Foster & Dunhill Scheme Ends In Denial of Deductions and Indictments For Bogus Insurance Tax Shelter

Contributed by Jay Adkisson (republished from Forbes June 23, 2013)

Texans John Thomas and Lee Kidd were in the oil business, and owned Thomas & Kidd Production, Ltd., and related businesses.

Through H. Glenn Henderson, who was their accountant, Thomas and Kidd hooked up with Stephen Donaldson, who was selling offshore tax shelter transactions through a marketing company called Foster & Dunhill. Donaldson controlled Foster & Dunhill, as well as an offshore trust company, First Fidelity Trust, and two offshore insurance companies, Fidelity Insurance Company and Citadel Insurance Company.

The Bogus Insurance Policies

One Foster & Dunhill transaction involved the sale of so-called Business Protection Policies (BPPs) issued by Fidelity and Citadel. In a power-point presentation by Donaldson, the benefits of the BPPs were listed as:

- Reduce Business/Personal Income Tax;
- Reduce Capital Gains Tax;
- Provide Asset Protection;
- Create Tax Free Retirement Income.

Notably absent from this list was any actual need by Thomas and Kidd for the Business Protection Policies.

The presentation went on to state the steps for the tax shelter:

1. Thomas and Kidd were to establish Foreign Asset Protection Trusts (FAPTs).
2. Thomas and Kidd were to purchase offshore cash-value life insurance policies, sometimes known as Private Placement Life Insurance (PPLI) policies, which allowed them to control the cash-value to make investments.
3. The businesses of Thomas and Kidd were to pay premiums for the Business Protection Policies.

4. Thomas and Kidd were to direct that the cash-value in their PPLI policies be used to back the risks of the Business Protection Policies — basically, through the PPLI policies, Thomas and Kidd were investing in their own risks in the BPPs.

The arrangement was set up so that the money went through the BPPs into the cash-value of the PPLI policies of Thomas and Kidd, such that their businesses took a deduction for the premiums for the BPPs but they paid no income tax on what was received in their PPLI policies.

The rather obvious flaw is this arrangement is that the BPPs were nothing like an insurance policy, since there was no "risk distribution", i.e., no sharing of risks with others. Apparently, to get suckers like Thomas and Kidd to invest in these arrangements, the Foster & Dunhill scheme promised that "the profitability of each life policy's reinsurance business is tied to that client's company's non-life policies and to none other."

Despite this obvious flaw, Thomas and Kidd went ahead with the deal. They set up two offshore limited liability companies in Nevis, and funded them with enough money to ultimately purchase seven cash-value PPLI policies. The Nevis LLCs were owned by their two investment partnerships, which in turn were owned by their irrevocable family trusts.

Beginning in 2001, and at least through 2006 (the year at issue), the businesses of Thomas and Kidd started buying Business Protection Policies from Fidelity Insurance Company, and the money circulated into their PPLI policies. Fidelity kept 15% of the premiums as its fees.

The Business Protection Policies actually provided no insurance, but as the Court noted:

> ***In reality, these policies were merely a conduit used to funnel income from [Thomas' and Kidds'] businesses to offshore entities in a scheme to avoid paying taxes due on that income.***

To try to conceal what was really going on, the Business Protection Policies were not purchased directly from Fidelity Insurance Company or Citadel Insurance Company, but were instead routed through a Donaldson company known as "KOFS Group", and then transferred to Fidelity and Citadel, thus:

> ***providing the Thomas and Kidd businesses with various sorts of coverage against remote and implausible risks.***

Fidelity and Citadel then executed “reinsurance” agreements with another Foster & Dunhill company called Yield Enhancement Company (YEC), which took over 83% to 85% of the nonexistent “risk” of Fidelity and Citadel.

YEC then executed “subscription agreements” that basically issued stock to Thomas’ and Kidd’s cash-value life insurance policies, so that most of the money that YEC received was paid as a dividend, purportedly tax-free, into Thomas’ and Kidds’ PPLI policies.

That is what the paper trail said. The cash trail was different, and the money went directly from Fidelity and Citadel to Thomas’ and Kidds’ PPLI policies. Within a day after that money hitting the cash-value accounts of their life insurance policies, Thomas and Kidd withdrew their money from those policies as “cash free loans” against the cash-value.

The Bogus Private Annuity Transaction

Another transaction that Thomas and Kidd did with Foster & Dunhill involved their transfer of oil & gas royalty interests to the offshore cash-value life insurance policies, so that those revenues essentially became “tax free revenues” that they “borrowed” from their policies’ values, just like with the Business Protection Policies.

For this tax shelter, Thomas and Kidd formed two Nevis LLCs that each owned their own Nevada LLC 100%. Thomas and Kidd then carved out a 31% royalty interest from Thomas & Kidd Oil Production, and transferred it via the Nevada LLCs and Nevis LLCs to their respective PPLI policies.

In exchange for this transfer, Thomas and Kidd acquired annuities (known as “private annuities”) of $178,579 and $192,810 respectively. These annuity amounts were heavily discounted, apparently for the lack of marketability of the LLCs, such that they were worth 26% less than the value of the royalties for which they were traded.

The Red Flags Were Waiving

The first year, 2001, that Thomas and Kidd were in the Business Protection Policies shelter, they obtained an opinion letter from Attorney #1. However, the second year Attorney #1 quite wisely refused to issue an opinion, and instead Thomas' and Kidds' own notes reflect that "Art backed out of an update."

