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TOPIC: Appeals Court Upholds Disallowance of Deductions for Sham Insurance Plan

CITE: *Salty Brine I, LTD., by and through Salty Brine, Inc. Tax Matters Partner, et al. v. U.S.*; No. 13-10799 (5th Cir. July 31, 2014).

SUMMARY: The Fifth Circuit Court of Appeals has upheld a district court decision—originally reported in *WRNewswire 14.2.06*—that disallowed deductions taken for premiums paid in complicated arrangements purporting to be business protection insurance policies (BPPs). The court agreed that the premiums were neither necessary nor ordinary business expenses. The arrangements did not cover insurable risks, did not shift risk, and did not distribute risk among a group of separate entities. In short, the arrangements were not "insurance." Instead, the arrangements were found to be tax shelters. The appeals court also focused on an arrangement where oil and gas royalty interests were moved into the segregated accounts of so-called offshore private placement life insurance contracts. Relying on the assignment of income doctrine and noting the lack of economic substance, the appeals court concluded that the transfer of the royalty interests should also be ignored.

FACTS: John Thomas and Lee Kidd were Texas oilmen. Through their accountant, H. Glenn Henderson, they were introduced to Stephen Donaldson, who was selling the so-called BPPs which were issued out of the British West Indies by Fidelity Insurance Company and Citadel Insurance Company. It appears that Henderson, as well as Thomas and Kidd, were taken in by Donaldson's presentation which represented the following "strategic goals" of the arrangement: (1) reduce business and personal income tax, (2) reduce capital gains tax, (3) provide asset protection, and (4) create tax free retirement income.

The district court found that no meaningful discussion of *protection* ever took place. Instead, the marketing and BPP product pricing centered on cash flow and desired tax deductions. A complicated structure, using so-called private placement offshore cash value life insurance policies, was arranged. Under this arrangement, Thomas and Kidd created irrevocable trusts (with each being the trustee of his trust) which purchased investment partnerships. The grantor's children were the beneficiaries of the grantor's irrevocable trust. The investment partnerships owned offshore (Nevis) limited liability companies which, in turn, owned the offshore cash value private placement life insurance policies on Thomas and Kidd. The investments of each of these cash-value life policies were held in "segregated" accounts and accounted for separately from other insurance policies. As a result, the owners of other insurance policies and creditors of the insurance companies had no access or right to the assets in these segregated accounts. Thomas and Kidd purchased their first BPPs in 2001 and began funneling their earnings into the private placement life policies in 2002. The court case focused exclusively on the 2006 tax return.

Approximately 85% of the premiums for the so-called business protection were shifted into the offshore private placement cash value life insurance policies. The remaining 15% was taken for various charges. The pitch to Thomas and Kidd was that the 15% cost of this arrangement was far less than the tax liability would have been on the earnings had the BPPs not been employed.

No claims were made or paid from the BPPs. Specifically, for 2006, the Thomas and Kidd businesses paid $4.6 million in premiums for the BPPs. These premiums were deducted as ordinary and necessary business expenses. Fidelity and Citadel took $730,000 as fees during the year. At the end of the year, the remaining premiums and earnings (over $3.8 million) were distributed into the segregated accounts of the so-called off-shore cash value life insurance contracts. One day after the funds were transferred into the so-called life policies, ALL of the transferred amounts were taken out of the policies on a tax-free basis as policy loans. Assuming a 35% tax bracket, the tax deduction would have saved $1.35 million in taxes. The fees charged under the arrangement ($730,000) were approximately one-half of the purported tax savings.

The district court found, and the appeals court upheld, that the BPP premiums were not deductible as business expenses under Code Section 162. In fact, the claimed deductions were found to be neither ordinary nor necessary expenses paid or incurred to carry on a trade or business. The BPP premium payments were reclassified as distributions from the Thomas and Kidd businesses to Thomas and Kidd and their families. The payments were not made for carrying on a trade or business, rather they were made to further the insureds' personal estate and tax planning.

In addition to examining issues involving the BPPs, the appeals court focused on the treatment of certain oil and gas royalty interests which were transferred (through a number of steps) into the private placement life insurance segregated accounts. Like the structure around the BPPs, the appeals court concluded that the arrangements involving the royalty interests were no more than an internal movement of the interests from one set of entities owned and controlled by Thomas and Kidd to another set of entities owned and controlled by Thomas and Kidd. After a lengthy consideration of the "assignment of income" doctrine, the appeals court affirmed the district court conclusion that the transfers of the royalty interests were an "anticipatory assignment of income" taxable in the year of assignment.

The appeals court agreed with the district court conclusion that the various arrangements lacked "economic substance." Specifically, it was noted that "transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration."

RELEVANCE: The Fifth Circuit's affirmation of the District Court's decision in *Salty Brine* is not surprising, and one wonders why the taxpayers appealed. In this case, there was little to no discussion of insured risks. Instead, the promotion focused almost exclusively on the promises of tax deductions and tax-free retirement income. Budgets for insurance were made based on the purchasers' available cash flow and desire for tax planning—not on the need for protection against defined risks.

At the end of the day, maybe the most important lesson to be learned from this unfortunate case is an old—and, seemingly eternal, lesson—"If it sounds too good to be true, it probably isn't true!"

***WRNewswire* #14.8.19 was written by Randy Zipse of The Prudential Insurance Company of America, Newark, NJ.**

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