

November 18, 2022

## Generations Fall 2022 - Choose Your Tax Advisor Carefully: A Cautionary Tale

In 2017, attorney Carlos Kepke responded to an email from a Pennsylvania automobile broker who stood to inherit a farm from his elderly grandmother and wanted advice on how to protect his inheritance from creditors and his ex-wife. Kepke explained that the broker needed to form a foreign trust with a corporate subsidiary that would own the broker's assets and shield them from creditors and U.S. taxation. The broker visited Kepke's home near Houston to learn how to create offshore financial accounts that would appear to be owned by a third party but would in fact be funded and controlled by the broker. Later that year, the broker's friend, a small-business owner, asked Kepke how to create an overseas company to protect his nest egg. Kepke suggested employing a relative to create a foreign trust in order to avoid tax on the trust's income. He explained that the business owner could contribute \$1 million to a limited partnership formed in Belize or Nevis and then sell his partnership interests to the trust in exchange for a note. The trust could then make tax-free payments back to the small-business owner. The problem for Kepke was that the automobile broker and his friend were actually undercover agents from the IRS's Criminal Investigations Division who were recording Kepke's advice. The conversations with Kepke were laid out in a 104-page sworn affidavit that established probable cause to search Kepke's home. Kepke is scheduled to go to trial in the Northern District of California in November on federal charges of conspiracy to defraud the United States and aiding and assisting in the filing of false income tax returns for, among others, billionaire Robert Smith, founder of San Francisco private equity firm Vista Equity Partners. The allegations from government filings read like a John Grisham novel. Swiss banks had previously identified Smith as a holder of undisclosed Swiss bank accounts under the Department of Justice's 2013 Swiss Bank Program. That program allowed Swiss banks to resolve potential criminal liabilities in the United States by disclosing cross-border activities and secret U.S. account holders. Later, a private investigator hired by Smith's ex-wife applied for an IRS whistleblower award, alleging that Smith had claimed tax deductions for payments for his girlfriend's luxury New York apartment and other living expenses. Through a grand jury investigation of Smith, the FBI and the IRS came to target Kepke as the professional tax advisor creating these structures—the "facilitator" of Smith's offshore tax schemes. Remarkably, this was not the first time Kepke had drawn the attention of the IRS. Beginning in 1999 and for some years thereafter, he was the subject of an IRS administrative investigation during which he allegedly admitted to an undercover agent how he used offshore entities to hide his clients' assets from U.S. taxation. In Kepke's own words:

What I basically try to do is take your wealth and make it a foreigner. Make it owned by a foreigner so that you, so that your wealth, your dollars, enjoy the tax benefits that you would enjoy if you were a foreigner; yet you keep them. You keep control. They're still yours. They're still yours to use and so on.

While the creation of foreign trusts by itself is perfectly legal, the government alleges that Kepke routinely created trusts and shell companies to serve as tax-evasion vehicles by failing to advise his clients to make required disclosures about the existence of those foreign trusts and shell companies and transactions involving those foreign entities. When Kepke's clients earned capital gains from these funds, the gains were not reported to the IRS as required by tax law. Portions of the proceeds were deposited into bank accounts in Switzerland and the British Virgin Islands owned by a foreign trust, also not reported to the IRS, where they were available for those clients to use at their discretion. Kepke faces five years in prison on the conspiracy count and three years in prison for each count of assisting in the preparation of a false return, not to mention personal liability for taxes, penalties and restitution.

## A New Enforcement Landscape

Failure to disclose foreign entities and transactions with foreign entities has been a major source of tax evasion in the United States for decades. The IRS is now much more aware of the magnitude of this problem than it may have been in the past, and it has made it a priority to improve compliance in this area. With the IRS set to receive \$80 billion in funding increases over the next 10 years, it is fair to expect an expanded IRS examination and collection staff to target taxpayers with complex international holdings for enhanced enforcement action. The IRS is likely to expand scrutiny of related-party debt instruments like those described by Kepke in his conversation with the undercover IRS agents. The IRS's 2022 "Dirty Dozen" list of abusive transactions identifies two specific offshore arrangements:

- Maltese (or other foreign) pension arrangements that misuse treaty benefits; and
- Puerto Rican and other foreign captive insurance company arrangements.

The IRS already has the tools it needs to tackle schemes like those alleged to have been perpetrated by Kepke. The IRS has broad statutory authority to attack transactions that lack "economic substance"—transactions that do not change a taxpayer's economic position (apart from taxation) and do not have a substantial business purpose (other than taxation). The IRS can seize all property or rights to property of an "alter ego" entity (e.g., a trust, corporation or limited liability company) to collect the tax liability of a taxpayer if the entity does not exist independently of the taxpayer. The IRS can also levy property held by an entity that is a taxpayer's "nominee"—one that merely holds bare legal title to property that the taxpayer continues to treat as his own.

## Crystal Ball

Treasury Secretary Janet Yellen has mapped out her priorities for the IRS's new funding, including hiring new examiners and revenue officers to pursue individual and corporate tax evasion. In an October 4 letter to Yellen, the Senate Finance Committee wrote that it also wants to see increased audits and tax collections of wealthy taxpayers, crackdowns on offshore tax evasion, and more criminal investigations. With congressional Republicans largely opposed to the IRS's funding increases and the midterm elections predicted to shift the composition of Congress, the expansion of the IRS's examination and collection powers is still in doubt. Clients should still be careful to take advice only from tax advisors who have earned their trust to ensure that their transactions comply with all legal requirements, in both form and substance. Taxpayers should be wary of advice from professionals that seems "too good to be true" and should seek referrals from people they know well before engaging a new advisor. Otherwise, they could find themselves in the sort of trouble that Kepke and his clients now face.

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