.[341]

The DOJ and I.R.S. actually believe that there are large values of undeclared assets in Israel, particularly in the lucrative jewel trade.[342] Due to these suspicions, in 2010, Israel's largest bank, Leumi, took the extraordinary step of sending letters to its U.S. customers, strongly advising them to disclose their accounts to the I.R.S..[343]Amid heightened scrutiny, such as the implementation of the Foreign Account Tax Compliance Act which penalizes all foreign banks for non-accountability on U.S. client accounts, Leumi is asking its clients to either declare that they are not U.S. clients or to reveal their accounts to U.S. authorities.[344]Leumi is particularly worried and vulnerable to I.R.S. and DOJ scrutiny since Leumi has a physical presence in the U.S.[345] Thus, the U.S. may utilize the full range of enforcement vehicles, including the threatened seizure of bank's U.S. assets and licenses.[346]

K. *Advisor Criminal Prosecutions*

The U.S. has not limited its criminal investigations to U.S. taxpayers and banks.[347] Rather, the U.S. has indicted several advisors for activities associated with U.S. citizen's undeclared

338. *Id.*
339. *Id.*
340. *Id.*
341. Rubinstein, *supra* note 277.
342. *Id.*
343. *Id.*
344. *Leumi to U.S. Taxpayers: Disclose Accounts*, REUTERS (Nov. 4, 2010) http://www.ynetnews.com/articles/0,7340,L-3978607,00.html.
345. *Id.*
346. *Id.*
347. Rettig, *supra* note 276, at 759.

offshore assets, including bankers, lawyers, and consultants.[348] Over the last three years, the DOJ has brought criminal charges against thirteen bankers and two attorneys as facilitators of offshore tax fraud.[349] The DOJ has successfully argued for convictions of one banker and one advisor on these charges.[350] In these circumstances, attorney client privilege and CPA privilege will not protect communications with advisors and their clients in the I.R.S.'s criminal investigations.[351] In recent years, the U.S. has indicted at least twenty-four advisers for contributing to taxpayers' attempts to use offshore accounts to avoid taxation.[352] Each new bank indictment leads to more names of advisors who have facilitated tax evasion by U.S. taxpayers.[353]

For example, the Wegelin investigation not only led to the bank's indictment, but also led to a superseding indictment for conspiracy to evade taxes against three Wegelin financial advisors.[354] The three advisors, Berlinks, Frei, and Keller, allegedly advised clients to evade U.S. taxes through undisclosed Swiss bank accounts linked to a chain of private foundations and sham corporations in Liechtenstein, Panama, Hong Kong, and other jurisdictions.[355] The individual Wegelin advisors face separate charges that could result in jail time and/or monetary fines.[356]

Similarly, seven Credit Suisse AG bankers and advisors, including the head of North American offshore banking, Markus Walder, were personally indicted on July 21, 2011 on charges of helping U.S. clients evade taxes through secret accounts.[357]Walder, a Swiss resident, supervised teams of private bankers in Zurich who worked in an unregistered private

348. *Id.* at 759, 764, 766.

349. Jeffrey Locke & Richard Kando, *Turning Up the Heat on Offshore Account Holders*, N.Y.L.J. (Feb. 14, 2012), http://www.newyorklawjournal.com/PubArticleFriendlyNY.jsp?id=1202541972683&slreturn=1.

350. Jeffrey Locke & Richard Kando, *Turning Up the Heat on Offshore Account Holders*, N.Y.L.J. (Feb. 14, 2012), http://www.newyorklawjournal.com/PubArticleFriendlyNY.jsp?id=1202541972683&slreturn=1.

351. *See generally* Jack Townsend, *Court Addresses Attorney-Client Privilege in Suit Against Tax Shelter Promoters*, FEDERAL TAX CRIMES (Sept. 1, 2010), http://federaltaxcrimes.blogspot.com/2010/09/court-addresses-attorney-client.html.

352. Rettig, *supra* note 276; Mish, *supra* note 271.

353. McCoy, *supra* note 297.

354. Goulder, *supra* note 17.

355. *Id.*

356. *Id.*

357. Voreacos, *supra* note 264.

banking business in the U.S.[358] The indictments claimed that managers and bankers working in the cross-border business knew or should have known that they were aiding and abetting U.S. customers in evading their U.S. income taxes.[359]

The bank disclosures are the primary method the I.R.S. uses to discover advisers who have facilitated in U.S. taxpayer offshore tax evasion.[360] As such, as more banks undergo investigation for facilitating offshore tax evasion, additional adviser indictments are likely to result. The advisors, banks, and clients of the banks have all been caught up in an extensive and growing I.R.S. and DOJ crackdown of international tax non-compliance.[361] The next section of this article discusses how the heightened enforcement of tax matters involving U.S. taxpayers doing business offshore may intersect with captive insurance companies domiciled in foreign jurisdictions.

