The Use and Abuse of Insurance in International Tax Planning

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As tax lawyers with a global practice, we are exposed to the tax systems of many jurisdictions. Over the years, we have worked with clients from every region of the world. Some of these clients are from mostly tax compliant jurisdictions and some are from jurisdictions where tax non-compliance is widespread and even an accepted fact of the particular culture or jurisdiction. We have also been exposed to and have actively participated in the development of financial products and services designed to address the needs of all such clients.

As we follow the global developments that affect high net worth families and their advisors, what we are witnessing is massive, unstoppable and increasingly faster change with respect to how the world community is viewing and dealing with lack of transparency and compliance. This change has not only been motivated by global concern over the enormous flow of undeclared and untaxed funds across international borders but has more recently been motivated and fueled by antiterrorism efforts to deal with the potential sources and mechanisms for the funding of global terrorism.

Set forth below is a general summary of some of the most important global developments in the tax area, which illustrate the changing landscape, the changing needs of our clients and the need for us to understand those needs and to change and adapt to be able to meet them and effectively compete going forward. Surprisingly, many advisors and others who deal with high net worth families and individuals are not aware of or are not heeding the changes and still believe what their clients need is secrecy and products and structures that can be used to hide undeclared funds.

As we move forward in this changing world, there are threats and opportunities for people with undeclared funds. In addition, there are risks and opportunities for advisors and others who work with such individuals. The future is not in trying to develop products and services that will help people hide their money or disguise its source but in learning about and promoting tax-effective and compliant products and services.

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Bank Secrecy

There is nothing wrong with bank secrecy, although it is associated by many around the world with hiding the money of politically-exposed persons, terrorists or tax evaders. In fact, bank secrecy, privacy and confidentiality are legitimate needs (sometimes even a question of life and death) for many families around the world. Some families live in countries where kidnapping and security issues are very significant. Although Mexico is now ranked the top kidnapping country in the world, this problem is not limited to Latin America but exists in many regions of the world. Privacy and confidentiality are also critical in the planning for families who live in countries where families are concerned about dissemination of information about wealth within the family itself and within the community, and about possible changes of government and other political risk issues. So bank secrecy serves legitimate purposes and should be protected to a certain extent, something that Switzerland, for example, is doing as effectively as possible under the circumstances. At the same time, bank secrecy should not be (as it still is in some jurisdictions) the primary focus or ultimate goal to the detriment of understanding what clients really need and what solutions can be offered to families in addition to just secrecy.

Products and Services that Offer Privacy and Confidentiality

Just as there is nothing, per se, wrong with bank secrecy, there is nothing wrong with efforts being made to develop products, services, structures that offer client privacy and confidentiality so long as those products, services and structures are not being designed solely as a way to hide funds or disguise the source of funds. Good tax planning and the development of tax compliant products and structures certainly takes into consideration that, among the needs of the families we deal with, are privacy and confidentiality.

The Erosion of Secrecy and the Dawning of the Era of Transparency

A number of developments worldwide have significantly eroded bank secrecy and are launching us into an era of global transparency. Developments in one country ripple through many others whether because they directly impact the other countries or because governments and tax authorities are gathering information, learning from one another, joining forces and leveraging their scarce resources in ways we had never seen before.

A. The U.S. QI System and Global Exchange of Information

One of the developments that originated as a single country enforcement effort but has had an enormous impact worldwide is the United States Qualified Intermediary ("QI") system, which came into effect at the beginning of 2001. The United States had withholding rules long before 2001, but they had many loopholes and were not serving as an effective enforcement vehicle. U.S. taxpayers were able to invest in the United States though foreign banks without being detected and without paying tax through withholding or otherwise.

