



Tax evasion and avoidance typologies

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Abstract

Purpose – The purpose of this paper is to explore tax evasion and avoidance typologies with a view to understanding how they work and the implications for those who handle the wealth of others.

Design/methodology/approach – American, Canadian and UK cases of tax avoidance and tax evasion are studied.

Findings – Structuring transactions to avoid or minimize taxes is highly complex, and thus, fraught with risk, particularly for advisors.

Research limitations/implications – Commercial and taxation law in a globalized economy is an ever-changing matter.

Practical implications – There is an enormous potential for reputational risk which can bear significant consequences for the unwary financial advisor. Money launderers can hide their assets applying methods similar to those used to evade or avoid taxes.

Originality/value – Thousands and thousands of pages documenting tax evasion and avoidance cases have been distilled into an overview paper.

Keywords Taxation, Tax planning, Money laundering, Criminal forfeiture, Assets

Paper type Research paper

This paper has been written for a session on the implications of fiscal crime for those who handle other people's wealth, held during the 25th International Symposium on Economic Crime at the University of Cambridge on 6 September 2007. Fiscal crime has an enormous impact on society. In the USA, the gap between taxes due and taxes paid is estimated at US\$310-\$350 billion (Beale, 2006). The USA could be losing \$30-\$70 billion to tax havens; recent clampdowns on evasion in Ireland resulted in the collection of €900 million from residents using the Channel Islands; a UK clampdown was estimated to recover £1.9 billion (Owens, 2006). A recent UK report on organised crime suggested that criminal assets available for seizure across a variety of untaxed criminal sources amounted to £2 billion with another £3.3 billion sent offshore (Home Office Organised Crime, 2007). Taxation is complex and navigating the tax system requires the advice of skilled lawyers, accountants and other advisors. Those advisors face a dilemma: tax evasion is unacceptable; tax avoidance is perfectly acceptable. Where is the line between the two? This paper examines transactional typologies with a view to exploring those boundaries and their implications for those who handle other people's wealth.

Standards and rules

Traditionally, the tax system is thought to consist of a series of rules, whereby a taxpayer may *ex ante*, order their affairs with certainty. Celebrated American jurist



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Learned Hand noted that taxes were “enforced exactions, not voluntary contributions”[1]. Taxpayers order their affairs and use rules to minimise their exposure to taxation. Over the past half century, there has been a sturm und drang: the state promulgates more rules; practitioners aggressively seek loopholes; the state plugs the loopholes. The US tax system has more than 10,000 pages of code and regulation, stark testament to the fact that tax rules invariably beget loopholes and uncertainty is unavoidable. More recently, state actors have added “standards” to mitigate that uncertainty in favour of tax collection. The difference between rules and standards can be demonstrated using the example of road safety laws[2]. A rule might prohibit speeding: driving 10 kilometers over the posted limit is a violation. A standard is more subjective. The state may require, as a standard, drivers not to be careless. Adjudicating a violation of the speeding rule is simple; one fact needs to be established (how fast was the vehicle moving?). Adjudicating a violation of a standard can be complex. How was the driver driving? What were the road conditions? What was the time of day? Given these factors, was the driver careless or the victim of circumstances beyond their control? To create taxation standards, governments have enacted anti-avoidance provisions, which operate like the negligence standard in tort[3]. While a literalist interpretation might support a loophole, a purposive reading of the tax rules on an anti-avoidance standard might make tax exigible.