In 2002, Thomas and Kidd obtained a tax opinion on the BPPs from Attorney #2. But the following year, 2003, Casey's new law firm, Lord Bissell & Brook, to their credit started to look deeper at these transactions and didn't like what they saw. Lord Bissell & Brook's legal opinion review committee questioned the bona fides of the BPPs and wondered why Fidelity Insurance Company used inventory accounting principles instead of insurance company accounting principles.

Attorney #2 started asking more questions of Foster & Dunhill's director, Duane Crithfield, but Crithfield had few answers. By September 2003, Attorney #2 had finally awakened to how the deal really worked. He withdrew his 2002 opinion letter and refused to issue a 2003 opinion letter. Instead, Attorney #2 wisely sent a letter directly to Thomas and Kidd that stated that various material facts were "not as they have been represented to us".

For his part, Kidd didn't care that Attorney #2 had withdrawn his opinion letters, since Kidd "believed that he could always find another lawyer." And he was right, since Jenkens & Gilchrist were in town — a law firm that was basically a drive-up window for opinion letters on transactions that were hopelessly flawed. In fact, by 2007, Jenkens & Gilchrist had folded, after paying a $76 million fine to the IRS and agreeing to cease practicing law — and facing a bunch of civil lawsuits by clients whose shelters had been blown up by the IRS.

For the 2003 to 2005 tax years, two of Jenkens & Gilchrist issued opinion letters on the BPP transactions. But by 2006, even Jenkens & Gilchrist were getting the heebie-jeebies about the Business Protection Policies, and the "linkage" between the BPPs and the cash-value life insurance policies. Ultimately, Jenkens & Gilchrist told Thomas and Kidd that there would not issue an opinion letter for the 2006 BPP transactions, citing a "risk distribution issue" (yeah, there wasn't any).

> ***Jenkens & Gilchrist also gave Thomas and Kidd an opinion letter on the private annuity transaction involving the royalties, the Court held that: The Thomas and Kidd businesses did not fully or accurately disclose to Jenkens the facts relevant to the tax treatment of the royalty transactions."***

But even beyond that, the Court noted that:

> ***Moreover, Jenkens never verified the representations it was given. It never explored whether control of the royalty interests and the income they produced remained firmly with Thomas and Kidd via the letters of wishes that conveyed their directions.***

Ah, yes, the Jenkens & Gilchrist drive-through opinion letter mill at its finest. But, as Kidd had said, there is always another lawyer who will give the opinion letter. That brings us to Attorney #5, who did issue an opinion letter to Thomas and Kidd for the 2006 year. Attorney #5′s opinion letter stated:

- ***Each of the risks covered by the Business Risk Policies issued to KOFS Group, LLC are genuine and material risks of the businesses;***
- ***There is no arrangement, plan, contract, or agreement that exists between the owners of any insurance policy and Citadel or Fidelity linking reserves of any particular Business Risk Policy, and Citadel and Fidelity, in their sole discretion, can use reserves in the Guaranty Fund to cover losses on the Business Risk Policies;***
- ***The coverages under the Business Risk Policies are similar to those under policies of insurance that are currently available from other insurers, the premiums are determined under valid and proper actuarial principles, and the premiums are determined at arm's length and are at fair market rates approximately equal to what other insurers would typically charge.***

If you are thinking that what Attorney #5 wrote didn't match up at all to the facts, then you're on the same page with the Court, which wrote very simply:

> ***[Attorney #5] did not attempt to verify the accuracy of the above representations. The above factual representations are false.***

The ongoing fiasco of the withdrawn opinion letters, Jenkens & Gilchrist's refusal to issue the 2006 opinion letter, and Attorrney #5′s utterly worthless opinion letter, combined with the fact that Thomas and Kidd never even read (and thus, never relied upon) any of these opinion letters, left Thomas and Kidd relying only on Henderson, their accountant, and Theodore Lustig, their

lawyer. But these two were hardly disinterested tax professionals, as the Court would note:

> ***Henderson and Lustig coordinated the creation of offshore entities, the execution of offshore transfers, and the investment of offshore funds. Their compensation, however, did not come from their clients. Instead, it came from Fidelity and Citadel. To promote their offshore transactions, Fidelity and Citadel used the marketing entity Foster & Dunhill. Fidelity and Citadel paid Foster a commission percentage of all funds that Foster clients contributed into Fidelity and Citadel products. Foster paid part of its commission to various client representatives. Henderson and Lustig received those Foster commissions.***

Attorney Lustig received a 3% commission on all the Business Protection Policy premiums, as well as 2.5% commissions for the annuity policies. These totaled $490,000 that Lustig received from Foster & Dunhill just in 2006, and more than $2.5 million over all the years that Thomas and Kidd were in these deals. While Lustig disclosed these fees to Thomas and Kidd, the record is silent as to whether they were disclosed to the Texas Department of Insurance.

Likewise, accountant Henderson received 2.25% of all premiums paid for the Business Protection Policies and on the life insurance policies. Henderson's commissions received from Foster & Dunhill exceeded $2.5 million too.

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http://www.forbes.com/sites/jayadkisson/2013/06/23/foster-dunhill-scheme-ends-in-denial-of-deductions-and-indictments-for-bogus-insurance-tax-shelter/