



## *Duke Law Firm, P.C.-in the News*

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### Conferences

#### **J. Richard Duke will be speaking at the *Legalease Conferences*:**

Practical Issues in Trust Administration, 19 September 2005, Westin Casuarina Hotel, Grand Cayman; and Practical Issues in Company Administration, 20 September 2005, Westin Casuarina Hotel, Grand Cayman. Practical Issues in Company Administration, 22 September 2005, British Colonial Hilton, Nassau, Bahamas; and Practical Issues in Trust Administration, 23 September 2005, British Colonial Hilton, Nassau, Bahamas: <http://www.Legalease.co.uk>

#### **Offshore Alert Report**

OFFSHORE ALERT reported on Nigel Scott Grant, who was announced as "of counsel" to Duke Law Firm in the June 2004 issue of this newsletter. That relationship did not come to fruition and neither Duke Law Firm nor any lawyer of Duke Law Firm has worked on a client case with Nigel Scott Grant, directly or indirectly. Duke Law Firm has not referred a client to Mr. Grant, nor has Mr. Grant referred a client to Duke Law Firm.

Mr. Duke advised David Marchant of the above facts. Mr. Marchant is the owner of KYC News, Inc. that publishes OFFSHORE ALERT and other newsletters.

<http://www.offshorealert.com/>

No one is currently serving as "of counsel" to Duke Law Firm, P.C.

#### **U.S. Tax Problems Caused by Per Se Corporations**

Assume a U.S. person (or more than one person) forms a corporation (that is referred to herein for discussion purposes as Per Se Corporation) under a foreign corporate law that is on the list of "per se" corporations in the Treasury Regulations. Treasury Regulation § 301.7701-2(b)(8) lists eighty "per se" foreign corporate statutes. Examples include the Sociedad Anonima statute of Panama, Brazil, Honduras and Costa Rica. Also included are the Barbados Limited Company, the Belize Public Limited Company and the Hong Kong Public Limited Company. This means that the foreign corporation is classified as a foreign corporation for income tax purposes and it cannot file a Form 8832 electing to be treated as a disregarded entity (one shareholder) or as a foreign partnership (two or more shareholders). The Per Se Corporation retains the services of a bank in Europe. The European bank is a qualified intermediary (QI), meaning that it has an agreement with the Internal Revenue Service that it will separate beneficial owners between U.S. persons and non-U.S. persons. The Per Se Corporation is a separate entity and must provide a Form W-8BEN (as the beneficial owner) to the European bank. This shows the bank that the Per Se Corporation is a corporation (separate entity) and is the beneficial owner.

A part of the funds are invested in the U.S. A foreign corporation that invests in the U.S. is subject to

withholding requirements, generally 30% on the income earned. And, if that corporation is not formed in a treaty country, the tax treaty with the U.S. cannot be used to reduce the withholding rate.

At the end of the first calendar year, let's assume that the investments in the U.S. resulted in interest income. The European bank must file Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) and Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) with the Internal Revenue Service, as well as withholding on the interest income (30%). If the Form 1042-S is filed on paper instead of electronically, a Form 1042-T (Annual Summary and Transmittal of Form 1042-S) must also be filed.

Now let's assume that the European bank is not a QI. Upon investing through a financial institution or institutions in the U.S., that financial institution or institutions, as withholding agents, must withhold the 30% on the interest income and file the Forms 1042 and 1042-S with the Internal Revenue Service.

The U.S. person or persons who transfer assets, directly or indirectly, to the Per Se Corporation are required to file a Form 926 (a few exceptions apply, but most often this form is due). Also, a Form 5471 (tax return for a foreign corporation) is required to be filed. Because the foreign corporation is owned by U.S. persons, it is a controlled foreign corporation with

subpart F income (passive investment income). Subpart F income must be reported each year by the U.S. shareholders whether that income is distributed by the corporation. Because it is a controlled foreign corporation with passive investment income, the following disadvantages result: (1) no capital gains rates are available with respect to investments; (2) losses on investments cannot be taken until the Per Se Corporation is liquidated; (3) investments in the U.S. result in withholdings (as stated above) and that income is also taxed to the U.S. shareholders (a credit is available against the withheld amount); and (4) at the death of the shareholder or shareholders, the basis of the stock in the Per Se Corporation does not step-up to the fair market value at the date of death.

The shareholder or shareholders are required to file a TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) and are also required to complete Schedule B, Part III of the Form 1040.