Abusive versus acceptable tax avoidance

Understanding the line between evasion and avoidance is never easy. Consider two relatively recent Canadian cases. In 2005, the Supreme Court of Canada was asked to review substantial capital cost allowance (CCA) claim by a large mortgage lender.[4] As part of their business, the lender obtained revenue from leased assets. They purchased trailers, circuitously leased them back to the vendor, and then claimed a large CCA. The Canada Revenue Agency (CRA) disallowed the claim. The mortgage company complied with the CCA rules promulgated by the Income Tax Act. CRA asked the court whether the CCA claim violated standards, known in Canada as GAAR or the general anti-avoidance rule. The court held that GAAR was not violated and applied a three-part test. One, was there a tax benefit? Two, was the transaction an “avoidance” transaction, that is not arranged for bona fides purposes other than to obtain a tax benefit? Three, was the tax benefit obtained consistent with the object, spirit or purpose of the provisions relied upon? The parties that agreed the first two tests had been met; there was an avoidance transaction to obtain a tax benefit. The court then asked, what the purpose of the tax benefit was? Further, on the facts, did the transaction defeat the purpose in issue? The court held that the tax provisions permitted a deduction of the CCA-based solely on the costs of the assets acquired. The court rejected CRA’s argument that this was not really a business transaction as there were no sums of money at economic risk for the mortgage lender, finding that risk was not a component of the purpose of the benefit.

In the Spring of 2007, the Federal Court of Appeal came to a different conclusion on a “cloned” shelter known as the “Smith Manoeuvre” a mechanism to convert home mortgage interest payments into a deductible business expense[5]. The Lipsons bought a \$750,000 house in Toronto; Mrs Lipson borrowed \$562,500 on an unsecured promissory note, backstopped by the husband’s covenant to repay; the husband then sold shares in the family business to his wife for \$562,500; the company’s solicitor held

the money with an irrevocable direction to repay Mrs Lipson's promissory note loan. The next day, two \$562,500 transactions occurred: \$562,500 went to the bank to repay Mrs Lipson's loan of the previous day, and \$562,500 went to the vendor from the bank (which took back a mortgage). The Lipson's then availed themselves of tax rules that deemed the share sale to have occurred at proceeds equal to their adjusted cost base, which defers a taxable gain or loss until a subsequent sale. Under attribution rules, any income or loss from the sale by Mrs Lipson would be attributed back to her husband. On paper, the mortgage provided financing for Mrs Lipson's demand loan and she took the position that she could deduct mortgage interest against her income from the shares. Over three years, roughly \$70,000 was claimed as a loss.

The Court of Appeal found that the Lipson's transaction violated GAAR. The use by the Lipson's of rules encouraging inter-spousal transfers and preventing income-splitting were not problematic. Mrs Lipson did acquire the income-producing shares in her family business with a bank loan; technically that loan was properly repaid by the mortgage loan. In other words, the "rules" were complied with. The court, however, looked at the series of transactions as a whole and determined that they were designed to create an otherwise unacceptable tax loss, that is, to make home interest payments deductible, which the court found to be an abusive tax avoidance scheme. One, practitioner has noted that "drawing the line" between "abusive and acceptable tax avoidance" has become a "truly Herculean task" (Louis, 2006). Another commentator noted that in seven recent GAAR cases, the taxpayer prevailed in four and CRA in three (Rand and Thomson, 2007).

Anti-money laundering rules and organised crime

Advisors must consider the overlay created by anti-money laundering rules in rendering their advice on tax matters. Money laundering is a technique used by criminals to obfuscate the connection between their crime and the profits generated by crime. Organised crime is in the business of making money from illicit activity. Barriers to money laundering have been erected within our financial system, primarily through financial reporting and know-your-customer (KYC) rules. Additionally, countries around the world have adopted remedies to address illicit profits and money laundering through a forfeiture process. An *in rem* proceeding is brought against tainted property, seeking extinguishment of title through forfeiture. Taxation is another technique which can be applied to attack profits (Bell, 2000). Fiscal crime, particularly crime committed through abusive tax shelters, employs typologies that are remarkably similar to those employed by money launderers (Simser, 2006). If a client will break the law for a tax advantage (e.g. creating a fraudulent tax loss), laundering and integrating apparently "legitimate" funds through an advantageous device from a tax perspective seems a logical next step.