IV. OFFSHORE CAPTIVE INSURANCE COMPANIES

A CIC can be formed under the laws of either a domestic U.S. state or a foreign country.[362] The decision as to whether to form the CIC domestically or offshore is affected by many factors, including but not limited to: (1) exposure to the U.S. tax system; (2) the capitalization burden at formation; (3) the investment flexibility afforded the CIC; and (4) the asset protection afforded the U.S. shareholders of the CIC.[363] Each of these issues is outlined below in detail.

A. *Exposure to the U.S. Tax System*

The U.S. tax and compliance burden on a CIC and its shareholders may effect the decision whether to form a CIC domestically or offshore. As a preliminary matter, it is clear that organizing a CIC in an offshore jurisdiction does not prevent the I.R.S. from exercising its extensive reach in assessing and collecting U.S. tax.[364] Thus, any analysis of whether to form in a

358. *Id.*

359. *Id.*

360. *See* Brian Mahany, *Lawyer Indicted For Helping Clients Set Up Offshore Swiss Bank Accounts*, MAHANY & ERTL - USEFUL ARTICLES FOR OUR CLIENTS AND INTERESTING COMMENTARY YOU WON'T SEE ANYWHERE ELSE, DUE DILIGENCE (Feb. 2, 2012, 11:57 PM), http://www.mahanyertl.com/mahanyertl/lawyer-indicted-for-helping-clients-set-up-offshore-swiss-bank-accounts/1383/.

361. *See id.*

362. England et al., *supra* note 14, at 701-02.

363. *See infra* parts IV.A.-D.

364. *Captivating! Captive Insurance Arrangements are Alive and Well*, supra note 2.

foreign jurisdiction should be governed by reporting burdens and taxation that a CIC would be exposed to, without any concern for the capability of the I.R.S. to enforce such taxation.

Every CIC, both domestic and offshore, is subject to U.S. income taxation.[365] If the foreign CIC makes an I.R.C. Section 953(d) election (discussed in detail, below), then the CIC will be taxed as an U.S. entity.[366] If the CIC does not make an I.R.C. Section 953(d) election, then assuming that the offshore CIC has more than 25% U.S. shareholder ownership,[367] the CIC would be considered a controlled foreign corporation ("CFC").[368] As a CFC, the CIC income (unless directly attributable to contracts issued on risks outside of the United States)[369] would be currently taxable to the CIC U.S. shareholders,[370] irrespective of the timing of the distributions.[371] Thus, the U.S. shareholders of an offshore CIC CFC would be required to currently include all CIC profits in the CIC owner's taxable income.[372]

Of course, one consideration that should be taken into account in making a decision to form a foreign CIC is the possibility that the I.R.S. offshore crackdown will increase the compliance burden of the CIC. Given that the I.R.S. is expending a great deal of resources and personnel time on all of the civil and criminal activities (as outlined above),[373] choosing to create a CIC offshore may increase the chances of an intrusive audit, simply by virtue of being an offshore entity that receives tax deductible payments. Since the I.R.S. has not yet publicly announced any specific focus on offshore CICs, there is no empirical way to prove that this will occur. However, it is clear that the I.R.S. and DOJ are very focused on tax compliance in the offshore world, so it is certainly possible that the I.R.S. will eventually broaden its focus in the offshore crackdown to launch a coordinated attack on foreign captive insurance companies – if it has not done so already in a non-public manner.

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365. *Id.* at 28-29.

366. *Id.* at 28-29.

367. I.R.C. § 951(b) (2006).

368. I.R.C. § 953(c) (2006).

369. I.R.C. § 953(e).

370. This is due to the U.S. government's installment of anti-avoidance regimes, most particularly in the arena of CICs. Elliott, *supra* note 21. The net effect is that the profits of a company in a low-tax jurisdiction are included in the taxable income of the shareholders resident in the high-tax jurisdiction. *Id.* Since the shareholders are subject to tax, not the company, tax treaty protection may not be afforded. *Id.*

371. *Captivating! Captive Insurance Arrangements are Alive and Well*, *supra* note 2.

372. *Id.* at 28-29.

373. *See supra* Part III.

