ASSET PROTECTION OR ABUSIVE TAX PLANNING?

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Andrew Brett Seiken and Andrew M. Nerney, associates in Cummings & Lockwood's Private Clients Group, published an article entitled "Asset Protection or Abusive Tax Planning" which appeared on *Trusts & Estates* magazine website on May 17, 2016.

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Former billionaires punished for using offshore trusts as personal "piggy banks" to defraud the IRS

"Never let a creditor get to your asset, no matter how bad your mistake." Upon this ideal, former Texas billionaire, Sam Wyly, and his now deceased brother, Charles, created an "enormously complex" arrangement of offshore trusts and corporations. The Wyly brothers, whose massive fortunes were earned founding and acquiring business entities, including Michaels craft stores and Bonanza Steakhouses, transferred valuable stock options in various business enterprises to offshore trusts in exchange for private annuities. The Wylys argued that their plan's intent was to have them "irrevocably surrender the enjoyment, control, ownership and all economic benefits attributable to the ownership of the options sold in exchange for the private annuity." The IRS contended, however, that the brothers anticipated that the U.S. tax authorities wouldn't tax the capital gains earned on the securities held in the offshore trusts. Federal Bankruptcy Judge Barbara Houser didn't buy the Wyly's argument that they reasonably relied on the advice of lawyers and tax professionals, nor did she agree that the trust's assets weren't under the family's control after the transfer. However, she did find that Charles' widow was entitled to the benefit of the innocent spouse defense.

Clear and Convincing Evidence of Fraud

Prior to a 2014 Southern District of New York Court's ruling that the Wyly brothers committed securities fraud in connection with various transactions undertaken by certain offshore trusts, Sam and Charles' widow, Dee, each filed for bankruptcy protection. After the court entered judgment against Sam and Charles' estate for $123,836,958.75 and $63,881,743.97, respectively, in April 2015, the Internal Revenue Service levied a $2.03 billion tax bill on Sam and a $1.1 billion tax bill on Charles' estate.

In Sam's bankruptcy petition, he claimed assets between $100 million and $500 million and liabilities totaling between $100 million and $500 million. During a two-week trial, Judge Houser had to decide whether the Wylys' trust arrangement was intended to defraud the IRS and, by “clear and convincing evidence,” she found in the affirmative. “There is little credible evidence in the record suggesting a legitimate business reason requiring this level of complexity,” Houser wrote. The IRS claimed that the Wylys’ lifestyle, including multiple mansions, fine jewelry and rare artwork, were purchased by the trusts and “loaned” to the family to avoid taxes and that gifts were made to younger generations for the same purposes. Houser’s 459-page ruling rejected the idea that the brothers were simply following the advice of their own employees and tax professionals to hide their assets in offshore trusts, allowing them to make hundreds of millions of dollars. The opinion states, “The court does not believe that the law permits Sam to hide behind others and claim not to have known what was going on around him.”

Innocent Spouse

In a more favorable ruling for the Wyly family, Judge Houser held that Dee was “innocent of any wrongdoing,” and that she “did not know the details of what Sam and Charles had done offshore....” As a general rule, when married persons file a joint income tax return, they become jointly and severally liable for the tax due with respect to that return. However, Congress concluded that under certain circumstances, such liability could be unfair. Dee sought and was granted “innocent spouse” relief pursuant to Internal Revenue Code Section 6015(b) and (c), which provides that relief from joint and several liability is available if: (1) a joint return was filed, (2) there’s an understatement of tax attributable to the erroneous items of one individual filing the return, (3) the spouse requesting relief didn’t know, and had no reason to know, of the understatement at the time of signing the return, (4) taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for the deficiency in tax resulting from the understatement, and (5) the requesting spouse asserts the innocent spouse defense within two years of the IRS commencing collection activities. “There was nothing that should have ‘tipped her off' that something was amiss,” Judge Houser concluded. “She did not commit fraud, she did not participate in any fraud, she was not willfully blind, and she is entitled to the benefit of the innocent spouse defense.” As a result, the court relieved Dee of responsibility for paying tax, interest and penalties on improperly reported and omitted items previously filed on joint tax returns.

Offshore Trusts Can’t Be Personal Piggy Banks

In reaching the conclusion that credible evidence was lacking in the record of a legitimate business need for this level of complexity, Judge Houser inferred that “a primary reason for making the offshore [trust] system this complex was the hope that no one, including the Court, could ever figure out what was going on here and why.” In what’s viewed as a big win in their fight against abusive tax planning, the IRS argued, the court agreed and practitioners should take note, “the Wyly family treated the offshore system as their personal piggy bank,” and consequently were found, by clear and convincing evidence, to have defrauded the IRS. Next on the agenda is to determine the amount the Wylys must pay.