Obvious avoidance: two UK tills

A London greengrocer, trading under the name Ambrosia, had a thriving trade. To minimise customer queues, the store employed two cash registers. All of the cash in the tills came from the legitimate sale of fruit. Customers were duly charged value-added tax (VAT). In December 2003, police intercepted two couriers with £100,000 in cash hidden beneath fruit from the store. There was evidence suggesting that the couriers had remitted another £100,000 in the previous month to Pakistan.

The government sought forfeiture of the money under the Proceeds of Crime Act, 2002. Ambrosia resisted, arguing that the money came from the entirely legitimate trade in fruit, not from the proceeds of crime. At the trial, Ambrosia succeeded. On appeal, the court held that Ambrosia's principal, MR, had over a period of four years "systematically cheated the revenue of income tax and VAT by under-declaring the takings of the business[6]". The defence contended that as MR and Ambrosia had not yet filed returns to revenue, they were merely harbouring an inchoate intention to not remit taxes. Under these circumstances, the defence argued the seized cash could not be proceed of crime. The court disagreed, finding that the presence of legitimate trading ought not to, in and of itself, defeat the anti-money laundering provisions of the Proceeds of Crime Act, 2002. The court held that where revenue can establish that they had been cheated, the proceeds of the cheat would be subject to forfeiture.

Tax haven abuses

A congressional report (Committee on Homeland Security and Governmental Affairs, 2006) released in August, examined tax haven abuses. Offshore tax schemes are no small problem: Americans have \$1 trillion offshore; \$30-\$70 billion in US taxes is annually evaded through offshore tax schemes. Some of the problems are notorious; Enron Corporation established over 441 offshore entities in the Cayman Islands. Other schemes are more mundane: phony loans, false billing and offshore credit cards. Generally, the report noted that the offshore tax haven industry had a number of key components. The report identified at least 50 jurisdictions that use secrecy, anonymity, law taxes and barriers to law enforcement inquiries[7]. Offshore promoters attract clients and utilise corporation formation agents and trust companies (as well as corporate and trust administrators). Trust protectors, financial institutions and law firms enable schemes. Money is transferred using a variety of techniques, including ATM cards, sham loans, credit cards, false invoices, annuities, mortgages and offshore insurance companies. Finally, transactions are used to manipulate and arbitrage the rules between tax shelters and domestic states.

The Turpen-Holliday case

Dr Turpen, an offshore promoter, wrote a how-to manual that was used by one of his clients, Robert Holliday, to move assets offshore. Both men pled guilty to tax-related charges[8]. The scheme was relatively simple. An offshore company was created to "own" the assets. Another offshore trust was created to own that company[9]. The real owner was then retained by that offshore company as a consultant. As a consultant, the real owner made "recommendations" to an offshore administrator; while independent from the real owner on paper, the administrator always followed the recommendations; the administrator, in turn, signed all cheques and documents (leaving no paper trail connecting the real owner to assets)[10]. Dr Turpen maintained his own series of offshore entities that handled all fees related to the enterprise, thus further distancing the real owner from his assets. Money and assets could be placed into the scheme through Dr Turpen's corporations in Nevada. From there, the money would flow either to apparently repay an inter-corporate billing or to make an inter-corporate loan.

Mr Holliday had run a series of escort agencies in the Atlanta area and had been convicted of money laundering. Following an unsuccessful attempt by a prosecutor to

forfeit his home, Holliday sought ways to hide and protect his assets. Holliday purchased a package from Dr Turpen that gave him a hybrid company in the Isle of Man (IOM) and a Nevada corporation. Holliday was also given a “confidential business plan” that explained the scheme. He was a management consultant; the nominee directors would ratify and support all of his business decisions; all government filing fees in Nevada and the IOM were paid by Dr Turpen’s companies. Holliday then had his offshore company bill his Atlanta enterprise for fictitious services; as those bills were “paid” money was moved offshore. A paper trail, to fool authorities, was created. For example, Holliday himself wrote a report on adult chat lines; he sent it to Nevada; Dr Turpen forwarded it to the IOM, where the “report” was placed on the letterhead of the hybrid company. The IOM then sent the report to Holliday in Atlanta, along with an invoice for \$45,000[11]. Holliday moved \$45,000 offshore (written off as a business expense) and later accessed those funds by borrowing them, under promissory note, from the offshore entity. He also used a credit card issued in Antigua (the IOM company paid all the bills, ranging from \$30,000 to \$90,000 a year). Holliday also operated brokerage accounts (initially in the IOM and later in Nevis). Holliday and Turpen were both given probation, home detention and fines following their guilty pleas.