The QI system was a brilliant idea because it essentially forced foreign banks to assist the IRS with its enforcement efforts thereby significantly leveraging the scarce resources the IRS had for attempting to identify U.S. taxpayers who had undeclared funds outside of the United States. In very simple terms, the QI system requires anyone, from any part of the world, who invests in U.S. securities to disclose full beneficial ownership of such securities, unless one exception applies. The exception applies when a bank or other intermediary is located in a country that has adequate exchange of information with the United States and adequate "know-your-client" rules. If this is the case, upon approval by the IRS, the bank or intermediary can become a Qualified Intermediary by entering into a "Qualified Intermediary Agreement" with the IRS. Under the agreement, the bank or intermediary agrees to (a) establish and implement procedures to properly identify all of its customers, (b) be audited periodically at its own expense to ensure that it has and is implementing the procedures it has established to identify its customers, (c) keep adequate records, and (d) provide information to the IRS with respect to U.S. investors or customers.

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And why would a foreign bank, including Swiss and other banks with strong secrecy rules, agree to implement enormously expensive procedures to help the United States enforce its tax laws? Because, in exchange, the United States agrees to permit Qualified Intermediaries to keep confidential the identity of their non-U.S. customers, provided the bank fully documents such clients. So the bank agrees to obtain and keep adequate records but can invest the funds of foreign clients (the vast majority of its clients) in blocks that benefit from reduced or no withholding that may be applicable to the particular block. This is of enormous value to the foreign banks because, when the United States gets beneficial ownership disclosure, it can exchange the information with other countries. So if a German has an investment in IBM stock, his or her name is given to the IRS, and the IRS exchanges that information with Germany. If the money is undeclared, the disclosure raises a huge problem for the bank's customer and the customer will not want to keep his or her funds at the bank.

Only a few years earlier, no one could have guessed that banks in a place like Switzerland would sign an agreement with a foreign tax authority, agreeing to enforce the foreign tax law at the expense of the bank. As set forth above, under the Qualified Intermediary Agreements, the banks have agreed to be audited at their own expense, and to have an auditor poke around the files and client names and see whether or not the bank is really playing by the rules.

Just how effective this system turned out to be began to manifest itself in 2000 when banks in Liechtenstein started to see some of their clients migrate to Swiss banks because Switzerland had, very early on, been approved as a location that qualified for the QI system. The Liechtenstein banks quickly sought approval from the IRS to become Qualified Intermediaries because they wanted to keep the identity of their clients confidential, but the IRS rejected the proposal because Liechtenstein did not have exchange of information with the United States, and the IRS did not think that the Liechtenstein "know-your-client" rules were sufficient. The Liechtenstein banks, in a panic, went to their Government, which flew a delegation to Washington, and, at the last minute, managed to convince the United States that Liechtenstein would enter into an exchange of information agreement with the United States (which they have now done), and that they would adopt new "know-your-client" rules (which they have). As a result, the banks in Liechtenstein are qualified intermediaries.

The beauty of the strategy was that the United States did not have to force any country to enter into an exchange of information agreement and to have the right know-your-client rules. It had countries coming to the United States offering to meet the conditions to be able to invest in U.S. securities on behalf of its clients, while keeping the identity of such clients confidential. Virtually every tax haven has now entered into exchange of information agreements with the United States, again not something that could have been predicted even a few years ago. This system has been a huge and almost effortless erosion to bank secrecy.

B. Pressure from other Industry Groups

The other important dynamic at play as these developments are occurring is that countries like Switzerland are not just banking jurisdictions but have other industries. Switzerland has pharmaceutical companies, food companies and others who do not care about bank secrecy. Industry cares about having effective tax treaties with other countries that put companies in Switzerland in the same position as companies from other jurisdictions so that they can effectively compete in their markets. So the United States, for example, has great leverage on Switzerland and other treaty partners seeking to protect privacy with respect to exchange of information because it can threaten to cancel the treaty if it does not get what it wants. Without an effective treaty, companies in other industries in those treaty partners would simply be forced to flee to other jurisdictions which would, of course, be a disaster to the treaty partner's economy.

