I. Money Laundering and Lawyer Liability

A. Background

The Financial Action Task Force (FATF) is a limited life inter-governmental body that was formed in 1989 to combat money laundering. Since its creation, FATF has pushed for the adoption and implementation of several recommendations aimed at financial institutions and professionals. These include confiscation of proceeds of all serious crimes, requirements for financial institutions to identify all clients and maintain records of their financial transactions (including that all suspicious transactions be reported), and entry into international treaties for the exchange of information. FATF views attorneys as gatekeepers, used by criminals to facilitate money laundering.

FATF issued a Consultation Paper on May 30, 2002, in which it discussed a number of initiatives to strengthen the FATF framework, including the so-called Gatekeepers’ Initiative. The Gatekeepers’ Initiative would require legal professionals, accountants, financial consultants, and other professionals to apply the same anti-money laundering preventative measures as are applied to financial institutions. A few examples of these measures are customer identification, recordkeeping, and reporting of suspicious transactions to competent authorities. FATF invited comments to the Consultation Paper to be submitted by August 31, 2002.

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B. Comments

Both the American College of Trust and Estate Counsel (ACTEC) and the American Bar Association Task Force on Gatekeeper Regulation (Task Force) submitted comments. Among other items, these comments underscored the importance of reconciling the Gatekeepers' Initiative with the Model Rules of Professional Conduct, which have been adopted in some form in forty-one States and the District of Columbia. The most important issues to be reconciled are the duties of loyalty and confidentiality, especially since the latter permits disclosure of confidential information only in limited instances, and even then, on a prospective basis only.

Both ACTEC and the Task Force were generally opposed to the suspicious transactions reporting requirements on the basis that it contravenes fundamental principles underlying the attorney-client relationship. ACTEC also pointed out that financial institutions might be in a better position to know or discern whether the facility was chosen for an illicit purpose due to their ongoing relationships with clients and their ability to receive updated knowledge of the clients' businesses. Attorneys, on the other hand, are often called upon by clients to assist in the creation of a particular structure (for example, a corporation, partnership, trust, or some combination) for legitimate purposes, but may not have ongoing involvement in the administration of the structure. ACTEC also argued that classifying a tax offense as a money laundering offense would place an undue burden on tax attorneys by requiring tax attorneys from one country to learn and enforce the tax laws of another country.

II. Rates for Estate and Gift Tax in 2002

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), a variety of estate and gift tax rates change from year to year. The following rates were in effect during calendar year 2002:

- Maximum estate tax rate: 50 percent
- Maximum gift tax rate: 50 percent
- Maximum generation-skipping transfer tax rate: 50 percent
- Amount excludable from the estate tax: $1,000,000
- Annual gift exclusion: $11,000
- Annual gift exclusion for gifts to a non-U.S. citizen spouse: $110,000

III. Offshore Credit Cards Crackdown

During 2001–2002, the Treasury entered into tax information exchange agreements with offshore financial centers, in which over 50 percent of offshore companies were located as part of its effort to identify U.S. taxpayers who hide income offshore. On January 15, 2003, the Internal Revenue Service (Service) announced the launch of an initiative targeted at bringing taxpayers, who use offshore credit cards or other financial arrangements to hide their income, into compliance with the tax law. Complete details of the Voluntary Com-

The Voluntary Compliance Initiative which grew out of the Service's "John Doe" summons investigation began in October 2000. The Service issued a series of summonses to a variety of financial and commercial businesses to obtain information on U.S. residents who held credit, debit, or other payment cards issued by offshore banks. Investigators used records from these summonses to trace the identities of those whose use of these payment cards could be related to hiding taxable income. The Service identified thousands of offshore payment cardholders for potential examination, and dozens of cases were referred to Criminal Investigation. An early estimate suggested that more than one million payment cardholders could be involved, but after reviewing records the Service reduced its estimate to "a substantial number" of taxpayers.

Under the Voluntary Compliance Initiative, eligible taxpayers who filed the required application on or before April 15, 2003, which must have included information about the promoters of the cards, would not face civil fraud, information return penalties, or criminal prosecution. However, they would still have to pay back taxes, interest, and certain accuracy or delinquency penalties. The Service hopes to identify the card promoters through these voluntary applications.