Basis shift and the cloned tax shelter

From 1996 to 2003, accounting giant KPMG created and marketed a tax shelter to American clients variously called an Offshore Portfolio Investment Strategy (OPIS) or Foreign Leverage Investment Program (FLIP) transaction[12]. The firm targeted high-net worth individuals and collected US\$124 million in fees. KPMG told clients that the tax shelter was legal. The Internal Revenue Service (IRS) took a different view, which ultimately prevailed, with KPMG paying the government \$456 million, submitting its tax practice and disciplinary compliance to a 16 month review and settling private lawsuits (\$195 million in damages and \$30 million in fees). A Senate Committee recently made public hundreds of documents, giving us insight not only into the shelter, but also into the internal debate within KPMG (US Senate Homeland Security and Governmental Affairs Committee, 2005).

One commentator has called the KPMG deals a “basis-shift cloned” tax shelter[13]. For a fee, the shelter purports to generate artificial tax losses without visiting the client with any real losses. Those artificial losses are then used to offset real capital gains; had the shelters been successful, they would have eliminated “\$10 billion (US) of gain from the [US] tax base”[14]. The deal is “cloned” in the sense that it is marketed to numerous investors. Documents within KPMG warned employees not to leave promotional documents with prospective clients as they might undermine the firm in a subsequent challenge by the IRS[15]. Those warnings were prophetic.

Using a simple example, a taxpayer (T) would pay KPMG \$7 million in fees to buy \$100 million in tax losses; with a 20 per cent capital gains rate, \$20 million could then be used to offset capital gains from unrelated transactions. KPMG set up a Cayman Island corporation (C Inc.) and T is given share options for C Inc.[16]. T then buys a modest number of shares in a chartered bank (UBS and Deutsche Bank were the primary participants). The bank then set up a transaction with C Inc: C Inc. is given a non-recourse loan; the loan is used to buy bank shares; the shares are redeemed shortly thereafter, and the loan is repaid. In other words, C Inc. participates in a transaction where nothing of economic consequence really happens. The transaction then relies on

the constructive ownership provisions as well as certain equitable relief provisions in US tax law. C Inc.'s stock transaction is treated as a dividend (which is of no consequence in the Caymans, where such transactions are not taxed). In legitimate domestic transactions, there's potential unfairness: a taxpayer is taxed on the income (not capital gains, which are taxed at a lower rate) from the dividend; the taxpayer does not get to deduct the basis (e.g. the original amount they paid for the share capital)[17]. To mitigate this unfairness, the tax rules allow C Inc. to shift its basis on the \$100 million in bank stocks to T. When T sells his small personal holding in bank shares, he has a "loss" (his sale less what he paid plus the \$100 million basis from the C Inc. transaction). One commentator has suggested that, contrary to KPMG's assertion, the rules were not applied correctly. Even if that is not so, the substance of the transaction fails when anti-avoidance standards are applied (creating utterly artificial tax losses)[17].

