THE LAW FIRM OF
BOVE & LANGA
A PROFESSIONAL CORPORATION

TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108
Telephone: 617.720.6040 – Facsimile: 617.720.1919
www.bovelanga.com

Trusts and Estates Forum

Tax Planning Within The Law Not Enough For Some

By Alexander A. Bove, Jr. and Melissa Langa

[Published in Massachusetts Lawyers Weekly, May 7, 2007]

No one likes to pay taxes. We are always looking for extra deductions, tax-deferred or even tax-free income, or any other acceptable method to legally reduce our tax liability. The question arises, however, as to what we mean by "legal" in this context. As attorneys, we certainly know or should know what that means, but then there are always those whose definition of legal, in the tax sense, really pushes the envelope (or should we say the tax return) right off the table.

For instance, there was a period in the 1980's when the price of silver was so high that a $1,000 bag of silver U.S. coins (i.e., 1964 and earlier) would fetch around $30,000 in the commodities market. Seeing this as a great tax planning opportunity, a popular newsletter (at the time) recommended that investors who had appreciated property should "sell" the property in return for bags of U.S. silver coins and only report the face value of the coins as the sales price. Since the coins were used in commerce at face value, it was all "legal." Not only would sellers using this approach reduce or eliminate any capital gain, but they might even have a loss! And believe it or not, because the coins were "legal" tender and the newsletter suggested it was permissible, some people actually went for it (the power of the printed word!). They also risked going to jail

for tax fraud and at best ended up paying the applicable tax (plus interest and penalties) based on the fair market value of the coins received.

Then there was the tax protestor movement which argued, among other things, that anyone who was paid in cash for services or employment didn't have to pay taxes because cash was worthless. Some may be old enough to remember when our currency contained a notice stating something like, "This note/bill is redeemable in silver at the Federal Reserve Bank." That is, since it was awkward for the government to issue and for everyone to carry around with them ounces and pounds of gold or silver to carry on trade and commerce, bills were issued that were (theoretically at least) backed by gold and silver, the international medium of exchange. In 1964, however, the government announced it would cease to issue such notes (because the growth in the economy and requirement for more paper dollars outpaced the ability to back every dollar with gold and silver), and from around that time, all of our paper currency has simply stated, "This note is legal tender for all debts, public and private." In other words, you can't take them to the government and redeem them for gold or silver.

This concept, according to a certain group of tax protestors, is no different from an individual issuing his personal note for something, like a car or a suit or a house, which note heads off into circulation being traded from one person to another ad infinitum but never being presented to the original maker for payment, and whenever the individual wanted to "buy" more, he would just issue more notes (just like our currency). Ridiculous? Perhaps, but a substantial group of erstwhile taxpayers adopted the idea and stopped filing tax returns because the dollars they received were inherently worthless and thus should not be subject to tax. When the IRS finally caught up with them many went to jail, including one of the leaders of the movement. For a concise history of Mr. Schiff's trials and tribulations and subsequent incarcerations for tax evasion, see also http://en.wikipedia.org/wiki/Irwin_Schiff.

As our tax laws became more sophisticated and complex, so did the approach of the tax protestors, as well as others whose schemes are so aggressive they fall just short of being categorized as protestors. Here's a modern day example: Wagner is an accomplished violinist whose performances are in great demand across the United States. In a typical year he earns $2

million. Wagner is approached by Weasel who asks if Wagner would like to keep all his earnings but pay almost no tax on them, *legally*. Weasel explains that he has contacts with a foreign corporation in the British Virgin islands, which will hire Wagner, contract for all his performances, pay his expenses, and pay Wagner a salary of $75,000 per year. The BVI company will charge $25,000 in annual management fees, and the entire remaining $1.9 million will be placed in an offshore deferred compensation plan to be held in trust and invested tax-free until withdrawn at Wagner's request. No strings attached. Weasel tells Wagner that since he is under legal contract with BVI and not with the concert managers, the only amount subject to U.S. income tax is the $75,000 salary paid to him. The rest of the money stays offshore growing tax-free in safe investments that, in fact, Wagner can manage if he wishes. And it is all "legal."

Well, it is certainly legal for Wagner to contract with the BVI company, and it is certainly legal for the contract to provide that a specified amount of the proceeds will be held in an offshore account for Wagner's benefit, and it is certainly legal for the BVI company (in light of its contract with Wagner) to contract with concert managers for Wagner's performances. There's just one problem – Internal Revenue Code ("IRC") section 409A(b)(1) provides that every dime that is put away offshore will be taxed to Wagner *at the time it is set aside for him*, regardless of whether or when he takes it. And just one more problem – IRC section 409A(b)(4) goes on to impose interest *plus a* 20 percent penalty on all such amounts set aside.

When we read about these too good to be true tax schemes, most of us ask one or both of two questions: 1) "Who would be gullible enough to think that this will work?" And even if there is a slim chance that such an aggressive plan might work, we ask 2) "If I try the scheme and it doesn't work, what's the worst that can happen?", followed by a rhetorical, "I'll just pay the taxes, right?"

