



# Duke Law Firm, P.C.—in the News

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## Recommended Reading

We previously recommended a book titled "The Scottish Invention of American Democracy and Human Rights," co-authored by Dr. Robert Munro, Professor, University of Florida College of Law. The following is the updated Web site regarding this book:  
[www.braveheartsoul.com](http://www.braveheartsoul.com)

## Seminars/Conferences

Richard Duke spoke at **The Offshore Institute 2006 Roundtable: Your Passport to Greater Knowledge of New Trends and Developments in the Offshore Finance Industry**, presented by The Offshore Institute, The Adam's Mark Hotel, Denver, Colorado, Thursday, April 20, 2006:

<http://www.offshoreinstitute.com/seminars.html>

**Chartered Wealth Manager and Certified Trust and Estate Practitioner Course:** Register for the Chartered Wealth Manager (CWM) and Chartered Trust and Estate Planner (CTEP) Designation Courses, May 2006, Wilmington, NC  
<http://mfsfinancial.com/bsiexecutiveeducation/>

The following comments regarding offshore life insurance were made by Richard Duke or included in his handout materials for The Offshore Institute 2006 Roundtable.

### Offshore Life Insurance—Economic Advantages

Offshore life insurance may be highly recommended for high net worth individuals. Offshore variable life insurance policies may have certain economic advantages that are not available with respect to variable life insurance policies issued by U.S. carriers.

First, a licensed offshore insurance carrier is not subject to subchapter L taxation under the Internal Revenue Code. The offshore carrier will pay licenses and fees, instead of taxes, to a foreign jurisdiction in which it is formed and operates.

Second, an offshore carrier does not have an expensive distribution system paying commissions to agents and brokerage firms. An offshore carrier has lesser internal costs due to having a small office and a small number of personnel. Generally, an offshore carrier pays referral fees to persons who introduce policyholders to the carrier, but these referral fees are generally less than commissions paid to insurance agents. The offshore carrier has a small office and number of personnel, thereby further reducing the internal costs.

Third, the offshore carrier can make worldwide investments, otherwise closed to Americans, under the Regulation S exemption of the 1933 Securities Act.

Fourth, properly formed and operated offshore insurance carriers include contractual arrangements with large reinsurers that help meet the requirements to pay death benefits upon the death of insured persons. Larger sums of insurance can often be purchased from offshore carriers than can be purchased from U.S. carriers due to the relationships with large reinsurers.

And, finally, the state premium tax (generally between 2%-4%) is avoided and replaced by a 1% excise tax.

### Offshore Life Insurance—Asset Protection

Variable life insurance policies issued by offshore carriers formed under jurisdictions with favorable insurance legislation provide maxi-

mum asset protection benefits to insured persons.

Those asset protection advantages include: (1) protection of separate segregated accounts from the claims against policyholders; and (2) in the event insurance carriers become insolvent or bankrupt, the separate segregated accounts of policyholders are not subject to the claims against insurance carriers.

State laws where insured persons reside determine the rights of claimants and creditors against policyholders. Many state laws provide little protection for policyholders against creditors. By acquiring variable life insurance from offshore carriers, asset protection benefits are determined by foreign insurance legislation, not state law.

#### **Offshore Life Insurance—Risk Shifting Required**

In order for an insurance policy to be classified as an insurance contract, the shifting of risk to the insurance carrier must occur. If the risk remains with some party or contract outside the insurance carrier, then the insurance is not an insurance contract but an investment.

I.R.C. Section 7702 states that a contract is life insurance only if it meets both the traditional risk-shifting/risk-sharing test and one of two mathematical tests: (i) the cash value accumulation test under I.R.C. Section 7702(b); or (ii) the guideline premium test of I.R.C. Section 7702(c) and the cash value corridor test of I.R.C. Section 7702(d)—this second test consisting of two parts. A qualified actuary must run the calculations in accordance with one of these tests. The purpose of either test is to ensure that the value of the investments when compared with the face value of the policy does not become so large that it becomes an investment instead of a life insurance contract. Only if the policy meets the statutory definition of a "life insurance" contract under I.R.C. Section 7702 will the

increases in cash value escape current income taxation.

The primary case that the IRS relies upon to attack structuring that provides tax deferrals or benefits with respect to property outside the life insurance is the U.S. Supreme Court case of *Helvering v. Le Gierse*, 312 U.S. 531 (1941). In this case, the insurer simultaneously issued a single-premium life insurance contract and a single-premium annuity contract, the risks of which offset each other. If the insured died prematurely, the insurer was compensated by a profitable annuity premium; if the insured lived beyond his life expectancy, the insurer was compensated by profitable insurance premium. Thus, no shifting of risk occurred to the insurer and, the U.S. Supreme Court held, no true life insurance existed.