Tax and succession planning: the Wyly brothers

Sam and Charles Wyly are Dallas-based billionaires, who through 2005 and 2006, came under the scrutiny of federal and congressional investigators. Since 1963, their empire had started, bought, built and sold a number of successful business, including earth resources, Sterling software, Michaels stores, the Bonanza restaurant chain and electricity supplier Green Mountain Energy. While the brothers declined to testify before Congress, they told the *Dallas Morning News* in 2006 that, "everything we've done is based on truth" (Fairbank and Reddy, 2006, p. 1). A congressional report found that:

[...] over a thirteen year period from 1992 to 2005, two U.S. citizens, Sam and Charles Wyly, guided by an armada of attorneys, brokers and other professionals, transferred at least \$190 million in stock options and warrants to a complex array of 58 offshore trusts and shell corporations [...] and used at least \$600 million in untaxed offshore dollars to provide substantial loans to Wyly interests, finance business ventures, acquire U.S. real estate and purchase furnishings, art and jewellery for the personal use of Wyly family members (Fairbank and Reddy, 2006, p. 113).

Through their lawyer, the Wyls responded that they simply "employed strategies" to "defer income tax and plan for succession". Their lawyer also noted that the Wyls were "surrounded by a virtual army of lawyers and advisers" (US Senate Homeland Security and Governmental Affairs Committee, 2006, p. 6). A full review of the Wyly transactions is beyond the scope of this paper. The congressional report takes hundreds of pages, along with thousands of pages of documents to review the transactions. This section of the paper will review the basic features of the structure and focus particularly on areas of concern to anyone advising such a structure.

The Wyly brothers, like many chief executive officers (CEO), received "share options" from the companies they worked for. Generally, such an option allows an executive to purchase shares in the company at a later date based on a price set at the time of issue (the "strike price"). In theory, the CEO will work to increase the value of all the company's shares and then sell at a profit (market price at time of sale less strike price). Generally, the options are not transferable and do not vest for a period of time (this encourages loyalty from the CEO and provides incentives for them to stay). The Wyls took \$190 million of their share options and moved them offshore into a series of trusts in exchange for annuities.

From a tax perspective, this transaction was meant to accomplish several objectives. First of all, options are taxed when they are exercised, not when they are issued.

The Wyllys, in transferring the options to an offshore trust, did not pay taxes on them. The trusts themselves resided in jurisdictions where the exercised options would not be taxed. The annuities granted to the Wyllys in exchange had long-term deferments of payment; capital gains taxes are exigible when the principal amounts are due, and the income consists of the increase in value (less the original capital) (US Senate Homeland Security and Governmental Affairs Committee, 2006, p. 168). The Wyly empire treated the trusts as irrevocably independent foreign taxpayers. If they were not “independent” rules and standards might collapse the trusts from a tax perspective attributing income back to the Wyllys. Trust distributions were designed in the transaction to be taxed in the hands of the beneficiaries.

From the advisor’s perspective, an offshore trust structure like the one used by the Wyllys poses several challenges. From a taxation perspective, the trusts (and their trustees) must have discretion to make determinations respecting both the corpus and the distributions from the trust. The congressional report found that the Wyllys paid lip service to this concept; they made “recommendations” to the trustee, which could be carried out or ignored. In fact, the congressional report concluded that recommendations from the Wyly organisation were always followed, and that there were no recorded incidents where the trustee independently exercised discretion. One example is particularly telling. In 1996, Cheryl Wyly purchased a painting, *Noon Day Rest*, at auction in London for £155,000. The painting was shipped to Dallas and one of the trusts in the IOM was invoiced. The trustee wrote to the Wyly organisation suggesting that selling treasury bills to buy an illiquid painting purchased at 222 per cent of the pre-auction estimate might not be a prudent investment. The Wyly’s Dallas-based lawyer, Mr French, wrote a strong letter, noting that the trust instruments “clearly” authorised a “purchase of personal property for personal use” by a beneficiary, and stating:

Unless there is a clear and unequivocal requirement of IOM law (which I doubt), that any such purchase that is specifically authorized by the trust agreement must nevertheless be weighed against the investment returns that could otherwise be obtained on the funds, then I must assume that this transaction is authorized and lawful. If you wish to search for such a legal prohibition, you should do so at your own expense and not that of the Trust.