The result is that even Switzerland has had to give in to some extent. In 2003, a new, more vigorous and effective exchange of information agreement was entered into

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by Switzerland and the United States and, at the present time, there are negotiations with respect to a new tax treaty between Switzerland and the United States largely because the United States is insisting on more transparency, more ability to get information from Swiss banks, more ability to enforce their tax laws in respect of individuals who hold accounts in Switzerland. There are too many pressure points and, even if reluctantly, Switzerland and other countries are going to play along. Many countries are vigorously negotiating and signing treaties and exchange of information agreements, and we can expect a rapidly expanding worldwide treaty network.

So, whether taxpayers fail to comply with tax rules in their country because they simply choose to evade tax or because the tax authorities in a country are corrupt and tax compliance poses serious personal risks for the taxpayer and his or her family, information will be exchanged and tax authorities will have available what they need to aggressively prosecute those who are non-compliant. Accordingly, families will be better served by planning that enables them to take advantage of tax efficient and tax compliant structures that will not expose them to the risk of criminal prosecution.

C. EU Savings Directive

Another significant development has been the EU Savings Directive pursuant to which most EU jurisdictions agree to automatically exchange information about the beneficial ownership of accounts. Jurisdictions with banking secrecy, such as Belgium, Luxembourg and Austria will not automatically exchange information but will instead impose a withholding tax on savings income. The EU banking secrecy jurisdictions agreed to the directive on the condition that other non-EU jurisdictions agree to implement or be found to already have "equivalent measures" to those contained in the directive. The non-EU jurisdictions include Switzerland, the United States, Liechtenstein, Monaco, Andorra and San Marino.

Although currently there are a number of ways to get around the Savings Directive (e.g., having clients invest through companies, transferring clients to Singapore), the EU Savings Directive is a first step—not a last step—in terms of transparency developments within Europe, and will have its own impact on bank secrecy and move the world further along into the era of transparency.

D. Technological Advances

Technological advances and widespread availability of technological resources is also having an impact on bank secrecy. A good example of this is the enormous amount of information the IRS has been able to gather about taxpayers with assets in foreign countries. For many years, the tax authorities in the United States requested information about American clients who had deposits in banks in foreign bank secrecy locations. The banks would usually ignore the requests or politely decline citing applicable bank secrecy rules.

So the U.S. authorities decided to seek the information elsewhere. VISA, Mastercard and American Express are American companies, and their computer systems—for some of their accounting transactions—are located in the United States. The authorities went to Court—initially in Miami—and requested access to the computer systems to get information about credit card holders with credit cards issued with respect to bank accounts located in secrecy locations if the cards were used in the United States. Despite the fact that the requested information did not relate to a specific taxpayer but requested information on all taxpayers who fit the parameters they established, the Court agreed and the IRS got the information.

Once again, this single country enforcement effort had global ramifications because the information sought and obtained does not relate only to U.S. taxpayers but covered credit cards issued on bank accounts in many places around the world when the credit card has been used with a certain frequency in the United States. To illustrate how this affects non-U.S. taxpayers, take the example of a French resident who opens an undeclared bank account in Switzerland and has a credit card issued on that account. That French individual decides not to use the credit card when in France because he is not declaring his money there but chooses to use the card when on vaca-

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tion in United States where he rents a boat, pays for his hotel room or rental car. If the card was used frequently enough in the United States to get caught by the request for information, the information about the card and cardholder was provided to the US authorities, and France has the ability to request that information under the exchange of information provisions in the U.S.-France treaty. So, in a world of increasingly developed and available technology, there is no way to prevent the flow of information.

E. Cooperative Efforts to Leverage Resources

To further leverage their resources, tax authorities worldwide are increasingly working together. In the United States, for example, the IRS announced in September of 2003 that it had formed a partnership with 40 states and the District of Columbia. The purpose of the partnership is to exchange information on abusive tax avoidance transactions and the taxpayers who participate in such plans. The goals are to prevent duplication of effort and allow the IRS and the states to "piggyback" on their individual efforts. By June of 2004, the IRS announced that the partnership had already shown promising early results. By then, 48 states were involved and more than 28,000 leads had been shared. Again, technology plays a part here because each of the agencies is better able to organize and sort the information it has so that it is useful to them and to the other partners in the alliance.