The primary target of the IRS, based on the *Le Gierse* case and other issues that the IRS is raising, is the use of the private annuity arrangement between the insured and an entity formed by one of the separate segregated accounts. The IRS is currently attacking these arrangements by taking the position that no risk has been shifted due to the carrier issuing an insurance policy and simultaneously entering into a private annuity arrangement, similar to the *Le Gierse* case. The position of the IRS is that the insurance policy fails as an insurance contract, causing the investments in the separate segregated accounts to be taxable to the policyholder.

Other areas of attack by the IRS include:

- the use of private annuity arrangements between U.S. persons, generally the insured parties, and entities formed by separate segregated accounts of offshore variable life insurance policies;
- payment of premiums with property;

- transferring businesses to entities formed by separate segregated accounts;

- transferring artwork to separate segregated accounts; and

- transferring real estate or interests in real estate to separate segregated accounts.

The transfer of appreciated securities to pay premiums is treated as a sale or exchange resulting in a capital gains tax. Thus, it is simpler to sell the appreciated securities and use the sales proceeds to pay premiums in cash.

#### **Offshore Life Insurance—U.S. Compliance**

Offshore life insurance must be compliant with the laws of the country in which the insured persons reside. The tax laws that must be met for U.S. compliant policies are complex. In addition, one of the two tests must be met as stated under "Offshore Life Insurance—Risk Shifting Required."

Much of the structuring that is directly linked with the acquisition of offshore life insurance is currently under attack by the IRS and is similar to the attacks on tax shelters. The position that the IRS is taking for structuring to provide advantages with respect to property outside the insurance itself is that risk has not been shifted to the insurance carrier and the variable life insurance policies are investments, not insurance contracts. Under the Internal Revenue Code, if policies are not insurance, then the internal build-up with respect to the investments is currently taxable to the policyholders. Among other arguments, the IRS will challenge these underlying planning arrangements as prearranged deals with the primary purpose of the planning to obtain alleged tax deferrals, thus causing the insurance not to be purchased for economic reasons. The attacks on tax shelter promoters by the IRS gives a strong indication that the

IRS will win in its arguments against the use of schemes to provide tax benefits outside the normal tax benefits of a life insurance policy, such as no tax on the internal build-up, the ability to borrow from a non-modified endowment contract, and the potential ability to remove the insurance proceeds from the gross estate for federal estate tax purposes.

#### **Life Insurance Contract Defined**

Internal Revenue Code Section 7702(a) states: "For purposes of this title, the term 'life insurance contract' means any contract which is a life insurance contract under the applicable law, but only if such contract—(1) meets the cash value accumulation test of subsection (b), or meets the guideline premium requirements of subsection (c), and falls within the cash value corridor of subsection (d)."

Internal Revenue Code Section 7702(g)(1)(A) states: "If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year."

#### **Now is the Time to Consider Acquiring Offshore Life Insurance**

High net worth individuals should consider acquiring offshore variable life insurance for economic and estate planning reasons. Proper acquisitions of life insurance involve the direct purchase of the insurance without outside structuring attempting to provide tax deferrals or tax advantages relating to other property. The IRS has no concerns with an offshore carrier issuing U.S.-compliant policies to trustees of foreign trusts or general partners of foreign limited partnerships where cash is paid to acquire the insurance. Such offshore variable life insurance can be bought with lower internal costs

and the avoidance of substantial commissions. In addition, the earnings in the separate segregated accounts will not be subject to tax nor questioned by the IRS, and loans may be obtained from the policies if they are non-modified endowment contracts. Insurance policies are classified as non-modified endowments contracts if they meet the 7-pay test that requires the insurance contract to provide for paid-up future benefits "after the payment of 7 level annual premiums." I.R.C. Section 7702A(b).

#### **The IRS and the Grant Case**

In 1983 and 1984, Raymond Grant established a Bermuda trust and a Jersey trust with himself as the beneficiary of one of the trusts and his spouse, Arline Grant, as the beneficiary of the other trust. In 1991 and 1993, the IRS assessed millions of dollars in back taxes against the Grants for the years 1977 through 1982 and 1984 through 1987. The government moved to repatriate the trust funds held in the Grants' offshore trusts in order to discharge a portion of the tax liability owed by the Grants.