The Protectors have already recommend [sic] this transaction. Please advise if you are unwilling to proceed on that basis in light of this *explicit* authorization for the transaction contained in the Trust Deed.

We need to resolve this issue at once[18].

The trustee later apologised for being obdurate and processed the transaction after a comfort letter was sent by the beneficiary[19]. The congressional report suggested this level of control was exercised on \$600 million invested in Wyly-related businesses, \$85 million in real estate purchases for family members, and \$30 million in purchases of art, furnishings and jewellery[20]. From an advisory perspective, an opinion on taxation and trust law implications of a complex structure like this cannot be rendered properly without a proper factual substratum. Are these trusts independent entities? Given the transactional history, would the IRS deem the trust to be controlled by the Wyllys? Would this undo the tax benefits?

The business structure posed other challenges for advisors. When assets were returned to the USA in the form of flow through loans and a variety of equities transactions, three potential problems emerged. First, under US securities law, a filing

requirement is triggered any time a shareholder is in a control position. In a structure, where the Wyly family can effectively control all transactions, the potential to violate reporting requirements exists. Is the trust independent or is control attributed to the Wyllys? How does the advisor ensure proper filings are made[21]? Second, there is always a risk of insider trading allegations. How does the advisor ensure that the “independent” trust does not trade at the direction of someone with insider information? Thirdly, following the passage of the Patriot Act in 2001, securities dealers had to comply with KYC standards[22]. In 2003, the anti-money laundering alarm system of Bank of America’s clearing broker, National Fund Services (NFS), was set off. While the Bank of America’s broker knew of the Wyly connection, they tried to put off the NFS inquiries about actual control. After nearly a year, subpoenas were issued by the Manhattan district attorney’s office[23]. Bank of America then closed the accounts and was fined \$3 million by the brokerage industry’s regulator (now known as the Financial Industry Regulatory Authority – FINRA) for not seeking information on 34 high-risk accounts with the IOM related to the Wyllys (NASD Fines Bank of America Investment Services, Inc., 2007).

Long-term capital

In the mid-1990s, a series of cross-border lease stripping transactions were created to generate artificial tax losses, which in turn were “cloned, sold twice and deducted by two different groups of taxpayers” (Warren, 2005). One set of transactions, involving pre-existing computer leases, used a master or wrap lease structure and was known as Computer Hardware Investment Portfolio (CHIPS). Another set used a sale/leaseback structure called Trucking Investment Portfolios (TRIPS). The object of both transactions was to strip income from deductions and rely on the differential tax treatment of USA and foreign entities to allow the deduction to be sold separately. The deductions were denied and long-term capital brought litigation challenging the IRS. One commentator speculated that their litigation strategy may have been premised on two notions: one, a cross-border lease strip is complicated and beyond the capacity of a trial judge to unwind; two, a coterie of blue-chip advisors, including two Nobel Prize Laureates, created the transaction which might influence the litigation[24].

If that was the strategy, it failed. The judge, Madame Justice Arterton, clearly understood the complex transactions and was unswayed by the reputations of the advisors who created the deal. Her rulings were affirmed on appeal (*Long Term Capital Holdings v. US*, 2004). The court ruled that the lease stripping transactions lacked economic substance and as such, was to be disregarded for tax purposes[25]. About \$106 million in capital losses were denied. In the alternative, the court found that the five steps of the deal should be collapsed and that the transaction should be recast as a share sale deal[26]. For the purposes of this paper, the rulings on penalties are most interesting. In US tax law, a denial of a claim for losses does not automatically ensure that there will also be a penalty. Taxpayers are entitled to assert that, based on accounting and legal advice they had reasonable cause to take their position. Here, the court denied their petition and upheld a 40 per cent gross valuation misstatement and a 20 per cent substantial understatement penalties.

