Case Note

Taxpayers committed US tax fraud with offshore trusts

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Abstract

In May 2016, a US bankruptcy court judge in Texas ruled that Samuel Wyly had committed tax fraud in using offshore non-grantor trusts to hide his income (*Re Samuel E Wyly, et al (Bankr ND Tex 2016)*). The court also found that the Dee Wyly, the widow of Charles Wyly, the brother, and business partner of Samuel, had not committed tax fraud even though she was a joint signer on Charles's returns. In addition, the court addressed the Wylys failure to file certain forms reporting the offshore accounts and gift tax issues.

The ruling resulted in a USD 1.1 billion judgment against Samuel Wyly. In addition, the Internal Revenue Service ("IRS") has filed a lawsuit against the estate of Charles Wyly to collect USD 249 million in penalties for failure to file certain forms to report the offshore trusts (*United States v Miller, ND Tex, No 3:16-cv-02643, complaint filed 9/15/16*). Furthermore, Dee Wyly will also be required to pay taxes, penalties, and interest for a completed gift she made to her children. This case highlights a number of issues the taxpayer should be aware of when engaging in offshore planning.

Background facts

Samuel and Charles Wyly were business associates for the majority of their adult lives. Over the course of their careers, the brothers enjoyed considerable success in founding or acquiring numerous companies. By the early 1990s, the brothers had amassed a significant fortune. As a result of their wealth, they sought advice with respect to US income and estate tax planning.

The Wylys and their advisers ultimately decided to implement an aggressive strategy involving the use of offshore trusts that was being promoted at the time by Mr. David Tedder. The strategy called for the Wylys to establish trusts in the Isle of Man and transfer their stock options in companies they owned to the trusts in exchange for annuities. The Wylys took the position that the trusts were non-grantor trusts for US income tax purposes. Meaning, any income earned by the trust would be taxed at the trust level and not automatically to the Wylys. Had the Wylys taken alternative position that the trusts were 'grantor trusts', then all income from the trusts would have been taxed to them regardless if a distribution was made. The Wylys took the non-grantor position even though an outside attorney reviewed the structure and advised that the IRS would likely treat the trusts as grantor trusts from a US income tax perspective. Thus, as a result, the Wylys did not report any income earned by the trusts.

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the trusts as grantor trusts from a US income tax perspective

In 2003, certain advisors to the Wylys began to re-evaluate the positions taken with respect to the Isle of Man trusts. The advisors concluded that there was a significant risk that Isle of Man trusts dating back to 1992 would be treated as grantor trusts for US income tax purposes. The advisors recommended an anonymous meeting with the IRS to see if a global settlement could be reached surrounding the offshore system. The meeting occurred but the IRS and the advisors did not reach an agreement.

The advisors also recommended that the Wylys formally disclose their tax positions by filing Form 8275. Form 8275 can be filed with the IRS when a position on a tax return has only reasonable basis of being sustained and is filed in order to avoid accuracy-related penalties. Beginning in 2002, Samuel filed Form 8275 and Charles and his wife, Dee, filed the form beginning with their 2003 joint tax return. Upon audit, the IRS asserted income and gift taxes, failure to file penalties for gift taxes and foreign reporting requirements, and fraud penalties. In addition, the IRS asserted willful neglect penalties for failing to file certain forms disclosing the foreign trusts. Charles passed away while the case was pending, leaving Dee and his probate estate to face the fallout.

Income tax fraud

The IRS carries the burden of establishing tax fraud by clear and convincing evidence separately for each tax year at issue upon review of all the facts and circumstances. For fraud to exist, the taxpayer's underpayment of tax must have been intentional with the purpose of avoiding the tax.

The courts have developed a non-exclusive list of indications of fraudulent intent. Such indications include (i) understatement of income, (ii) inadequate maintenance of records, (iii) failure to file tax returns or make estimated tax payments, (iv) offering implausible or inconsistent explanations of behaviour, (v) concealment of income or assets, (vi) failure to cooperate with tax authorities, (vii) engaging in illegal activities, (viii) dealing in cash, (ix) offering false or incredible testimony, and (x) filing false documents. No single indicator may necessarily be sufficient to establish fraud; however, the existence of several indicia may be persuasive evidence of fraud.

The court pointed to a number of facts in this case that convinced it that Samuel and Charles Wyly acted with fraudulent intent by failing to report the income earned by the offshore trusts. For example, the structure the Wylys established was unnecessarily complex. The Wylys settled multiple foreign trusts, which in turn owned numerous foreign corporations that in turn owned US corporations. The court mentioned specifically 54 offshore trusts or corporations and at least 10 US corporations. The trusts were not adequately capitalized and had charities or family members as beneficiaries. The court agreed with the IRS and found the complexity was much greater than actually needed. It even pointed out many multinational corporations that were not structured so complexly.