1. I.R.C. § 953(d) Election

To calm the nerves of U.S. taxpayers who read about the I.R.S. offshore crackdown, some advisors who advocate forming an offshore CIC have raised making an I.R.C. Section 953(d) election as a compliance panacea.[374] Under I.R.C. Section 953(d), an offshore CIC may elect to be treated as a domestic company for U.S. federal tax purposes.[375] These electing companies would then be directly subject to U.S. federal income tax on all income earned globally, rather than indirectly through the U.S. shareholders of the CIC under subchapter F of the I.R.C.[376]The advantages of a U.S.-owned offshore CIC making an I.R.C. Section 953(d) election include exemption from the federal excise tax ("FET"), and simplification of compliance and administration.[377] Once made, the I.R.C. Section 953(d) election is irrevocable without I.R.S. consent.[378] Theoretically, making this election would communicate to the I.R.S. that the offshore CIC is not something that the I.R.S. offshore crackdown need be focused on.

The problem with this theory is that the CIC is still a tax-advantaged entity that is operating under the laws of a foreign country. Thus, regardless of any election that has been made, the I.R.S. may still put the CIC in the suspect offshore entity class that is currently subject to such heightened scrutiny. In fact, the presence of an I.R.C. Section 953(d) election may actually allow the I.R.S. to easily locate each offshore CIC for audit. Should the I.R.S. choose to start auditing offshore CIC arrangements, it is would not be difficult to screen all I.R.C. Section 953(d) elections that also have tax characteristics of a captive insurance company. The bottom line is that the I.R.C. Section 953(d) election is unlikely to cure any perceived offshore taint that may be attached to the foreign CIC.

2. The Federal Excise Tax

In certain circumstance, the I.R.S. may also impose a federal excise tax ("FET") upon insurance policy premiums paid by a U.S.-insured to an offshore CIC.[379]An offshore CIC arrangement

374. *Captivating! Captive Insurance Arrangements are Alive and Well*, *supra* note 2.

375. *See* I.R.C. § 953(d).

376. *See id.*; *See Captivating! Captive Insurance Arrangements are Alive and Well*, *supra* note 2, at 28-29.

377. *See* I.R.C. § 953(d); *Captivating! Captive Insurance Arrangements are Alive and Well*, *supra* note 2, at 28-29.

378. *See* I.R.C. § 953(d).

379. I.R.C. § 4371 (2006).

is likely to be viewed as the "importation" of a service since the offshore CIC essentially provides insurance, actuarial, and management services to its shareholders.[380] The importation of a foreign service to the U.S. is subject to the FET.[381] Premiums for property/casualty exposures paid by U.S. payers to an offshore CIC are subject to a FET of 4% for original insurance transactions[382] and 1% for reinsurance transactions.[383] As such, the shareholders of an offshore CIC may be exposed to additional U.S. taxation in the form of the FET, that shareholders of a domestic CIC are generally not exposed. Of course, some domestic state jurisdictions also charge premium taxes,[384] so avoiding such taxes would require the CIC to choose a premium tax-free domestic state. Regardless, choosing a domestic state domicile that does not require premium taxes would have a clear advantage over formation in a foreign jurisdiction that is subject to premium taxes.

B. *Capitalization Burden*

The minimum capitalization requirements for formation of a CIC in domestic jurisdictions have traditionally been between $300,000[385] and $300 million,[386] with the variation depending factors such as the type of CIC, the proposed coverage offered by the CIC, and the relation between the CIC and the insured.[387] The general public, and even some experienced tax and insurance advisors, perceive that a CIC formed in an offshore jurisdiction is subject to relaxed rules and regulations relating to capitalization requirements.[388] This is because offshore jurisdictions typically have lower minimum capital requirements for insurance companies organized within the offshore jurisdiction,[389] and do not generally perform regulatory examinations, but instead rely on independent CPA verifications.[390]

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380. *See id.*

381. *See id.*

382. I.R.C. § 4371(1).

383. *See* I.R.C. § 4371(3).

384. *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, *supra* note 14, at 704.

385. Utah Code § 31A-37-603 (2008).

386. S.C. Code Ann. § 38-90-45 (West 2011).

387. *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, *supra* note 14, at 706.

388. *Id.* at 704-05.

389. *Running a Captive Correctly*, *supra* note 32.

390. *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, *supra* note 14, at 704-05.

Of course, a CIC must still be considered an insurance company, and the policies must still reflect an insurance arrangement, in order for premiums to be deductible under I.R.C. Section 162 and for the CIC to receive the tax benefits of I.R.C. Section 831(b).[391] To be considered an insurance arrangement, there must be a finding that the parent transferred the risk of economic loss to the CIC—risk shifting.[392] Adequate capitalization is an especially important factor in determining whether risk shifting has occurred between a CIC and the insured, because without it the CIC may not have proper reserves to pay insured claims.[393] Therefore, in order for the CIC to avail itself of tax benefits provided to insurance companies under the U.S., a CIC may be required to maintain capital in substantial excess of the capital required by the minimum capitalization requirements of the offshore jurisdiction's insurance regulations.[394]

Finally, it is also noteworthy that the minimum capitalization requirements in certain U.S. states have become more manageable in recent years. For example, in Delaware, the minimum capitalization rules have been reduced to $250,000 for combining capitalization among separate CIC limited liability companies that all are formed and are administered as part of the same series.[395] Thus, provided the remainder of the CIC law is followed properly, a group of individual CIC arrangements may share the same capitalization – making the requirements very reasonable, while maintaining the amounts necessary for proper risk shifting. As such, the capitalization rationale for choosing an offshore jurisdiction over a domestic state to form a CIC has been significantly diminished.

