

**Testimony of Jack A. Blum, Esq.**  
**before the**  
**Senate Finance Committee**  
**on**  
**Tax Schemes, Scams and Cons,**  
**Part II: The IRS Strikes Back**

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My name is Jack A. Blum. I am a partner in the Washington, D.C. law firm of Lobel, Novins & Lamont. For much of my legal career I have worked on the issues of money laundering, offshore tax evasion, and financial crime in a variety of capacities – as a member of the Senate staff, as a private practitioner, and as an expert consultant for executive branch agencies.

Although I am currently on contract to both the Department of Justice and the Internal Revenue Service, I appear here this morning a private citizen. The views I share with you this morning are my own and have not been cleared by any government agency.

The problem of the use of offshore accounts and trusts to evade taxes is not a new one. What is new is that the internet has provided average citizens access to the offshore world and credit and debit cards have made it possible to easily access money held offshore. As a result, offshore tax evasion has grown geometrically as has the threat to the U.S. system of voluntary taxation.

What makes matters worse is that a few of the wealthiest Americans have used highly sophisticated methods backed by opinion letters from top flight law firms to avoid paying current taxes on offshore hedge fund earnings. The success of the very rich in beating the system has allowed low end promoters to tell their clients that all they are doing is offering a version of the same product for the common man.

While the credit card enforcement initiative will go a long way toward controlling the offshore evasion trend, I urge this committee to examine the entire offshore avoidance/evasion problem. I am especially concerned about the use of the offshore world by sophisticated tax lawyers who are offering highly questionable tax avoidance products. These products go unchallenged by the IRS because no trace of the offshore structure appears on the tax returns.

These products include:

- Offshore “charitable trust” arrangements in jurisdictions which do not define charity or regulate the trusts.
- Insurance products in which the insured is the owner of the insurance company and its

- only client.
- Offshore trusts which use insurance policies as the beneficiaries.
  - U.S. holding companies which cover holdings in offshore assets.

This committee must understand that, because the Internal Revenue Service has been starved for money and manpower, a sector of the tax bar has become so “aggressive” in its use of offshore products that the entire tax system is in jeopardy.

Much of what has been done masquerades as “asset protection.” The lawyers who do it say asset protection is legitimate and that it is up to the clients to file proper tax returns. In my opinion, there is very little that is legitimate in the asset protection field. It is a form of what people in Latin America call impunity. By that they mean that the rich escape the consequences of their actions by stepping out of the legal system. As officers of the court, lawyers have no business helping client hide money for clients faced with alimony and child support payments, judgments in civil cases, and fines and penalties in criminal cases. Every lawyer who knows why his client is “protecting assets” knows that for the protection to work, the client will have to commit perjury. Lawyers cannot and should not suborn perjury.

A second point which is essential is what the offshore mess means for people whose income is subject to withholding. They get to make up the lost revenue by paying higher taxes or by having important benefits cut. Middle America gets to pay for the social benefits of the offshore evaders. The offshore evaders enjoy our schools, hospitals, courts, and our national defense. They should pay their share.

The offshore tax evasion problem is an old one. I first became aware of its seriousness on my first visit to the Cayman Islands in 1974. I was working for the Senate Foreign Relations Committee at the time. I was investigating the methods Robert Vesco used to hide the money he stole from Investors Overseas Services. There were three or four hotels, the most important of which was the Holiday Inn. On the morning after I arrived, the phone system in the hotel failed. The only way to make a phone call was through a pay phone in the hotel lobby. As I came into the lobby that morning I saw a line of well dressed men, mainly Americans, waiting to use the pay phone. Eavesdropping was not difficult, and it did not take long to discover that the men were American lawyers and accountants trying to make appointments with Cayman bankers.

The lawyers and accountants were there to set up bank accounts and trusts for their U.S. clients who did not want to pay taxes. The bankers I met with at the time were quite frank about the source of their business. The American bankers in the Caymans told me they refused business from U.S. persons but referred the U.S. business to their Canadian colleagues. Likewise, the Canadians referred Canadians to American bankers.

At that time there were approximately 25 banks in Cayman. Most of those had moved from the Bahamas to Cayman because the depositors feared the consequences of Bahamian independence and wanted to have the security of operating from British territory. Today there are

590 banks in Cayman and the Islands have gone from being a sleepy backwater to a major world financial center. The flow of American lawyers and accountants continues, and the problem this represents for the American tax system continues.

To give you a sense of how the offshore tax evasion system works let me share several case histories. In cases I worked on for the government I will disguise the facts, but if the committee wishes, I can identify the cases in closed session so that you can obtain the records from the Internal Revenue Service using your oversight authority.

Several years ago I was asked to help a lawyer who represented the wife in a divorce case understand some papers his client had obtained. The wife had been the subject of physical abuse. She got a court order barring the husband from the family home, and soon thereafter had a locksmith drill a safe she found in the bedroom. The safe contained all the documents relating to her husband's plans to hide assets from the wife and their two young children. At the same time the plan allowed, indeed required, that the husband fail to report his offshore income.