Once again, there was proposed legislation to tax individuals who renounce U.S. citizenship for the purpose of avoiding U.S. taxes. On June 25, 2002, H.R. 4880 was introduced and on July 22, 2002, S.2769 was introduced (collectively, House bills). The Senate version passed as an amendment to H.R. 5063 on October 3, 2002, while the House bills died in committee. Although nothing passed Congress in 2002, similar legislation was introduced in January 2003. Indeed, one bill, S.19, introduced on January 7, 2003, would apply retroactively to September 12, 2002, if enacted.

Citizens and residents of the United States are generally subject to U.S. income tax on their worldwide income and are also subject to U.S. estate and gift tax on transfers of their worldwide assets. Accordingly, some individuals have sought to limit their U.S. tax exposure by relinquishing U.S. citizenship or terminating their U.S. residence. If one of the principal purposes of relinquishing citizenship or terminating long-term residence is avoidance of tax, the individual is subject to an alternative method of taxation, which can apply to income, estate, and gift taxes for a ten-year period following the date of expatriation or termination of long-term residency.

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For this purpose, a long-term resident is defined as an individual who has been a lawful permanent resident of the United States (green card holder) in at least eight of the preceding fifteen taxable years.\(^6\) In applying this rule, an individual is presumed to have expatriated or terminated long-term residence with a principal purpose of avoiding U.S. taxes if either (1) the individual’s average annual U.S. federal income tax liability for the five taxable years ending before the date of the expatriation or termination of long-term residence is greater than $100,000 (the tax liability test) or (2) the individual’s net worth as of the date of such loss or termination is $500,000 or more (the net worth test).\(^7\) If the individual falls within certain enumerated categories, however, he or she may avoid the application of the section 877 presumption by submitting a ruling request to the Service, demonstrating that the expatriation or residency termination did not have, as one of its principal purposes, the avoidance of U.S. tax. In addition, under the Reed Amendment, U.S. citizens who renounce their citizenship may be denied reentry into the United States if they are “determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States.”\(^8\)

B. PROPOSED LAW

Because the Service has found these provisions difficult to administer, on October 3, 2002, the Senate approved new legislation that would subject both U.S. citizens who relinquish their U.S. citizenship and long-term permanent residents who terminate their residence, to a tax on the net unrealized appreciation in their assets, as if such assets were sold at fair market value at the time of such expatriation or termination. This deemed gain would be required to be included as income at the time of such expatriation or termination, to the extent it exceeded $600,000 (or $1.2 million in the case of married individuals filing a joint return, both of whom relinquished their citizenship or terminated their residence).

The proposed law would permit an individual to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that is covered by the expatriation tax. Under this election, the individual would continue to be subject to U.S. income, estate, and gift taxes on that property at the rates applicable to U.S. citizens. To benefit from the election, the individual would also be required to waive any tax treaty provisions that waive the collection of the tax and to provide adequate security to ensure payment of the tax.

The proposed law would permit only very limited exceptions. One such exception would apply to individuals born with dual citizenship provided that the individual continued to be a citizen of and taxed as a resident of the other country, and the individual had not been a resident of the United States for at least five years prior to expatriation. A second exception would apply for a U.S. citizen who relinquishes citizenship before reaching age 18-1/2, provided he or she also had not been a resident for at least five years. Interestingly, there do not appear to be any exceptions available for an individual who terminates long-term residence.

The deemed sale would apply to all property owned by the individual, both from the United States and from any foreign source. Furthermore, the exclusion from income otherwise applicable to the receipt of property acquired by gift or inheritance\(^9\) would not apply.

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6. See id. Taxable years in which a dual resident taxpayer claims foreign residency under the provisions of an applicable tax treaty do not count towards the eight-year limit.
7. Id. These dollar amounts are indexed for inflation and for 2002 were $120,000 and $599,000, respectively.
to any property received from an individual who had been subject to this tax, and any such amounts would be includable in the gross income of the recipient (subject to the exceptions noted above for dual citizens and minors). As originally proposed, these provisions would apply to all U.S. citizens who relinquish their citizenship, and all long-term residents who terminate their residence on or after September 12, 2002.