The court also agreed with the IRS on other indicia of fraud by Samuel and Charles. For example, the Wylys used the structures to commit securities fraud, failed to resolve conflicting legal advice as to the legitimacy of the transactions, established trusts and companies to muddy the nature of the structure, and falsifying documents and filings. Of particular note, on multiple occasions the Wylys caused the trusts to take certain actions, including spending money for the benefit of family members or make certain investments. Indeed, the court stated that the Wylys treated the trusts as the 'Wyly Family Piggy Bank'. Despite all of these indications of direct control, the Wylys did not report the income earned by the trusts as their own.

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Therefore, with respect to the income tax fraud issues, the court found the IRS had met is burden in proving fraud. Under similar reasoning, the court also concluded the Wylys acted with wilful neglect for failing to file Forms 3520-A and 5471 to report the existence of the offshore accounts and trusts.

Samuel Wyly's reasonable cause defence

Samuel Wyly employed the 'reasonable cause' defence against the fraud penalties. This defence allows the taxpayer to assert he or she relied on the advice of legal counsel and, therefore, should be exempt from the fraud penalties. Samuel pointed to the fact that he received a legal opinion from the original promoter of the structure and that he had relied on the advice of his in-house counsel in implementing the structure. The court found these arguments unpersuasive for a few major reasons.

First, with respect to the legal opinion from the original promoter of the structure, the IRS prohibits taxpayers from relying on the written opinion of a promoter of a tax shelter. Furthermore, Wyly had received conflicting advice from another adviser around the time of inception informing him the IRS would likely treat the trusts as grantor trusts. This failure to resolve the conflicting legal advice was a sticking point for the court.

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In addition, with respect to Samuel's argument that he relied on the advice of his in-house counsel, the court found this unpersuasive because the in-house counsel was not a tax expert and Samuel apparently knew this. Also of note, the in-house counsel never offered tax advice but served as a middleman between the outside lawyers and Samuel. Thus, the court rejected Samuel's reasonable cause defence.

Dee Wyly's innocent spouse defence

Charles Wyly filed his tax returns jointly with his wife, Dee. As Dee was still alive during the trial but Charles was not, the fallout from the investigation and trial fell on her. During the trial, Dee asserted the 'innocent spouse' defence. This defence provides an exception to the general rule that spouses who file joint returns are jointly liable for the tax, penalties, and interest due. Over the course of the trial, Dee was able to show that she did not have any knowledge or involvement in the establishment of the trusts. She was also able to prove that a reasonable person in her situation would also not have known. Of particular importance, the court noted Dee's lack of education or sophistication in business and tax matters. Dee was primarily the homemaker in the relationship and rarely, if ever, involved herself in her husband's business affairs. As a result, the court determined Dee carried her burden of proof and established that she was an innocent spouse with respect to the tax, interest, and penalties due, and thus not liable even though she signed the tax returns at issue as well.

Gift tax issues

In addition, the court examined certain alleged gifts made by Samuel to his children and Dee to her children. The transactions were quite complex. However, with respect to Samuel, the issue came down to the fact that Samuel never made a completed gift because he did not relinquish dominion and control of the gifted assets. For Dee's gifts, the court did find one completed gift resulting in Dee being liable for the gift tax due. However, the court did not find that Dee was liable for a fraud penalty on the failure to report the gifts and pay the tax because persuasive evidence did not exist that Dee understood the transactions. Rather, she entered into them with full reliance on Charles's direction.

Planning consideration

The Wyly cases provide a number of important points to be aware of when engaging in offshore planning from a US tax perspective. First, the taxpayer should receive an opinion from a qualified and competent

US tax adviser. Even if the planning is disallowed later on, obtaining the opinion will provide the taxpayer with an additional argument against the implementation of the fraud penalty.

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Secondly, whenever the taxpayer engages in an aggressive planning position, it will likely benefit the taxpayer to disclose the position to the IRS and to provide the IRS will all pertinent information. This puts the IRS on notice and prevents the argument that the taxpayer acted fraudulently by withholding information.

Finally, should a problem arise, it may be possible for the spouse to make use of the 'innocent spouse' rule. If successful, this would allow a spouse who did not have any involvement with the scheme to re-avoid joint liability for the wrongdoing.

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