This is another case involving "control" by the U.S. settlor or U.S. beneficiary. The trust instrument gave control to Raymond and Arline grant. Duke Law Firm takes no position on whether a foreign trust, properly funded and drafted and not controlled (directly or indirectly) by a U.S. settlor or a U.S. beneficiary, can avoid repatriation of foreign trust assets from a demand by the IRS in a U.S. court. But including specific language in a trust instrument granting control to the settlor and a beneficiary, as in the Grant case, will result in defeating the claims of no future creditors, whether government or private. For a foreign trust to provide any asset protection benefits, the trust document must be properly drafted showing no control by the U.S. settlor or other U.S. beneficiaries, and the U.S. settlor and U.S. beneficiaries must exercise no control (directly

or indirectly) over the trustee or foreign bank/asset manager that is managing the trust assets.

The following is from the Grant case:

The only issue here is whether for purposes of repatriation, the corpus of a trust is any different than funds held in an ordinary offshore bank account, or for that matter, any offshore asset of a taxpayer. Therefore the query must be: is this a trust over which the beneficiary lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets to the United States? -- or, does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? If she has such power, then this asset is no different than any other asset.

Once the power of the person who is either the owner or the beneficiary of the asset to repatriate is established, the court can require that person to repatriate the funds. In the case of the Bermuda Trust, the trust document confers upon Arline Grant the power to change the trustee at any time, and further provides that should the trustee be changed, and the new trustee resides outside of the location of the trust, the law governing the trust will change to the law of the place in which the new trustee is located. Specifically, the Bermuda Trust document states that:

During the lifetime of the Grantor, he (or, following his death, his said spouse, ARLINE GRANT, if she shall survive him) shall have the right, at any time, to discharge an existing or acting Trustee (including the Trustee executing this Agreement) *and to appoint such other Trustee in any jurisdiction throughout the world, as he (or his said surviving spouse) may in his (or her) sole and unreviewable discretion determine ...* (D.E. No. 11, Exhibit A, FOURTH) (emphasis added).

The document further provides that:

if in the course of time, a successor or substitute Trustee is appointed pursuant to the foregoing provisions of this Indenture, which is organized and is located and functions under the laws of a jurisdiction other than Bermuda, then and thereafter for so long as such successor or substitute Trustee shall remain in such capacity, the rights and duties of all persons with an interest in the Trust Estate ... shall for all purposes be interpreted and construed exclusively in accordance with the laws of such other jurisdiction and the courts thereof shall be the sole forum for all purposes requiring judicial determination in the execution, operation or termination of the trusts herein created. (D.E. No. 11, Exhibit A, TWENTIETH).

Arline Grant contends that her power to appoint a new trustee to either trust is "limited to such trustees as I in my 'sole and unreviewable discretion

may determine.'" (D.E. No. 111 at ¶ 4). She further argues that a court order requiring her to exercise her power would "violate the terms of each trust because I have no wish to appoint a U.S. trustee and such appointment would not be one that is made in my 'sole and unreviewable discretion.'" (D.E. No. 111 at ¶ 5) (emphasis added). In the context of offshore trusts, the seeming conundrum claimed by Ms. Grant has been addressed and debunked. See *In re Lawrence*, 251 B.R. 630 (S.D. Fla. 2000). In *Lawrence*, the Court found that a party who deliberately configured an offshore trust so as to prevent the beneficiary from having the power to access or repatriate the trust assets to pay judgment creditors was in contempt of a court order requiring him to do so. This Court need not even go so far as *Lawrence* in deciding it has the power to require Ms. Grant to repatriate. The trusts here have no limitations on the beneficiary's power preventing her from acting, as in *Lawrence*. To the contrary, Arline Grant's powers over the trusts are extensive, and thus the Court's powers are necessarily co-extensive.

#### **Isle of Man Reduces Taxes to Attract High Net Worth Individuals**

The February 24, 2006 article of *The Financial Times*, along with other news publications, report that certain offshore financial centers are competing to attract wealthy residents by capping the amount their citizens have to pay in taxes. The Isle of Man recently instituted an income tax cap of £100,000, with Guernsey considering a cap of between £200,000-£250,000.

#### **Foreign Banks Not Investing in U.S. Securities**

Some private client departments of foreign banks are including language in their contracts to manage assets that no assets will be invested in U.S. securities. Upon entering into contracts with foreign trustees of foreign trusts established by U.S. grantors, these foreign banks are taking the position that because no investments will be made in the U.S., U.S. grantors are not required to issue the Form W-9 and the foreign trustees are requested to issue the Form W-8BEN. This is incorrect and in violation of the withholding and QI Treasury Regulations and the instructions to Form W-8IMY. U.S. attorneys representing U.S. grantors must ensure that the U.S. grantors issue the Form W-9 and that the foreign trustees issue the Form W-8IMY.