Let's see how the situation can be changed. First, a corporation with one shareholder will be considered and the second will be a corporation with two or more shareholders.

The U.S. person can form the foreign corporation in a foreign jurisdiction that is not on the "per se" list of corporations under the Treasury Regulations. The foreign corporation can then file a Form 8832 electing to be treated as a disregarded entity for income tax purposes. As a result, the sole shareholder is treated as the beneficial owner and the payee of income with respect to that foreign corporation.

The U.S. shareholder of the foreign corporation issues a Form W-9, gives it to the foreign bank, and the foreign bank invests a portion of the assets in the U.S.

Because the bank knows that the foreign corporation (entity) is disregarded for income tax purposes and that the owner is a U.S. person for income tax purposes, those investments are treated as if they were made directly by the U.S. shareholder. Thus, capital gains rates are available, losses on investments may be taken, no withholdings on income apply and, at the death of the shareholder, the basis in the assets of the corporation steps-up to the fair market value.

No Form 926 or Form 5471 is required to be filed.

The shareholder or shareholders are required to file a Form TD F 90-22.1 and are also required to complete Schedule B, Part III of the Form 1040.

Now assume that two U.S. shareholders (or more) form the foreign corporation referred to in the previous paragraph. The corporation files a Form 8832 electing to be treated as a foreign partnership for tax purposes. As a result of this filing, the foreign partnership is treated as a flow-through entity, meaning that all income, gains and losses are reported directly by the partners, not the partnership. The partnership, for tax purposes (a corporation for legal purposes), issues a Form W-8IMY (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding), along with a W-9 for each of the partners (shareholders for legal purposes) to the bank. The bank knows that the partnership is a flow-through entity and that all income, gains and losses are taxed to the U.S. partners for tax purposes. Thus, capital gains rates are available, losses on investments may be taken, no withholdings on income in the U.S. applies and, at the death of a partner, the basis of the foreign

partnership interests steps-up to the fair market value (and an election can be made to step-up the basis to the fair market value in the assets attributable to the deceased partner of the foreign partnership).

The partners file a Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships).

No Form 926 or Form 5471 is required to be filed.

The shareholder or shareholders are required to file a Form TD F 90-22.1 and are also required to complete Schedule B, Part III of the Form 1040.

### **Impact of Pasquantino Case**

See the May 2005 issue of the Duke Law Firm newsletter for the initial discussion of the Pasquantino case. The following discussion is from Bruce Zagaris, International Enforcement Law Reporter, Volume 21, Issue 7, July 2005:

On May 2, 2005, the United States Supreme Court has given another victory to the Canadian government trying to enforce its excise taxes on spirits and cigarettes when it denied a certiorari application trying to appeal criminal conviction for a wire fraud scheme that deprived foreign governments of tax revenue. *Fountain v. United States*, U.S. Supreme Court, No. 04-294, *cert. denied*, May 2, 2005. The same day the U.S. Supreme Court vacated dismissal of a RICO action brought by the European Community and various EC cases against RJR Nabisco for cigarette smuggling to evade excise taxes.

The appellate court in the U.S. Court of Appeals for the 2d Circuit held that taxes owed to any government—even if not yet collected—are “property” of that government under the wire fraud statute. 18 U.S.C. § 1343. The appeals court denied relief to a petitioner who used the habeas corpus statute to appeal a conviction of conspiracy to launder the proceeds of a wire fraud scheme, based on currency activities trying to evade high Canadian excise taxes on tobacco products.

On May 2, 2005, the U.S. Supreme Court also vacated an appeals court judgment that held that the common law “revenue rule” bars courts from adjudicating foreign sovereigns’ claims, brought under the federal Racketeer Influenced Corrupt Organizations Act (RICO) statute, for damages resulting from defendant tobacco companies’ cigarette smuggling scheme that allegedly caused loss of tax revenues to the plaintiffs European Community (EC) and various EC countries. *European Community v. RJR Nabisco Inc.*, U.S. Supreme Court, No. 03-1427, judgment vacated, May 2, 2005.

The order vacating the judgment in the RJR Nabisco case and the denial of certiorari in *Fountain* followed the Supreme Court decision the prior week in *Pasquantino v. United States*, in which the court held that a scheme to defraud a foreign government of tax revenue violates the wire fraud

statute, notwithstanding the revenue rule, which generally bars courts from enforcing the tax laws of foreign sovereigns.