Although this bill did not pass Congress last year, in part because of objections from the Republicans in the House of Representatives, similar legislation has been re-introduced in the 2003 Senate, as noted above.

V. Asset Protection—Affordable Media Settlement

FTC v. Affordable Media LLC, also known as the Anderson case, which involved a Cook Islands asset protection trust, was settled near the end of 2002. On December 13, 2002, the Federal Trade Commission announced that it approved a settlement regarding the collection of assets being held in an offshore trust in the Cook Islands on behalf of Michael and Denyse Anderson, two of the defendants in Affordable Media, LLC.

A. Background

The FTC originally filed suit against the Andersons in 1998 as part of “Project Risky Business,” an investment fraud sweep. Through a limited liability company, the Andersons ran a telemarketing scheme selling shares of future profits from the sales of various products, and then used the proceeds from later sales of such shares to pay the earlier investors, leaving no profits to pay to the later investors, a classic “Ponzi” scheme. The Andersons created an irrevocable trust under the law of the Cook Islands in which they named themselves as protectors and co-trustees, together with a Cook Islands trustee services company, AsiaCiti Trust Limited (ATL), to hold their share of the profits from the marketing scheme.

The U.S. trial court ordered the Andersons to repatriate all assets held in their offshore trust. The Andersons claimed, however, that the effect of that order, under the trust agreement, was to automatically remove them as co-trustees and to prevent ATL, as the remaining trustee, from repatriating the assets because a so-called “event of duress” occurred. They argued that due to this occurrence and the refusal of the foreign trustee to repatriate the assets, it was impossible for them to comply with the court order. The trial court found that the Andersons still retained a great degree of control over the trust as protectors, held them in contempt, and ordered their incarceration. The Ninth Circuit affirmed.

10. Fed. Trade Comm’n v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999).
12. Affordable Media, 179 F.3d 1228. The Andersons were charged with violations of the Federal Trade Commission Act and the Telemarketing Sales Rule for their participation in a scheme to telemarket fraudulent investments to consumers.
13. Id. at 1231.
14. Id. at 1232.
15. Id.
16. Id. at 1242.
In light of this decision, the Andersons agreed to remove the existing Cook Islands trustee, ATL, and to appoint a corporation organized by the FTC as a substitute trustee in their capacity as protector of the trust. ATL did not agree, and sought a ruling by the Cook Islands High Court as to the legality of such a transaction. In April of 2000, the U.S. court granted the FTC's motion for summary judgment against the Andersons and entered a $20 million judgment against them.

In addition to the U.S. proceedings, in 1999, the United States, on behalf of the Federal Trade Commission, also filed suit in the Cook Islands High Court against the trustee, ATL, to recover the Andersons' money from the trust. On December 4, 2001, the High Court entered a judgment in favor of ATL stating that "the proceedings disclose no reasonable cause of action" based primarily on conflict of law and private international law principles, specifically the rule that "English Courts have no jurisdiction to entertain an action: (i) for the enforcement either directly or indirectly of a penal revenue or other public law of a foreign state; or (ii) founded upon an 'act of state.'" The United States, on behalf of the FTC, appealed this decision, which was discontinued upon reaching a settlement with ATL.

B. Settlement

In the settlement, dated November 29, 2002, the United States, on behalf of the FTC, reached an agreement with ATL to resolve all disputes between them relating to the trust and to the U.S. and Cook Islands proceedings. Through the settlement, ATL turned over to the FTC $1.2 million from the Andersons' trust, ending the litigation against ATL. As a result, the FTC will have approximately $1.4 million in a redress account to distribute to the defrauded investors through a plan that was still pending.

VI. Withholding from Foreign Partnerships and Foreign Trusts

In Notice 2002–6616, the Service extended the transitional documentation and reporting relief specified in Section IV of Notice 2001–4, for foreign partnerships, Qualified Intermediaries (QIs), and U.S. withholding agents, through the end of calendar year 2002.