C. *Investment Flexibility*

Certain foreign CIC jurisdictions permit more flexibility in the types of investments that the CIC may invest in with surplus CIC funds.[396] Surplus is defined as the amount of premiums or income that is retained by a CIC in excess of the funds needed by

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391. *Running a Captive Correctly, supra* note 32.

392. *See* Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 840-41 (6th Cir. 1995); Rev. Rul. 2002-90, 2002-2 C.B. 985.

393. *See Malone & Hyde, Inc.*, 62 F.3d at 841; Rev. Rul. 2002-90, 2002-2 C.B. 986; *Running a Captive Correctly, supra* note 32.

394. *See* Malone & Hyde, Inc., 62 F.3d at 840-41; Rev. Rul. 2002-90, 2002-2 C.B. 986; *Running a Captive Correctly, supra* note 32.

395. DEL. CODE ANN. tit. 18, § 6905 (West 2010).

396. *Captive Insurance Companies: A Growing Alternative Method of Risk Financing, supra* note 14, at 704-06.

the CIC for current claims payments.[397] Certain foreign jurisdictions allow a CIC to invest surplus in any investment vehicle, so long as such investment does not impair the capital base or undermine any foundational requirements related to the insurance arrangement,[398] including making unreasonably illiquid investments that may prevent payment of its actuarially anticipated claims.[399] As previously discussed, a CIC that does not maintain its solvency requirements would not be considered a valid insurance company for any purpose, since the ability to satisfy claims as they accrue is the primary responsibility of any insurance company.[400] As such, any use of an offshore jurisdiction's looser CIC investment rules, requires that the CIC not run afoul of the I.R.C. rules about what is required for an arrangement to be deemed insurance.[401] A CIC would not be considered an insurance company where the CIC is not primarily engaged in the business of underwriting insurance or reinsurance activities.[402] While CIC compliance with the foreign jurisdiction's local insurance rules and regulations is significant in determining whether a CIC is primarily engaged in the insurance business, the character of the business actually done in the taxable year is the controlling factor in analyzing whether a company qualifies as an insurance company.[403]

The I.R.S. has also issued pronouncements warning about the non-compliant nature of certain insurance arrangements where the insurance business is outweighed by its investment activities.[404] Some of this guidance appears in the context of life insurance – something that a CIC may not insure.[405] However, the problems raised that are applicable to a life insurance company should be equally applicable to insurance of risks other than life. In I.R.S. Notice 2003-34, the I.R.S. warned taxpayers about investing in certain U.S. shareholder-owned purported offshore life insurance companies[406] to defer recognition of ordinary income (or to characterize ordinary income as a capital

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397. *Id.* at 706-07.

398. *Id.*

399. *Id.* at 706-07.

400. *See* Malone & Hyde, Inc., 62 F.3d at 840-41.

401. *Running a Captive Correctly, supra* note 32.

402. Treas. Reg. § 1.801-3(a).

403. *Id.*

404. I.R.S. Notice 2003-34, 2003-23 I.R.B. 991 (June 9,2003); Howard M. Zaritsky& Stephan R. Leimberg, *Offshore Life Insurance Companies*, Tax Plan. Life Ins. § 1.15 (Thomson/RIA 2012) [hereinafter *Offshore Life Insurance Companies*].

405. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies, supra* note 405.

406. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies, supra* note 405.

gain).[407] The I.R.S. stated that these (and similar) arrangements are used to invest in hedge funds or investments in which hedge funds typically invest.[408] Under such an arrangement, the actual insurance activities of the offshore entity are generally relatively small in comparison with the offshore entity's investment activities.[409]