Documentation is key because the withholding agent, especially one who has QI status, can do its job based only upon receiving proper and complete information.

This is the key because it drives two completely different sets of rules. The primary focus of the withholding rules and the QI status is to separate U.S. beneficial owners from non-U.S. beneficial owners. A QI is responsible for separating U.S. beneficial owners from non-U.S. beneficial owners, and the fact that investments may not be made in the U.S. is not relevant. It is the separation from U.S. and non-U.S. that is required. If a QI is not involved with the investment transactions, then the withholding agent must separate between U.S. and non-U.S. clients or customers, and the failure to receive required documentation falls under the default rule that the persons investing are U.S.

#### **Law Firm GCs Continue to Multiply**

*Leslie A. Gordon*  
*GC California Magazine*  
*March 10, 2006*

This article states, in part:

Dan Carroll receives nearly a dozen phone calls and e-mails every week from one of his biggest clients. Raising complicated questions about everything from liability matters to ethics issues, the client can be demanding. Fortunately, however, Carroll is highly motivated to help this particular client thrive. After all, it's his own 115-lawyer firm.

The Sacramento-based Downey Brand is just one among an increasing number of law firms around the country that are pulling lawyers away from revenue-generating work to serve as general counsel. More than two-thirds of the top 200 law firms in the United States now have a designated in-house general counsel, according to a recent survey conducted by Altman Weil, the legal consulting company.

"This is reflective of larger law firm recognition of the need for risk management in our post-Enron, Sarbanes-Oxley environment," says Ward Bower, a principal at Altman Weil. "These are billion-dollar law firms and it's hard to imagine a billion-dollar company not having a designated GC. They've got a whole host of legal issues that any business of comparable size would have."

<http://www.law.com/jsp/ihc/pubarticleihc.jsp?id=1141898562122>

### **GCs Brace for Work Force's Shifting Sands** *Texas Lawyer*

Among the demographic, technological, cultural and political forces that shape a general counsel's world, three fast-approaching,

inexorable trends guaranteed to impact GCs are: an aging work force, a multicultural work force and geographic migration. Ford & Harrison's Michael P. Maslanka presents a look at how population trends will concern general counsel in a future that is not very far away. And, yes, there are some positives along with the negatives.

### **Cayman Islands News**

Cayman Islands Monetary Authority Chairman Timothy Ridley cautioned attendees at a global educational symposium on investment strategy to ensure they understood an overseas jurisdiction's legal and regulatory framework before investing there. STEP (Society of Trust & Estate Practitioners) Offshore News Digest 13 April 2006.

### **USA-Former Senior State Judge Charged with Offshore Tax Evasion**

*(Tax.News.com)*

Sam Currin, the former head of the North Carolina Republican Party and an ex-state Superior Court judge, has been arrested and charged with using offshore companies set up in the Caribbean to evade United States federal taxes.

<http://www.tax-news.com/asp/step/story.asp?storyname=23368>

### **IRS Gets a Victory on Tax Shelter**

*By Robert Guy Matthews and David Reilly*  
*April 22, 2006; Page A4 [in part]*

The U.S. Tax Court handed a victory to the Internal Revenue Service in the first civil case involving the widely used abusive tax shelter called "Son of Boss," vindicating the agency's threat to vigorously pursue taxpayers who refused to accept the settlement terms that it had offered earlier.

Tax Court Judge David Laro, in Washington, D.C., in an opinion not yet released, granted the IRS summary judgment earlier this

week in its case against now-defunct RJT Investments X LLC, which was based in Omaha, Neb. The IRS argued that RJT used scam accounting to create large losses in order to slash its federal taxes.

The Tax Court decision could have an impact on the coming trial of 18 individuals facing criminal charges related to sales of tax shelters by KPMG LLP. The government has contended that the structures were illegal. Attorneys for the defendants, 16 of whom are former KPMG executives, have argued that tax courts have yet to agree with that determination.

In the RJT case, RJT didn't challenge the IRS on the merits of the case. Instead RJT defended the case on a jurisdictional issue, which the judge rejected.

### **Tax Avoidance—Tax blow for offshore trading**

*(Financial Times)*

Hundreds of the wealthy [U.K.] investors who have been trading in stocks and shares through offshore companies are facing tax bills for hundreds of millions of pounds as the government cracks down on evasion. The Revenue's request follows a voluntary disclosure by a group of five City traders who had set up an offshore company based in the British Virgin Islands through the unnamed bank to trade shares and avoid paying tax on investment gains.

<http://news.ft.com/cms/s/0b48e978-d19c-11da-a38b-0000779e2340.s01=1.html>

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