An example of a similar initiative at the global level is the joint task force established in April of 2004 by the tax authorities of the United States, Australia, Canada and the United Kingdom to increase collaboration and coordinate information about abusive tax transactions. These tax authorities recognize that it is getting harder and harder to hide money so schemes designed to do so are also becoming increasingly complex and international (i.e., they cover a number of jurisdictions). The task force's initial focus is to understand ways in which financial products are used in abusive tax transactions by corporations and individuals to reduce their tax liabilities and the identification of promoters developing and marketing these products and arrangements. By acting together, they can share information, expertise and best practices thereby leveraging their individual resources enormously. In addition, the information countries can share is also increasing exponentially because each of the jurisdictions is making significant internal efforts to gather more and more information especially about the activities of their taxpayers in foreign countries. In the United States, for example, U.S. taxpayers must file information returns to report almost any connection with a foreign country (e.g., a financial account over which the taxpayer has a financial interest or signature authority, creation of or transfers of assets to a foreign trust, receiving distributions from a foreign trust, receiving gifts from a foreign person, serving as director of certain foreign corporations, having an interest in certain foreign corporations or partnerships, having an interest in an entity that is disregarded for U.S. tax purposes, etc.).

F. Amnesties

At the same time that jurisdictions are making significant enforcement efforts and are gathering huge amounts of information, they are recognizing that significant resources are also needed to prosecute all of the offenders they might uncover. Accordingly, many jurisdictions around the world are encouraging taxpayers to come clean. Even in the United States, where amnesties are politically controversial, a partial amnesty was introduced in 2003. It was called the Offshore Voluntary Compliance Initiative ("OVCI"). OVCI encouraged taxpayers who failed to report or underreported income from offshore activities or who failed to file information returns reporting their offshore activities to get into compliance by filing those returns for a period of 3 or 6 years, and pay tax and interest due in exchange for virtually eliminating the risk of criminal prosecution, and waiver of very substantial penalties.

In addition to becoming compliant, taxpayers who participated in OVCI were required to provide information about the person or persons who encouraged them to take their assets offshore (the "promoters"), which could be any advisor or intermediary who participated in the planning or setting up of any structure to hold the taxpayer's assets. By requiring this information to be provided, not only was

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the IRS getting all participants compliant but it was learning about the schemes or structures that have been designed to hold undetected money offshore. The IRS is now going after the promoters who are not only likely to disclose further information about the planning and relevant structures but also provide additional information about other taxpayers who may have participated in the same or similar plan. With this strategy, the IRS got huge leverage from the cases that were handled through the OVCI.

Other countries are also actively pursuing promoters and other advisors who assist taxpayers because they recognize that the planning is becoming so complicated that taxpayers need advisors to plan and implement the structures through which funds are held. Accordingly, targeting advisors is much more effective. In some jurisdictions, advisors (including lawyers) are required to file suspicious activity reports on their clients if they suspect or have reason to suspect that they have engaged in criminal activity (including tax evasion). In the United States, organizations of lawyers such as the American Bar Association and the American College of Trusts and Estates Counsel are fighting similar efforts because they erode the attorney-client privilege with enables clients to seek legal advice without fear that information communicated to the attorney will be disclosed without the client's consent.

Other jurisdictions are encouraging taxpayers to come clean through full blown and very effective amnesties. There are active amnesties in Italy, Belgium, Germany and Israel. There is a discussion of the possibility of an amnesty in Switzerland and other jurisdictions. This is a trend that is likely to continue. In fact, there are those who advocate a Europe-wide (or even a world-wide) amnesty, which makes a lot of sense given the changing needs and attitudes of families around the world. As these changes unfold, there is less and less reliance on secrecy.