The plaintiffs in RJR Nabisco alleged that the defendants were actively involved in smuggling contraband cigarettes into the EC, the member states, and various locations around the world, for many years. The plaintiffs argued the defendants’ smuggling activities included conduct and effects in the Eastern District of New York. The complaint alleged the defendants made an agreement with distributors, customers, agents, consultants, and other coconspirators to participate in a scheme to smuggle contraband cigarettes and that they conspired with others to promote and conceal their smuggling activities by means, including fixing the price of contraband cigarettes; and that, in the process of smuggling cigarettes, the defendants engaged in the business and services of narcotics traffickers and money launderers, and hence facilitated or engaged in laundering the proceeds of crime. The plaintiffs requested monetary, declarative, and injunctive relief.

On February 19, 2002, the district court in the Eastern New York dismissed the action based on the revenue rule, which the RICO action triggered. On January 14, 2004, the Second Circuit affirmed, holding that the USA Patriot Act and its legislative history did not provide

clear evidence of a congressional intent to abrogate the revenue rule as it applies to claims brought under RICO. For additional background see Raul Cabrera, *Court’s Pasquantino Ruling Spawns, Review of Revenue Rule in Racketeering Context*, DAILY REP. FOR EXEC., May 3, 2005, at G-7.

#### *Analysis*

The implications from *Pasquantino* are ominous and are sending shock waves through the U.S. business community. In at least approximately one-third of the world, including most of Latin America, the former Soviet Union, Africa and the Middle East, mainstream businesses commonly arrange their affairs so as to evade tax, often through the use of offshore structures to receive and make payments. Ostensibly the arrangements on their face are to avoid currency restrictions that in some countries itself may be a tax crime. In other countries avoiding currency restrictions may not rise to the level of a crime, but only an administrative penal offense. Many countries, such as Brazil and Russia, are rapidly changing their tax laws, closing loop-holes, such as the ability of citizens and residents to maintain for purposes of receiving income offshore accounts (e.g., Brazil) (Raymond Colitt, *Bank Chief in Tax Fraud Probe*, FIN. TIMES, May 13, 2005, at 2, col. 1 (discussing the authorization of criminal investigation against Henrique Meirelles, the central bank chief, over alleged tax

fraud and misdemeanors against the financial system because his personal wealth was incompatible with the tax returns he has filed since 1996. Brazilians commonly opened offshore bank accounts into which they received foreign source income. Mr. Meirelles worked in the U.S. for international organizations while receiving some of the income, which is the source of the tax controversy)) and penalizing the use of offshore mechanisms for the same. For instance, Russian revenue officials are very aggressively auditing and bringing criminal actions against a variety of businesses.

Certain economic sectors may be more vulnerable than others. For instance, due to the dynamic upsurge in the energy sector, many foreign governments are aggressively trying to extract more revenue from the sector by aggressively auditing and bringing criminal actions against foreign operators, issuing administrative rulings, and enacting legislation. Many of these cases lead to lengthy disputes, the outcome of which is costly and uncertain. Some foreign companies are invoking investment agreements in order to bring cases in international dispute fora to resolve the disputes. These agreements have the advantage of providing for a wide range of obligations by the host country to accord the investment national treatment, most-favored-nation treatment, and treatment

in accordance with customary international law.

A major problem in the U.S. for businesses that are issuers or public companies is that they are subject not only to the wire and mail fraud statutes giving rise to the *Pasquantino* type cases, but simultaneously to reporting requirements in the Sarbanes-Oxley Act (SOX). SOX requires U.S. businesses to follow new rules and procedures in connection with the financial reporting and auditing process. Among those requirements (e.g., Sec. 302) are for the CEO and CFO of each issuer to prepare a statement to accompany the quarterly financial reports which certify that they have disclosed to their audits and the audit committee all significant deficiencies and material weaknesses in their internal control system, and that they have disclosed material changes in those control systems subsequent to the last evaluation.

Specifically, Sec. 302(a)(6) of SOX requires the CEO/CFO to certify that the issuer has disclosed in the quarterly (or annual) report any change in internal control over financial reporting during the last quarter that has "materially affected, or is reasonably likely to materially affect" the issuer's internal controls. This could include any corrective actions with regard to significant deficiencies and material weaknesses.

According to the final Securities and Exchange Commission (SEC) rule implementing this provision, the rule does not explicitly require the company to disclose the reasons for any change that accrued during the fiscal quarter, or to otherwise elaborate about the change. However, the company will have to determine, on a fact and circumstances basis, whether the reasons for change, or the information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading.