Holding these two questions for a moment, how about this idea: There is a provision in section 861 of the Internal Revenue Code (IRC) that some (not many) interpret as providing that we only pay taxes on income from foreign based sources (the so-called "861 argument"). In other words, if your employer is based in the U.S., all your compensation is tax-free. (We wish!) Who would actually go for this off-the-wall proposal? Someone named Wesley did. Wesley was in the

entertainment business and very successful in his career, regularly earning millions per year. Several years ago Wesley was approached by Eddie Ray, the head of a company called American Rights Litigators ("ARL," its successor is Guiding Light of God Ministries), which was dedicated to "representing and protecting the rights of American citizens," and which charged a membership fee, of course. Once you joined, ARL would put you in touch with an attorney and a CPA who would represent you in all Internal Revenue Service (IRS) tax matters. Wesley joined ARL and Eddie Ray put him in touch with Douglas, a former CPA (license revoked) but who continued to work as a CPA. Eddie Ray and Douglas told Wesley that under the 861 argument, Wesley could not only stop paying income taxes, but he could get full refunds of the millions he paid in taxes over the previous several years. All he had to do, with their help of course, was file amended returns citing the 861 argument as his basis for the refund of all his taxes, and wait for the millions in tax refunds to roll in. Under the ARL membership and guidance arrangement Wesley would then pay Eddie Ray's company 20 percent of the refunds, and part of the 20 percent would be paid by ARL to ex-CPA Douglas. With their "professional assistance" Wesley filed the amended returns, apparently against the vigorous protest of his long time tax advisors.

Now let's go back to our two questions: the first one was: "Who would be gullible enough to think that this will work?" Wesley in our story is a real person, as is Eddie Ray and Douglas. And Wesley is not just any real person. He's a movie star who acted in movies like *Blade*, *Demolition Man*, *U.S. Marshals*, and *White Men Can't Jump*, to name a few. That's right – it's Wesley Snipes. How could such a talented and successful person think that this scheme could work? Turns out there were an additional 200 or so successful if not talented individuals on ARL's list who were gullible enough to think, or at least be convinced, that the scheme would work. Apparently, the "professional" advice of Eddie Ray and Douglas, who had lots of experience with tax scams, whoops, we mean tax schemes, convinced people they would work, despite common sense to the contrary. And Snipes, like the energetic characters he plays, jumped in with both feet. Not only did he file for refunds for previous years through the amended returns, but with one or more subsequent returns Snipes enclosed a "Bill of Exchange," one of them for $12 million, signed by Snipes and tendered as payment as his estimated tax for

the applicable years. (This was totally inconsistent with the 861 argument, but either way he paid no taxes.)

Now for the second question: "If I try the scheme and it doesn't work, what's the worst that can happen? I'll just pay the taxes, right?" Not quite. As a result of this scheme there is now a lot more than taxes for Snipes to worry about. On October 12, 2006 Snipes was indicted for tax fraud by a federal grand jury. And so they shouldn't feel left out, Eddie Ray and Douglas were also named in the indictment. If Snipes is convicted on all eight counts, he could face a maximum of 16 years in prison. The only reason Snipes wasn't arrested after the indictment was the government couldn't find him, and it was later discovered he had gone to Namibia to film a movie. Coincidentally, Namibia has no extradition treaty with the U.S. As for Douglas, he is in custody in Florida, and Eddie Ray is reported to be in Panama. And Snipes himself later returned voluntarily to the U.S. and surrendered to authorities. After pleading not guilty to the criminal charges, Snipes was released on $1 million bond and allowed to return to Namibia to finish the movie he is making there, but he was ordered to return on January 10, at which time he must surrender his passport. So much for the clever tax scheme.

This is certainly not to say that all tax schemes are risky and potentially fraudulent. As we tax lawyers frequently say, the difference between tax avoidance and tax evasion is twenty years (only 16 for Snipes). Most competent and experienced tax lawyers and tax accountants are aware of ways to legally avoid taxes, only the Eddie Ray's and the Douglas's will help clients *evade* taxes. But as we noted, not all tax avoidance schemes constitute tax evasion. Take Wagner, our violinist, for example. On the above facts, he is unlikely to be prosecuted for tax evasion, but he will without question end up paying 120 percent of his regular tax, plus interest, and possibly even civil fraud penalties.

In sum, if a plan is proposed to you or your clients that promises more than seems reasonable what should you do? First, have your client request an opinion letter from the promoter, one prepared by a reputable law firm. Failure to provide one may itself be a sufficient red flag to warn you and your client away. If an opinion letter is tendered, get your client's authorization to go over it with a fine tooth comb, consulting with your client's other relevant advisors, such as

his tax attorney, accountant, insurance advisor, or benefits consultant. And equally important, remember to just ask yourself (and your client), "What's the worst that can happen if it doesn't work?"

Copyright © 2006 by Alexander A. Bove, Jr. and Melissa Langa. All rights reserved.