A. Background

In 2000, the Service issued some very controversial and comprehensive withholding regulations under sections 1441–1446, 1461–1463, 6402, and 6413 of the Internal Revenue Code. These regulations became effective January 1, 2001, but compliance on an international basis seemed difficult.

Under the withholding regulations, as well as the qualified intermediary (QI) withholding agreement, a foreign partnership generally is treated as a flow-through entity, and therefore,
prior to receiving a payment, must provide a withholding agent with a Form W-8IMY together with documentation from each partner and a withholding statement that allocates the payment to each of the partners in the partnership. Recognizing that these rules result in the withholding agent receiving a high volume of documentation, the Service allowed a foreign partnership to become a withholding foreign partnership under an agreement with the Service, similar to the QI Agreement. A withholding foreign partnership generally would not be required to provide documentation for its partners to the withholding agent.

Pending the publication of a model agreement for entering into a withholding foreign partnership arrangement, the Service issued Notice 2001-4, applicable for calendar year 2001, which allowed foreign partnerships to provide the withholding agent with a withholding statement based on withholding rate pools, along with certain other documentation. In addition, the required documentation for partners that were foreign persons or U.S. exempt recipients could be provided to the withholding agent at any time during the calendar year 2001.

B. Notice 2002-41

In Notice 2002-41 the Service published proposed guidance for entering into a withholding foreign partnership (WP) or a withholding foreign trust (WT) agreement. These proposed WP and WT agreements adopted procedures for documentation, reporting, and auditing that were tailored towards partnerships and trusts and intended to facilitate compliance and reduce administrative and audit costs. The Service determined that it was appropriate to extend the transition relief for foreign partnerships under Section IV of Notice 2001-4 through the calendar year 2002 to allow time for comments on the proposed WP and WT agreements. The Service stated that it anticipates finalizing the WP and WT agreements in the near future and will enter into WP and WT agreements with foreign partnerships and trusts in 2003, allowing them to function as WPs or WTs as of the beginning of 2003.

Under the transition relief of Section IV of Notice 2001-4, as extended by Notice 2002-41, for calendar year 2002, the IRS would permit a foreign partnership to provide a withholding agent, including a QI, with a Form W-8IMY together with a withholding statement that provides the withholding agent with information regarding withholding rate pools. The foreign partnership must provide a separate withholding rate pool for each U.S. non-exempt recipient partner. The foreign partnership must associate the documentation from each of its partners with the Form W-8IMY. If a partner is a foreign person or a U.S. exempt recipient (for example, a corporation) that documentation may be provided to the withholding agent at any time during calendar year 2002. If a partner is a U.S. non-exempt recipient, a Form W-9 must be provided before a payment is made to a partnership.

VII. Deferred Compensation—"Rabbi" Trusts

The American Competitiveness and Corporate Accountability Act of 2002 included a provision relating to the taxation of deferred compensation benefits provided through offshore trusts.

23. H.R. 5095, 107th Cong. (2d Sess. 2002) (hereinafter American Competitiveness and Corporate Responsibility Act of 2002); Title IV, Section 403(a) (proposed addition of Section 409A to the Code).
A. Background

Under a typical rabbi trust arrangement, a trust is established by an employer to hold assets from which deferred compensation benefits will be paid. Although the trust may be irrevocable, the assets contributed to the trust remain subject to the claims of the employer's creditors in the event of bankruptcy. In such circumstances the Service has accepted that the arrangement is not regarded as funded for income tax purposes, and, therefore, contributions made to the trust are not taxable to the employee until they are actually paid.24 Some have apparently sought to limit the exposure of the trust's assets to the claims of creditors by establishing the trust in an offshore jurisdiction.

B. New Legislation

Under the proposed legislation, however, if assets are set aside for the purpose of providing deferred compensation benefits outside the United States, such as in a foreign trust, that factor would “make it more difficult for general creditors to reach the assets in the trust than it would be if the trusts were held directly by the employer in the United States,” and, thus, the plan is treated as failing to meet the requirement that the assets remain the property of the employer and be subject to the claims of the employer's general creditors at all times.25 Therefore, contributions to such a trust would be taxable to the employee when the amounts contributed are otherwise no longer subject to a substantial risk of forfeiture, regardless of when actually paid.