If a U.S. company discovers that the way it is and has been doing business is a criminal violation of a foreign jurisdiction and thereby has a U.S. wire and mail fraud violation, it has the dilemma of continuing to do business, thereby increasing its risks of U.S. and foreign criminal proceedings or changing the ways it does business, thereby undermining its market. Assuming at some point it decides to change the ways it does business, the change would likely precipitate an internal investigation and SOX implications. The stakes, risks, and issues for multinational corporations with widespread international operations are heightened.

Clearly *Pasquantino* and its progeny pose enormous new legal, business, and ethical traps for the way in the U.S. because of the enormous gap

between business practices and the law, both in the U.S. and throughout the world. U.S. businesses are in a conundrum and a very uncertain situation that may undermine their competitiveness until they are able to obtain more certainty in resolving the uncertainties brought by the *Pasquantino* decision and its implications in the context of other U.S., foreign and international law.

### **U.S. District Judge Rules IRS "Reckless"**

Charlotte Amalie, U.S. Virgin Islands: A federal judge threw out evidence against 4 men charged with laundering \$60 million+ through their chain of USVI grocery stores, ruling that FBI agents acted in "reckless disregard for the truth" using fraudulent search warrants. Defendants charged anti-Arab, anti-muslim prejudiced was involved.

\*U.S. judge throws out IRS money laundering evidence:

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### **Baucus, Kyl Agree On Estate Tax 'Parameters'**

*Published by Tax AnalystsTM*

The two senators charged with finding a permanent, bipartisan compromise on the estate tax have reached an agreement on the framework of a deal, according to Republican pointman Sen. Jon Kyl, R-Ariz.

Kyl and Senate Finance Committee ranking minority member Max Baucus, D-Mont., have been trying for over a month to find an estate tax relief compromise that will muster enough bipartisan

support to clear 60-vote procedural hurdles in the Senate.

According to Kyl, they have agreed that any estate tax bill will retain current law's "step-up in basis," which allows the value of inherited property to be "stepped up" to its fair market value at the time of inheritance when calculating capital gains. Kyl and Baucus have also agreed to keep intact the extended periods estates may use to pay off their tax bills, Kyl said. Farm estates, for instance, are allowed 10 years to settle their estate tax liability under current law. But the heart of the estate tax relief package will include a cut in estate tax rates and "a good-sized exemption that would be indexed for inflation," Kyl said.

Document: (Doc 2005-14884)  
Electronic Citation: See 2005 TNT 133-1

### **U.K. Tax Collectors Mimic U.S. IRS**

*The Sovereign Society Offshore A-Letter: Monday, June 20, 2005-Vol. 7 No. 123*

LONDON: Taking a leaf out of the IRS play book, British Revenue is tracking down U.K. residents offshore credit and debit card use for possible tax evasion. New EU tax rules mean that accounts held offshore, in places such as Luxembourg, Guernsey and Jersey, can no longer be kept from the scrutiny of the taxman if you are a EU resident.

### **Gunster Yoakley Faces Two Malpractice Trials**

*Daily Business Review*

Gunster Yoakley & Stewart faces two legal malpractice trials in which plaintiffs are accusing the Florida-based law firm and its attorneys of conflict of interest and are seeking tens of millions of dollars in damages. Both suits—one involving heirs to the Gannett newspaper fortune—claim that Gunster lawyers failed to properly notify a client that the firm

represented one or more other parties with whom the client did business. Some experts say a loss could force the law firm into bankruptcy.

<http://www.law.com/jsp/article.jsp?id=1119344735785>

### **Aggressive Lawyering Goes Over the Line**

*The Connecticut Law Tribune Law.com*

In a landmark dispute on the limits of aggressive lawyering, a jury has delivered a resounding verdict against two Connecticut attorneys for fraudulent conduct in violation of civil portions of the Racketeer Influenced and Corrupt Organizations Act. Lawyers involved in the case say, to their knowledge, the verdict is the first in the nation in which the private cause of action under the federal RICO statute has been used successfully against lawyers for actions related to representation of a client.

<http://www.law.com/jsp/article.jsp?id=1119603913467>

### **Firms Compete For Class Settlement Action in KPMG Investor Suits**

*Published by Tax AnalystsTM*

Under threat of indictment, KPMG's recent public admission of wrongdoing is fresh meat for the circling plaintiffs' lawyers now vying to be appointed lead counsel for a potential class of investors who are suing the beleaguered accounting firm, Deutsche Bank, and Sidley Austin Brown & Wood, among others.