Instead, the offshore entity's portfolio of investment income, particularly in hedge funds or similar investment vehicles, will substantially exceed the offshore entity's ordinary insurance business needs.[410] The shareholder will typically not receive any current distribution under such an arrangement, and will instead claim that the appreciation constitutes capital gain (rather than ordinary income), as the appreciation involves the conduct of insurance business rather than mere passive investment income.[411] The I.R.S. explained that, while the business of an insurance company will almost always require substantial investment activities, genuine insurance companies use their investment earnings to pay claims, support writing more business, and fund distributions to the company's owners.[412] The I.R.S. further noted that the mere qualification of an offshore company as an insurance company under the rules and regulations of a foreign jurisdiction does not render the offshore company an insurance company for federal income tax purposes.[413] This is especially true where the company is not primarily and predominantly engaged in the issuance or reinsurance of insurance or annuities.[414] An insurance company only exists, for federal income tax purposes, where the entity uses its capital primarily in the earning of income from insurance underwriting.[415] The I.R.S. will analyze an entity's total operations and sources of income in making this determination.[416]

An offshore CIC would not be considered an insurance company, for federal tax purposes, where the offshore CIC is primarily used as a vehicle by which a hedge fund investment is

407. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
408. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
409. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
410. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
411. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
412. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
413. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
414. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
415. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.
416. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies*, *supra* note 405.

made.[417] Such an offshore CIC would instead be subject to taxation under the Passive Foreign Investment Company ("PFIC") rules.[418] The PFIC rules, under I.R.C. Sections 1291 through 1298, "impose current U.S. taxation . . . on U.S. persons that earn passive income through a foreign corporation."[419] I.R.C. Section 1297(a) provides that a foreign corporation is a PFIC if: (1) 75% or more of the corporation's gross income is passive income, or (2) at least 50% of the corporation's assets, on average, produce passive income or are held for the production of passive income.[420] The PFIC rules do not apply to a corporation predominantly engaged in the active conduct of insurance business, since the corporation would otherwise be subject to federal income tax under the U.S. life insurance company rules found in I.R.C. subchapter L.[421] In I.R.S. Notice 2003-34, the I.R.S. clearly stated its intent to challenge the validity of these types of investment schemes - by applying the PFIC rules where the I.R.S. determines that a foreign corporation is not an insurance company for federal tax purposes.[422] Thus, while an offshore jurisdiction may allow a CIC to invest under very liberal rules, I.R.S. Notice 2003-34 makes it clear that a CIC, whose investment activities exceed its insurance business activities, will be challenged as a PFIC.[423]

D. *Asset Protection*

Many offshore jurisdictions claim that their CIC regulators and corporate registrars keep CIC company information on assets in strict confidence, for the purpose of permitting the CIC to be formed and operated in secrecy.[424] Many people also believe that a valid I.R.C. Section 953(d) election can create a situation in which the identity of the parent entity does not have to be

417. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies, supra* note 405.

418. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies, supra* note 405.

419. I.R.S. Notice 2003-34; *Offshore Life Insurance Companies, supra* note 405.

420. I.R.S. Notice 2003-34 (discussing I.R.C. § 1297(a) (2006)); *Offshore Life Insurance Companies, supra* note 405, at *4.

421. I.R.S. Notice 2003-34, *supra* note 405, at 991; *Offshore Life Insurance Companies, supra* note 405, at *5.

422. I.R.S. Notice 2003-34, *supra* note 405, at 991; *Offshore Life Insurance Companies, supra* note 405, at *5.

423. I.R.S. Notice 2003-34, *supra* note 405, at 992; *Offshore Life Insurance Companies, supra* note 405, at *5.

424. *See, e.g.*, Duncan E. Osborne & Mark E. Osborne, *Asset Protection Trust Planning*, ST022 A.L.I.-A.B.A. 1, *79 (ALI 2011) (explaining the very strict Bahamian bank secrecy law) [hereinafter *Asset Protection Trust Planning*].

reported to the I.R.S.[425] Secrecy from both foreign and domestic records may be viewed as a valuable characteristic of offshore CIC arrangements, since such secrecy makes it difficult for creditors to follow the money.[426] The inability of a creditor to follow the money may act as an effective asset protection tool, because a creditor may prove to be less willing to undertake expensive and prolonged litigation where the creditor is unsure as to whether the debtor is "judgment proof."[427]

More importantly, an I.R.C. Section 953(d) election could potentially allow a CIC to effectively choose the applicable law and venue in which a creditor may sue the CIC, by forcing a creditor to bring all actions against the CIC in the chosen offshore domicile's courts.[428] This is possible due to the fact that a valid I.R.C. Section 953(d) election only applies to the I.R.C. and not to any other titles of the U.S. Code.[429] Since an offshore CIC election for treatment as a domestic corporation does not apply to the Federal Code of Civil Procedure, the creditor may not argue that the corporation is domiciled in the U.S. Since the corporation is not domiciled in the U.S. for civil procedure purposes, U.S. courts would only exercise proper personal jurisdiction over the CIC if it can be shown that the CIC had minimum contacts or purposefully availed itself of U.S. court jurisdiction.[430] Of course, a foreign CIC that insures a U.S.