G. Enforcement Efforts in Less Developed Jurisdictions

The initiatives discussed above relate primarily to countries that traditionally have enjoyed pretty high rates of tax compliance but enforcement efforts are not limited to those jurisdictions. Less developed or compliant countries are recognizing that to effectively compete in the world economy, they cannot raise taxes but must increase their revenue. Given the relatively low or very low rate of tax compliance in these jurisdictions, enforcement is fertile ground for increasing revenue. These efforts have been fueled by pressure on developing countries from the International Monetary Fund ("IMF") and others to enforce their tax laws. When countries in Latin America, for example, run into financial difficulty and look to the IMF to extend or reorganize debt, the response is that one of the reasons for the financial crisis is lax enforcement of tax laws and help will be provided so long as the country in question takes the necessary steps to address this issue. Countries, such as Mexico, that are now members of the OECD want to demonstrate that they deserve to be members of international organizations. Mexico and other Latin American countries have enacted pretty significant tax reforms and are looking for ways to seriously step up their enforcement efforts. In some of these jurisdictions, the wealthier families are being targeted and one could expect that some notorious cases designed to set an example will start to be reported in the press as these efforts continue. To better equip the tax authorities of some of these less developed countries, the IRS is providing training. For example, the IRS trains the Mexican Hacienda, the Chinese tax authorities and others. At Harvard Law School, there is an International Tax Program that is for foreign tax officials, training them in the U.S. approach to tax enforcement.

Understanding Client Needs as we Move into the Era of Transparency

Families don't want to pay any more tax than they have to and, as discussed above, they have legitimate needs for privacy that are driven by far more important things than tax minimization or evasion. In addition, families face a number of other issues including succession issues, probate avoidance, business succession, protection of the family, political risk, etc.

As we move into the era of transparency, too many advisors and others who deal with high net worth families

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are preoccupied, at their own peril, with finding new and more complex ways to hide the family's undeclared funds or disguise their source. This effort often occurs to the exclusion of efforts to find compliant ways to meet the client's needs. This occurs partly because the advisors assume that the family is not interested in exploring tax compliant solutions. It is true that families or individuals sometimes show little interest in engaging in a thorough planning exercise and exploring compliant alternatives, something they might perceive as an expensive exercise in futility. In our experience, this is partly because they are misinformed or have insufficient information about the changes that are taking place worldwide and the availability of planning solutions that can meet their needs and objectives and add enormous value to them and their families. This is not to suggest that families can expect perfect planning solutions that provide total confidentiality at no cost, tax or otherwise. The reality is that families don't really expect that and, with proper analysis and prioritization of their objectives, good tax efficient solutions can generally be found. Unless people are putting their heads in the sand, tax and planning costs will never come close to the costs and risks of being non-compliant. These risks include but are not limited to the risk of criminal prosecution, potentially much higher tax (due to failure to plan to minimize the tax) interest and penalties, political risk if the family is not able to freely travel in or out of a particular country, the risk that a trusted advisor or unhappy family member who participates in the hiding of the money will turn on the family or seek compensation to prevent disclosure of embarrassing or incriminating documents or information.

The Role of Insurance

Insurance has enjoyed significant tax and non-tax benefits in many jurisdictions, including high tax and highly regulated jurisdictions like the United States. In other jurisdictions, insurance and its favorable tax attributes have received little attention although that seems to be changing and not necessarily for the right reasons as discussed below.

Insurance products can be used to address many of the needs of the families we work with. These needs, some of which have been discussed above, include family income replacement, business succession issues, the need for liquidity to pay estate or inheritance tax, the need or desire to provide for a family member or another person who might not benefit from the family's estate for some reason, creditor protection, tax minimization, short or long term tax deferral, privacy, etc. When used in combination with other planning approaches, i.e. trusts, creative and powerful planning approaches and solutions can be achieved.