With a putative class-action suit pending against it in a federal district court in Arkansas brought by a local firm and a New York firm, KPMG has been negotiating with another firm, New York-based Milberg Weiss Bershad & Schulman, for a "prepackaged" settlement deal, according to a June 22 motion filed by the New York plaintiffs' firm of Bernstein Litowitz Berger & Grossmann. Consequently, counsel of the proposed class in Arkansas is seeking appointment as interim class counsel

to enjoin KPMG from entering into a potentially collusive agreement with Milberg Weiss and to enjoin the latter law firm from filing a class action.

Document: (Doc 2005-13720)  
Electronic Citation: See 2005 TNT 121-2

### **Tort Lobby Sharpens Its Aim**

*Legal Times*  
*Law.com*

An enduring image in the legal reform community is trial lawyers as a vast insect horde, ceaselessly picking their targets, filing their lawsuits, making their billions and moving on to the next tort. And that image gives tort reformers little chance to rest, even after back-to-back victories on class action and bankruptcy bills. "Trial lawyers are a business," says Lisa Rickard, president of the U.S. Chamber of Commerce's Institute for Legal Reform. "And people need to understand they're a business."

<http://www.law.com/jsp/article.jsp?id=1119431117713>

### **Investors Criticize Tax, Financial Network for Pushing Cobra-Like Plan**

*Published by Tax AnalystsTM*

Three people who purchased a foreign currency option plan dubbed HOMER—a grantor trust scheme designed to generate fake losses to help offset legitimate income gains—are suing Bank One and its financial and legal partners for peddling the tax scheme.

Bank One personnel purportedly developed the Hedge Option Monetization of Economic Remainder (HOMER) strategy along with fellow defendants Deutsche Bank and White & Case LLP. American Express and Arthur Andersen LLP are also named in the suit for signing off on the HOMER plan while preparing the plaintiffs' 2001 tax returns.

Shelter buyers Donald R. Wilson Jr.; his wife, Laurie Wilson; and business associate Kenneth S. Brody filed suit in federal court on

June 13 charging their respective financial and tax advisers with breach of contract, fraud, negligent representation, and civil conspiracy for not warning them about the estate planning maneuvers. The shelter clients claim they were told the plan "took advantage of a 'legal' loophole in the tax code to reduce tax liability."

The plaintiffs maintain they were also kept in the dark about the abusive tax shelter amnesty program offered by the IRS in 2002.

The three investors paid Bank One and its associates roughly \$5.4 million to purchase tax avoidance packages they say their advisers knew violated the anti-COBRA rules outlined in Notice 2000-44. Brody and the Wilsons have subsequently paid another \$5.3 million in penalties and interest to the IRS since coming under audit.

### **Government Doing Just Fine in Shelter Cases, O'Connor Says**

*Published by Tax AnalystsTM*

Eileen J. O'Connor, assistant attorney general for the Tax Division at the Justice Department, said on June 16 that, despite some losses in the courts, the government is doing "very well" in obtaining information from alleged promoters of abusive tax shelters.

Speaking at a meeting of the American Institute of Certified Public Accountants in San Francisco, O'Connor took an implicit shot at the tax press, cautioning against putting too much stock in media reports of government losses in the courts related to the current war on tax shelters.

O'Connor said that "justice sometimes takes a very long time to run its course," and one decision does not always paint an accurate picture of what is going in a case. "You cannot always read a tax story and have the whole story. The pieces will be reported to you

as they occur, and not all reporters are able to, or have the time to, or are inclined to put all the pieces together to show you the whole picture of what happened," she said.

O'Connor referred to a decision in the case of the law firm BDO Seidman case last year as an example. In June 2004, a district judge denied the government's motion to compel disclosure of 110 documents for which BDO Seidman had asserted the attorney-client privilege and the work product doctrine in a summons enforcement action against the firm.

The theme in media coverage of the decision was "government loses a big one," according to O'Connor. She noted, however, that BDO Seidman had already been forced to hand over thousands of other documents in the case.

"What that story didn't tell you is that this is ongoing litigation," O'Connor said.

O'Connor declined to comment on the Justice Department's investigation of past tax services offered by KPMG LLP, citing government policy in ongoing investigations. KPMG announced on June 16 that it is in "discussions" with Justice regarding the government's investigation into services KPMG offered from 1996 through 2002.

Document: (Doc 2005-13158)  
Electronic Citation: See 2005 TNT 116-3

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