425. Certain offshore insurance companies may make an election under I.R.C. § 953(d) to be treated as a domestic corporation for federal income tax purposes, which eliminates, *inter alia*, the FET requirement that is extremely unfavorable to transactions between offshore CICs and U.S. parent entities. PricewaterhouseCoopers, *Treatment of Insurance Companies under Consolidated Loss Regulations*, http://www.pwc.com/en_US/us/insurance/assets/dcl_regulations_insurance.pdf (last visited Sept. 3, 2012). Since an I.R.C. § 953(d) CIC is itself a U.S. taxpayer and owner of all CIC assets, the "U.S. Person" in terms of any W-9 or FBAR forms is the CIC and not the parent-shareholder entity. Benno K. Raeber & Sarah Frei, *Recapturing American Clients through use of a 953(d) Private Placement Life Insurance Carrier in the Bahamas*, PRIMEADVISORYGROUP.COM (Sept. 2009), http://www.fiveoceanslife.bs/site/downloads/bfsr_953d_article.pdf [hereinafter *Recapturing American Clients*]. The fact that the CIC is itself the "U.S. Person" could make it much more difficult for creditors to discover the existence of a relationship between an onshore debtor and an offshore CIC. *Id.*; *but see* PricewaterhouseCoopers, *Treatment of Insurance Companies under Consolidated Loss Regulations*, http://www.pwc.com/en_US/us/insurance/assets/dcl_regulations_insurance.pdf (stating that a FC making a 953(d) election is required to send a U.S. Shareholder list to the I.R.S.).

426. *See* SEC v. Merrill Scott and Assocs., No. 2:02-CV-39-TC, 2009 WL 2984043, at *2 (D. Utah Sept. 17, 2009).

427. *See id.*

428. *Asset Protection Trust Planning*, *supra* note 425, at *61.

429. I.R.C. § 953(d); *Recapturing American Clients*, *supra* note 426.

430. *See* Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945); Burger King Corp. v. Rudzewicz, 471 U.S. 462, 474-75 (1985).

insured in exchange for a substantial premium may very well have established such minimum contacts as to be considered subject to a U.S. court's jurisdiction. Assuming that the U.S. courts were found not to have personal jurisdiction over an offshore CIC, then it is likely that a creditor may only sue the CIC in the offshore jurisdiction of formation. Effectively forcing creditors to sue in a foreign domicile's courts, while using the foreign domicile's law, could impose a formidable obstacle upon any creditor, especially where the jurisdiction has particularly stringent asset protection and account secrecy laws.[431] Furthermore, some commentators have noted that, even if U.S. courts are found to have jurisdiction over an offshore CIC, the foreign jurisdiction may be unwilling to enforce the U.S. judgment (which may be quite significant if the debtor has very little in onshore assets).[432]

Once a U.S. court has rendered a judgment against a U.S. citizen, it is always possible that a U.S. court will nullify an offshore transfer at its source as illegal or invalid, rather than simply abdicating jurisdiction over a perceived fraudulent attempt to defeat creditors of the transferor.[433] This is especially true where a creditor manages to position the transferor into a bankruptcy action. U.S. bankruptcy courts have very broad powers to invalidate and set aside transfers that have the effect of delaying or hindering a creditor's claim satisfaction,[434] and often these powers are exercised by using the U.S. bankruptcy laws to thwart offshore asset protection arrangements.[435] For instance, a debtor may seek to become insolvent by transferring significant assets abroad (perhaps in the form of a policy premium payment to a foreign CIC) and outside of the debtor's control and beneficial enjoyment.[436] The creditors could force the debtor into bankruptcy if the debtor is shown to be insolvent.[437]

431. *See* Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1048-50 (2000) (discussing the bank secrecy doctrine and, *inter alia*, the stringent asset protection laws in place in the Cook Islands).

432. *Asset Protection Trust Planning*, *supra* note 425, at *61.

433. *See, e.g.*, In re Brooks, 217 B.R. 98, 103-04 (Bankr. D. Conn. 1998) (finding that stocks transferred to an offshore account was invalid under the laws of Connecticut, and, as such, were a property of the bankruptcy estate).

434. *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a), 7A pt. 2 U.L.A. 58, 58 (2006); UNIF. FRAUDULENT TRANSFER ACT § 7, 7A pt. 2 U.L.A. 155, 155-56 (2006) (explaining the remedies available to the creditor).

435. *See generally* In re Brooks, 217 B.R. at 104 (using Connecticut state law, as opposed to the law of the offshore trust's situs, to hold that shares of Connecticut Corporations, held by a Connecticut debtor, were part of the bankruptcy estate).

436. *Asset Protection Trust Planning*, *supra* note 425, at *62-63.