As is the case with almost anything, insurance can be used (quite effectively) or abused. As bank secrecy erodes, as financial institutions are under increasing pressure to obtain and provide detailed beneficial ownership information, it is no surprise that insurance products are suddenly the focus of a great deal of attention and are being used to legitimately address client needs locally and globally. Unfortunately, insurance or products that can hardly be viewed as insurance are being promoted and used as vehicles in which families with undeclared funds can hide their funds until they can be paid to family members in the form of insurance proceeds. Such use of insurance products can be considered money laundering in a number of jurisdictions, in which tax evasion (including foreign tax evasion) is considered a predicate offence to money laundering. If such "planning" is considered money laundering in the relevant jurisdiction, the advisors and any other person involved in planning or implementing such a structure are at risk of being prosecuted for aiding and abetting or conspiring to commit a crime. In addition, in some jurisdictions, insurance is being used in a way that causes the insurance policy to not be considered insurance at all. If the product is characterized as something other than insurance (e.g. a mutual fund) expected tax and other consequences will simply not be achieved exposing the family and its advisors to undue risks.

As insurance products are abused, more and more jurisdictions are beginning to focus on insurance, not as a vehicle that can provide taxpayers with significant benefits

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but as a vehicle that lends itself to abuse and must be dealt with. The result is that favorable tax and other benefits are eroded as tax authorities seek to deal with abuses by eliminating benefits that would not be problematic if not abused. Just as bank secrecy in Switzerland and other secrecy jurisdiction has become, for some, synonymous with tax evasion, insurance has the potential for being viewed as an abusive product which needs to be regulated and the tax benefits of which need to be curtailed, to the detriment to all of those who legitimately use insurance products to address family needs in a compliant way.

The Role of the Insurance Advisor

As discussed above, some of the changes that are occurring in the United States and abroad are making insurance a vehicle that is more attractive than ever. With proper planning and often in combination with other vehicles such as trusts, it can be an integral part of the overall, tax effective and compliant estate plan of a domestic or international family. The insurance advisor would be well advised to keep up to date and stay well informed about planning opportunities available to families and steer clear of schemes that promote non-transparency and non-compliance. As coordinated as countries are about enforcement, it will be a long time (if it ever happens) before all countries tax the same way. It is in these differences that planning opportunities arise for families. There will be many opportunities to build a career working with families who want to engage in proper and often sophisticated and challenging planning all without the risks that arise from dealing with undeclared funds.

Families with undeclared funds should be advised to seek proper advice about becoming tax compliant (e.g. by taking advantage of an amnesty, making a voluntary disclosure, etc.) or at least protecting family members who have not previously been involved in dealing with the undisclosed assets from acquiring further risks. Often, members of the younger generations have a better understanding of the inevitable changes that are occurring and can actively participate to create an appropriate plan for the family or for themselves going forward.

Philip Marcovici, who is one of our partners and director of Law in Context (Baker & McKenzie's on-line training and information unit which includes a help desk that provides country by country information about the needs of families), coined three golden rules for dealing with undeclared funds:

1. "Don't make your client's problem your problem." For many intermediaries and banks it is not well-understood that despite the fact that, in some jurisdictions, it is not necessarily illegal to be involved with a family with undeclared money, you could very easily be dragged into very serious problems where you are trying to help your client. Many advisors have been and will continue to be prosecuted because tax authorities view the advisors as one of the roots of the problem that must be eradicated. It is very easy for the client's problem to become the advisor's problem. In some cases, the client who used to be the advisor's or intermediary's best friend, is the person with the tape recorder seeking to implicate someone else to get a lighter sentence.

2. "No new undeclared money." It is not difficult to understand why so many families have undeclared funds but, in this day and age, it simply does not make any sense to add to the problem by creating additional undeclared funds, which the family may never be able to access. Instead, compliant and tax effective approaches should be sought for funds the families accumulate at this point.

3. "No new bad guys." This means that if the older generation of a family has undeclared funds, other members of the family should not be implicated. If other family members are not involved in the planning or structuring with respect to undeclared funds and they one day inherit or otherwise gain access to the funds, they may want to take advantage of voluntary disclosure approaches that might be available to them if they are innocent parties.

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What does a family really need? It needs advisors who understand their needs, who understand our fast changing world and who understand how the services they provide fit into a well conceived, designed and implemented overall plan that takes advantages of the opportunities and avoids the unnecessary risks of not playing by the rules. Advisors need good, current, information and ongoing training to meet the challenges ahead and to thrive in the new era of transparency.