Long term had been a spectacularly successful hedge fund, posting returns of 58 per cent in 1995 and again in 1996. Their portfolio managed between \$5 and \$7 billion in assets; institutional investors, as well as high-net worth individuals, contributed at

least \$10 million each to the fund, locked in over three years. As 1997 approached, the fund forecast lower returns (in the mid-teens). The CHIPS and TRIPS transactions were set up by long term, as well as a San Francisco-based investment bank, with their legal advisors, blue-chip law firm Shearman and Sterling. Price Waterhouse, Coopers & Lybrand and other accountants reviewed the firm's tax returns. There were three building blocks to the transactions: a foreign entity not subject to US taxes; UK tax treatment of prepaid rent; and, US tax treatment for non-recognition incorporation transactions. Throughout the advisors were aware that the IRS could undo, deny or collapse the transaction. Sherman and Sterling offered "should" level legal opinions; the opinions were conclusory, without detailed legal analysis and based on factual assumptions[27]; the clients felt there was a memorandum of law beneath the opinion, but it was never produced for the court. The opinions cost long term \$500,000 in fees, but long term's principles elected not to read them. Long term argued that they should escape penalties based on the "should" opinions; they argued that those opinions gave them substantial authority for the transaction and alternatively allowed them to form a reasonable belief on the basis claimed. The court held that the opinions did not give long term a substantial authority to underpin the deals. Further, there was no evidence adduced to support the contention that long term itself analysed the relevant facts and authorities "to conclude in good faith that there a greater than 50 per cent likelihood that the tax treatment of the item would be upheld if challenged" (*Santa Monica Pictures, LLC v. Commissioner* (2005); Michel and Thorn, 2006, p. 49). In other words, simply relying on the opinion of a blue-chip firm is not enough.

Conclusions

The complexity of commercial transactions has increased steadily over the last 20 years. The global financial system has more interconnections now than at any other time in history. The US sub-prime mortgages may appear to be a niche American market, yet problems there affect banks in Paris and markets in Tokyo. The complexity of our tax system has also grown. States have found that a purely rule-based approach is simply not sustainable and have developed anti-avoidance standards. The primary challenge for the advisor is uncertainty. Some transactions are clear; a client who runs two tills but reports to authorities on only one is clearly breaking the law. No legitimate advisor would want to be tainted by that sort of cheating.

More sophisticated transactions create genuine uncertainty. A deal designed for legitimate commercial purposes that arbitrages complex tax rules for additional gain needs to be examined closely. KPMG held hotly contested debates within the firm about the viability of the OPIS and FLIP transactions. Taking in \$124 million in fees is small comfort against \$681 million in losses. The Department of Justice chose not to name KPMG as a firm in their prosecution (as they had done with Arthur Anderson in the Enron case), but instead entered into a deferred prosecution agreement (fines and standards instead of a charge being pursued). KPMG is a reminder to advisors about the prospects of a prosecution in tax cases[28]. The Wyly transactions underscore the continuing risk posed to advisors; as laws change, in this case the extension of KYC standards to brokers, so must the position of advisors; advice also needs to anticipate shifting facts. Finally, long-term capital shows us that paying US\$500,000 for a top flight legal opinion is not enough to insulate a deal in the face of subsequent judicial scrutiny.