VIII. Offshore Life Insurance

A. Background

Over the last several years there has been an increased interest in the use of offshore variable life insurance for international cross-border estate planning. Although the death benefits provided under such policies may vary, in part, depending on the asset's stated investment return, like all insurance, if it qualifies as such for U.S. tax purposes, the income earned on the investment of assets within the policy is not subject to tax during the lifetime of the insured. Moreover, during that time, if the policy qualifies as a non-modified endowment contract (non-MEC), the policy owner may be able to access the assets within the policy through policy loans. At death, the beneficiaries of the policy receive the death benefits free of income tax and, if held in an irrevocable trust, the death benefits may also be free of estate tax.

B. Private Letter Ruling 200244001

The Service recently examined such a policy, however, and, under the circumstances in question, ruled that the policy did not qualify as life insurance for U.S. tax purposes because the owner of the contract was perceived to have retained too much control over the assets.


of the contract. Accordingly, the owner of the contract was treated as the owner of the assets held in the policy.

The ruling involved three insurance companies that offered variable life insurance contracts that purported to qualify as such for U.S. tax purposes. Under the contracts, the insurer was to establish segregated separate accounts for the assets supporting the contracts, which would be maintained separately from the insurance companies' other accounts. Each separate account was, in turn, to be divided into various sub-accounts, and, at the time of purchase, the owner of the contract was to specify the allocation of premiums among the available sub-accounts (the owner could also change this allocation for later premium payments). Initially, the only sub-account options included a money market fund and a number of private investment partnerships (PIPs), which were described as entities taxed as partnerships sold in private placement offerings (it is generally thought that these PIPs were hedge funds). Although no PIP was publicly traded, within the meaning of section 7704 of the Code, interests in the PIPs could be sold to accredited investors, as well as to the insurance companies for use in these contracts. The Service took the position that because the PIPs were available to the public as well as to life insurance companies under their sub-accounts, the policies failed the diversification requirements that must be satisfied to qualify as life insurance under the Code.26

The diversification requirements in question are included in section 817(h) of the Code. The addition of this section to the Code in 1984 actually relates back to the investor control doctrine that had been developed by the Service in a series of rulings beginning in 1977 covering both variable life insurance and annuity products.27 In these rulings the Service took the position that annuity and life insurance contracts would not qualify as such where an owner of a contract retained too much control over the assets in the contract. In one such ruling the Service describes a number of factual situations in which they considered the applicability of this doctrine to a series of annuity contracts, and in four of the five factual situations presented, the Service concluded that the investments under the annuity contracts were considered to be owned by the contract holder rather than the insurance company.28 In Situation 3 of that Ruling, the Service took the position that the owner of an annuity policy would be deemed to have impermissible control over the assets in the contract where the assets in question were available for sale both to the general public and the insurance company.29

Because these standards as promulgated by the Service were somewhat subjective, many viewed the enactment of Code Section 817(h), requiring sufficient diversity within the contract, as overriding the more subjective investor control doctrine.30 In PLR 200244001, however, the Service determined that, because the PIPs were available both to the general public and to life insurance companies, the investor control doctrine as set forth in Rev. Rul. 81-225 was violated. In rejecting the arguments of the insurance company, the Service

26. I.R.C § 817(h).
29. The position of the Service in this ruling was confirmed by the Eighth Circuit in Christoffersen v. U.S., 749 F.2d 513 (8th Cir. 1984), rev'g 578 F. Supp. 398 (N.D. Iowa, 1984).
argued that the enactment of Code section 817 was evidence of support for the investor control theory and that Rev. Rul. 81-225 had not been pre-empted by the enactment of that section. As a result, the income earned on the assets was regarded as taxable to the owner of the contract.

Although the position of the Service may not be sustainable, it is prudent for companies offering variable life insurance contracts to limit their investments to assets that may be held only by such companies. This might be accomplished by creating a mirror or clone fund separating the investment from that which is available to the general public. In addition, the ruling can be distinguished if an investment advisor under the insurance contract selects the investments in question, rather than the policyholder.