437. *Id.* at *53.

In bankruptcy, the bankruptcy trustee would take charge of the debtor's estate.[438] A bankruptcy trustee may have the ability to force a waiver of the attorney-client privilege in order to obtain confidential information provided by an asset protection attorney to the debtor.[439]This means that a bankruptcy trustee would likely be able to obtain documents and other information to expose the whereabouts of a debtor's foreign assets.[440] In the CIC context, such documents likely would include all of the non-public accounting of where the CIC assets are held. This valuable information would make it a simple process for the bankruptcy trustee to undo an asset protection scheme that renders a debtor insolvent and reclaim the assets for the benefit of the creditors.[441] In a foreign CIC arrangement, this may involve repatriating the premiums, or the assets that have been purchased with the premiums, so that these assets may be used to satisfy the creditor's claims.

U.S. courts have also stated that enforcement of the laws of a foreign country is against public policy where those foreign laws violate settled principles of U.S. law.[442] The laws of foreign jurisdictions notorious for asset protection are unlikely to withstand an attack on public policy grounds since these foreign laws were oftentimes intentionally drafted to contradict U.S. law that would otherwise apply. As a result, a U.S. judge would probably choose not to apply such intentionally contradictory foreign law.[443] Thus, a U.S. court may unwind a foreign CIC arrangement where it determines that the foreign laws are being utilized in a manner that violates public policy.

In sum, a creditor of a U.S. related party (shareholder or insured) to a foreign CIC may succeed in voiding a transfer (capitalization or premium payment) of funds from the U.S. party to the CIC, by arguing that the transfers were actually made for improper asset protection purposes.[444] As outlined above, a creditor's success in making this argument is more likely once the U.S. debtor is in U.S. bankruptcy court, due to the broad powers and reach that bankruptcy courts have in collecting funds for the bankruptcy estate. Regardless, if the I.R.S. and DOJ can

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438. *See* NANCY C. DREHER, BANKRUPTCY LAW MANUAL § 4:4 (5th ed. 2011) ("The trustees administer the estate and perform other administrative duties in connection with the gathering of assets and the distribution of those assets, if any, to creditors.").

439. *See generally Asset Protection Trust Planning*, *supra* note 425, at *77.

440. *See generally Asset Protection Trust Planning*, *supra* note 425, at *82-83.

441. *See id.* at *84.

442. *See id.* at *59.

443. *See id.*

444. *See id.* at *56.

show that the ulterior reason for forming a CIC was asset protection, it may also undermine the contention that the CIC has been formed and is being administered as an insurance company at all.

V. CONCLUSION: CIC COMPLIANCE ISSUES AMPLIFIED BY THE OFFSHORE TAX CRACKDOWN

The I.R.S. and DOJ have used various investigatory and compliance devices to gather significant information on offshore tax activities of U.S. taxpayers, including but not limited to: holding Congressional hearings; the VDI programs; the Qualified Intermediary regime; increased offshore audits; and international tax treaties.[445] The DOJ has also made use of the information to bring civil and criminal tax cases to send a message as to the importance of such offshore tax compliance, including but not limited to cases against: UBS; Wegelin; Credit Suisse; and HSBC.[446] The domestic U.S. and offshore client, advisor, and banking communities have been warned that U.S. tax avoidance overseas will be highly scrutinized and punished severely where appropriate.[447] The negative consequences may include significant civil tax penalties, as well as stricter enforcement of criminal penalties for tax evasion, conspiracy to defraud, money laundering, wire fraud, and violations of the RICO Act.[448]

The penalties for the above U.S. criminal offenses are generally very harsh, risking the liberties and fortunes of U.S. taxpayers, advisors, bankers, accountants, and attorneys involved in non-compliant offshore investment arrangements.[449] Furthermore, even if an individual or entity is not subject to the jurisdiction of U.S. authorities, the U.S. government has displayed broad powers to enforce its will abroad through other means.[450] These broad powers include seizing an individual or

445. *Tax Compliance*, *supra* note 16.

446. *See* DEALB%K, *supra* note 255; *see* Goulder, *supra* note 17.

447. *See Banks Beware: IRS Criminal Investigations Expanding*, *supra* note 17; Goulder, *supra* note 17; *see also Tax Compliance*, *supra* note 16, at 2; *see TAX COMPLIANCE: OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR THE IRS: HEARING BEFORE THE S. COMM. ON FINANCE*, *supra* note 17, at 7; *see HSBC Case Alerts Asia Banks for U.S. Tax Probes*, *supra* note 17, at para. 5; *Practitioners Assess Offshore Initiative as Deadline Approaches*, *supra* note 17, at 665.