Notes

1. *Commissioner v. Newman* (1947), 159 F. 2d. 848 (2nd Cir) at 851.
2. Logue's (2006) article presents an excellent discussion on rule and standard-based mechanisms in tax law.
3. The Canadian anti-avoidance rule (GAAR), for example, is a standard whereby a transaction's overall purpose is examined. Section 245(2) of the Income Tax Act states, "where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that included that transaction." Schwartz (2006).
4. *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 SCR 601. See also *Mathew v. Canada*, [2005] 2 SCR 643. American law looks at the economic substance of a deal separate from the tax benefit. See the long term capital discussion at Note 39 et. seq.
5. *Lipson v. Canada*, [2007] FCA 113; at the time of writing and application for leave to appeal to the SCC has been filed. A case considering a similar scheme, *Overs v. Canada*, [2006] TCC 26 came to the opposite conclusion on GAAR.
6. *R v. IK*, [2007] EWCA Crim 491 at paragraph 20.
7. The report notes Belize, the British Virgin Islands, the Cayman Islands, the IOM, Panama and St Kitts and Nevis, as key jurisdictions. Committee on Homeland Security and Governmental Affairs (2006, p. 15).
8. Committee on Homeland Security and Governmental Affairs (2006, p. 29). Dr Turpen plead guilty to conspiracy to charge the IRS and was sentenced to three years probation and six months of house arrest with electronic monitoring. He was ordered to pay a \$10,000 fine, perform 300 hours of community service and pay back taxes. Holliday was sentenced to five years probation, 12 months house arrest and a \$30,000 fine.
9. The trust held all voting shares; the "real" owner beneficially held a second class of shares, addressing all distributions of capital and dividends.
10. Turpen could only recall two instances where the administrator did not cooperate; the trust indenture had a "duress" clause; if a request was compelled by court order or law enforcement, the administrator was to ignore it. Committee on Homeland Security and Governmental Affairs (2006, p. 38).
11. Other schemes included real estate investment advice (\$200,000), business feasibility studies (\$450,000) and real estate management (\$200,000). Committee on Homeland Security and Governmental Affairs (2006, pp. 29-41) and pp. 1869-910.
12. The FLIP was the first such vehicle; the OPIS employed derivatives instead of options, but operated in essentially the same way.
13. Johnson (2005) also refers to this as a Defective-Redemption shelter.
14. Johnson (2005, p. 432). In fact, the IRS offered a settlement to taxpayers, who gave up 80 per cent of their tax losses and still faced penalties. A total of 92 per cent of affected taxpayers accepted the offer. These were well-advised, high-net-worth people and Johnson estimates 450 tax lawyers recommended the settlement to their clients.
15. Annuities and trusts are no strangers to tax abuse schemes. Settling an annuity or trust and immediately "borrowing" back the original amount, is deemed unacceptable under tax laws.
16. Johnson (2005) and note 21, uses this example. Variants of the scheme used partnerships and derivatives, but those wrinkles are not important to understanding the deal's essence. Stock options are used to avoid the IRS charging a \$100 million dividend against T, which would be taxed as income.

17. For example, a husband, a wife control 100 per cent of WH Inc. The husband redeems \$1,000 in stock, which is taxed as a dividend, not as a return of capital. The control in WH Inc. does not change. Out of fairness, the IRS will allow the wife to add the husband's \$1,000 basis to her shares. In other words, the basis shifts (Johnson, 2005, p. 436).
18. Exhibit No. 66, Hearing Report, p. 4959.
19. Hearing Report, p. 4964.
20. Hearing Report, p. 118.
21. Particularly in respect of shares of Sterling software; Hearing Report, p. 154.
22. For private banking accounts with at least \$1 million with foreign account holders, the securities firm must identify both the nominal and beneficial owners.
23. Hearing Report, p. 316.
24. Warren (2005, p. 27). Dr Merton and Dr Scholes each won Nobel prizes in 1997; the other founder was a Harvard Business School professor.
25. The court examined the taxpayer's subjective business purpose, as well as the objective economic substance of the transaction.
26. The step transaction doctrine was applied to ensure that substance prevails over form by treating the steps in a transaction as a single deal, "as if all steps were substantially linked." *Long Term Capital Holdings v. US* (2004, p. 193).
27. *Long Term Capital Holdings v. US* (2004, p. 58). In *Santa Monica Pictures, LLC v. Commissioner* (2005), the legal opinion of tax advisors did not exculpate the defendant in a scheme to defeat tax through contributions of high basis, low value asset contributions into a partnership.
28. In the subsequent prosecution, two KPMG employees have pled guilty and charges were dismissed against 13 others. Charges are still pending for four people (Browning, 2007).

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