IX. Canadian in U.S. on Temporary Visa — Potential U.S. Estate Tax Domiciliary

In the Estate of Jack,31 the parties filed cross-motions for partial summary judgment to determine whether a Canadian citizen employed in the United States on the date of his death, who had been admitted to the United States under TC and TN nonimmigrant, temporary professional classifications, was legally capable of forming an intent to be domiciled in the United States for federal estate tax purposes.

A. Background

The estate tax definition of resident, as detailed in the Treasury regulations, is actually one of domicile. If a person is determined to be a resident in that sense, his or her worldwide assets are subject to the U.S. estate tax, as is a citizen of the United States. If, on the other hand, the non-U.S. citizen person is not a resident for estate tax purposes, then only those assets considered to be situated within the United States will be subject to the estate tax. To be a resident for estate tax purposes requires physical presence and a subjective intent to remain in the United States indefinitely.

B. Estate of Jack

Dr. Jack's estate paid an estate tax of $15,415.00, as a non-resident not a citizen of the United States, based on the value of his gross estate in the United States and excluding assets outside the United States at the time of his death. The estate tax return was audited and the Service, which assessed an estate tax deficiency of $80,443.00, issued a Notice of Deficiency. The deficiency was premised on a determination by the Service that Dr. Jack was domiciled in the United States on the date of his death and thus, the reported value of Dr. Jack's estate should be increased by the entire value of the gross estate outside the United States.

In the Court of Federal Claims, the government argued that Dr. Jack was a resident for estate tax purposes; the executrix of Dr. Jack's estate argued that he was not. On motions for partial summary judgment, the government argued that the holder of a TN Temporary Professional visa is legally capable of forming the intent to be domiciled in the United States for federal estate tax purposes. The executrix claimed in her cross-motion for partial

summary judgment that the intent to establish domicile by the holder of a TN Temporary Professional visa would be in direct violation of the terms of the visa, and that such an intent would therefore be precluded as a matter of law. According to the executrix, “Dr. Jack's nonimmigrant visa establishes Dr. Jack's intent to depart, provides for his deportation should he fail to depart and, accordingly, precludes his forming an intent to remain indefinitely.”

The facts indicated that Dr. Jack was born in Winnipeg, Canada in 1947, and died in Davis, California in 1996. Until October 1992, Dr. Jack resided and was domiciled in Canada, where he practiced veterinary medicine. In October 1992, Dr. Jack was offered a two-year employment contract with the University of California at Davis in the School of Veterinary Medicine, for the period of January 1993 through December 1994. On November 2, 1992, Dr. Jack applied for admission to the United States as a TC class nonimmigrant and obtained TC Temporary Professional status, allowing him to be admitted to, and remain in, the United States for a period of one year. In December 1992, Dr. Jack moved to Davis, California, under his TC Temporary Professional visa, and in January 1993, commenced his duties at the school of medicine. Dr. Jack obtained extensions of his TC Temporary Professional visa to fulfill his employment contract. In January 1995, Dr. Jack renewed his contract with the University of California at Davis in the School of Veterinary Medicine for another two years, through December 1996, and on the basis of the renewed contract, on or about May 25, 1996, Dr. Jack obtained an extension of his TN Temporary Professional visa through November 17, 1996. Approximately three months later, on August 27, 1996, Dr. Jack died in Davis, California. According to the executrix, while living in California, Dr. Jack maintained bank accounts in Canada, continued affiliations with Canadian professional associations, remained a licensed Canadian veterinarian, maintained his Canadian driver's license and voter registration, and also maintained a Canadian mailing address.

In denying the executrix's motion for partial summary judgment, and granting the government's motion, the court held that the "government should be able to prove, consistent with the notice of deficiency and the assessment, that Dr. Jack had developed the intent to domicile in the United States, even though in violation of the terms of his visa at the time of his death."

X. Summary

During 2002 the primary focus was on scrutinizing a number of offshore practices. Although a number of "expatriation" tax proposals surfaced, none passed.

32. Id. at 591.