448. *See Banks Beware: IRS Criminal Investigations Expanding*, *supra* note 17.

449. *See Banks Beware: IRS Criminal Investigations Expanding*, *supra* note 17; *see* 18 U.S.C. § 1962; 18 U.S.C. § 1956.

450. *See generally* UNIFORM FRAUDULENT TRANSFER ACT § 4(b) (1984); *Asset Protection Trust Planning*, *supra* note 425, at *128.

entity's U.S. assets. In the banking sector, the seized assets can include banking licenses, as well as the offending client's funds from an offshore bank's U.S. correspondent accounts.[451] In *Wegelin*, the U.S. government seized roughly $16 million from UBS clients' correspondent accounts operated out of the UBS Stanford, Connecticut branch.[452] Such seizures often put tremendous pressure on offshore entities and individuals to reach an agreement with U.S. authorities.[453] For instance, the U.S. government forced the Swiss Bank UBS to settle claims of aiding and abetting U.S. tax evasion and to turn over names of U.S. account holders by threatening the seizure of UBS's U.S. held assets and banking licenses.[454] Following the precedent set by the *Wegelin* court in seizing client accounts, the U.S. government could attempt to seize onshore assets of the U.S. owners in order to ensure the compliance of an offshore CIC.[455] This I.R.S. and DOJ offshore tax crackdown does not show any sign of abetting any time soon.[456] Thus, any offshore CIC (even one with no CIC onshore assets) should be very concerned with U.S. tax and regulatory compliance.

To be U.S. tax compliant, all domestic and foreign captive insurance companies with U.S. shareholders must satisfy I.R.S. risk shifting and risk distribution requirements to be considered insurance.[457] As discussed above, risk shifting exists when an insured transfers an economic risk of loss to an insurance company,[458] while risk distribution occurs where several insurance companies (or other unrelated entities) pool insurance premiums so that the no particular insurance company (or entity) has all the risk for an economic loss.[459] There now exist I.R.S. safe harbors for satisfying risk shifting and risk distribution requirements.[460] In addition to these fundamental requirements, the I.R.S.is also aware of certain less-prevalent I.R.C. Section 831(b) CIC tax-motivated compliance problems.[461] These issues include: (i) the use of life insurance on the CIC

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451. *See* Goulder, *supra* note 17; *Tax Compliance*, *supra* note 16, at 31.

452. Goulder, *supra* note 17.

453. *See Tax Compliance*, *supra* note 16, at 64.

454. Rubinstein, *supra* note 277, at para. 1.

455. *See* Goulder, *supra* note 17.

456. *Id.*

457. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

458. *The Service Clarifies the Facts and Circumstances Approach to Captive Insurance Companies*, *supra* note 75, at 169.

459. Humana, Inc. v. Comm'r, 881 F.2d 247, 256 (6th Cir. 1989).

460. *See id.* (referring to risk shifting and risk distribution).

461. *See* Bunting et al., *supra* note 22; Life Insurance and Captives, *supra* note 106.

owner's life as a major investment of the CIC; (ii) engaging in tax motivated loan back arrangements between the CIC and its owners; and (iii) structuring the CIC ownership in the name of a children's trust (or other entity) to avoid Federal Estate and Gift Taxes. While these compliance issues are not present in a majority of I.R.C. Section 831(b) CIC arrangements, the potential downside of non-compliance for those that do partake in them is significant. Obviously, the best way to avoid a negative compliance audit outcome is to utilize the safe harbors for risk shifting and risk distribution, and choosing not to participate in any of the above-described tax-motivated specific activities. That being said, any CIC that does not follow this course of tax compliance would be best served to avoid any additional unnecessary audit risks.

Since a CIC can be formed either under the laws of a U.S. state or a foreign jurisdiction, a prospective CIC shareholder must review several factors before making this decision, including: (1) exposure to the U.S. tax system; (2) the capitalization burden at formation; (3) the investment flexibility afforded the CIC; and (4) the asset protection afforded the U.S. shareholders of the CIC. As outlined above, on balance these factors do not dictate a significant reason – even under the best of circumstances – for U.S. taxpayers to choose to form in a foreign jurisdiction. As a result, any I.R.C. Section 831(b) CIC choosing to form offshore may end up compounding all these compliance risks by virtue of ending up eventually in the middle of the I.R.S. offshore tax crackdown. As the offshore tax crackdown expands, compliance and audit costs for even a fully compliant foreign CIC may rise significantly. The fact that a tax beneficial entity (the CIC) is organized and operated from a foreign jurisdiction may become cost prohibitive (if compliant) or the target of serious penalties (if non-compliant) by virtue of the I.R.S.' current bias against U.S. taxpayers doing tax avoidance transactions overseas.