The papers showed that the husband had gone to a large Philadelphia law firm which referred the client to an "asset protection" specialist in the firm's London office. The London lawyer suggested forming a Cook Islands trust which in turn would control an offshore corporation which would hold the client's assets. The client would have a power of attorney for the corporation's accounts and would thus be able to trade stock and manage the money. The client could also use the corporate credit card for his day to day expenses.

Tax evasion was an essential part of the program because tax returns would be discoverable in the divorce proceeding. If the husband had been truthful on his returns, both the wife and the divorce court would have known about the offshore trust arrangements.

I was especially disgusted by the role of the Philadelphia law firm in this affair. No American law firm, even one with a British office, should be in the situation of suborning perjury and assisting in outright tax evasion. Because I learned the facts in a privileged setting, there was little I could do.

In another recent case, the taxpayer was sued by the government for civil fraud. The lawsuit and the resulting appeals went on for years. The taxpayer hired a well known asset protection lawyer who set up state of the art asset protection trusts in the Cook Islands, and a fake insurance annuity program in an offshore haven. The trust beneficiary was the annuity. The trusts in turn controlled all of the taxpayer's business and personal assets. The taxpayer took a modest salary from the offshore companies and charged all of his expenses to the offshore company's credit cards. The taxpayer is resisting the government's efforts to collect taxes on the offshore earnings, but he knows that, even if he loses, the government will have nothing to levy against. The offshore credit cards are an essential part of the scheme because they allow the taxpayer instant, and virtually unlimited, access to the money that is beyond the reach of the Internal Revenue Service.

In 1998, I suggested to Brian Ross, ABC's Chief Investigative Correspondent, that ABC send an undercover team to a conference in Cancun, Mexico, run by Jerome Schneider. Schneider is a well known proponent of offshore tax evasion. He ran regular ads in airline magazines featuring pictures of a couple on a beach and inviting the reader to cut his tax bill by going offshore "the way the wealthy do."

Two ABC producers went to Cancun and taped private meetings they had with Schneider and several lawyers who Schneider had on the program. In the taping, Schneider proposed that they would be tax evaders purchase banks in Vanuatu. The banks would then open a correspondent account with a Canadian bank which could be controlled by the taxpayer as his personal checking account. The identity of the taxpayer, he argued, would be completely protected. The bank would also be in a position to authorize the issuance of credit cards.

When one of the producers asked a lawyer Schneider had invited to his conference what the chances of being caught by IRS were, the lawyer answered, "How big is your mouth?"

There were more than 400 people who attended the Cancun conference. Many of the attendees bragged to the producers that they had been evading taxes for years and were at the conference to learn the latest evasion and avoidance techniques. I am please to report that the ABC taping led to aggressive action against Schneider by IRS and as a result the airline magazine ads and the conferences have stopped.

Even though the Patriot act has controls on offshore "shell banks" and correspondent accounts, Europe does not yet have similar controls and European banks are offering to step into the breach. It is essential that the European Union's Commissioners adopt a directive which controls shell banking.

In 1994 I went to the Cayman Islands with a film crew from BBC and did an undercover taping of John Mathewson, the "Chairman" and proprietor of the Guardian Bank and Trust. Mathewson's bank was selected because he advertised heavily in airline and hotel magazines. The ads suggested that, if one used his services, paying taxes became an optional matter.

In the meeting, Mathewson told me that his bank would set up a corporation for me. The corporation would then open bank and brokerage accounts that I could trade in by using a power of attorney so that all of the records would remain offshore. To access the money, he offered me a gold Mastercard on which he said I could have a spending limit as high as \$1 million a month. Of course, he said, I would have to have that amount on deposit with him.

Since that time, Mathewson has been arrested and charged, and has turned his customers over to the IRS. But Mathewson's bank was only one of dozens throughout the Caribbean, Panama, the Pacific Islands, and the Channel Islands advertising the same services. A quick search of the internet using the terms offshore banking, or tax haven will show you how easy it is to evade our the tax system.

These cases represent a small sampling of the offshore issues I have encountered. All of the cases have one or another of these themes:

- A desire to hide money from a spouse, a judgment creditor, or a law enforcement agency in which tax evasion is a necessary corollary.
- A sophisticated plan using a thin veneer of legality to place assets out of reach of the income and estate taxes.
- A naive taxpayer who falls for the schemes advanced by a sleazy promoter.
- A criminal con-man, stock fraud artist, or drug dealer who is using the offshore system to launder money and who will never consider paying taxes of the ill gotten gains.

The schemes are aimed at different market levels. At the high end, tax planners, lawyers and accountants alike devise complex “structures” through which their clients invest in offshore hedge funds and partnerships. These structures show no current income and as a result the client pays no taxes until the funds are repatriated. The structures are rarely challenged because they appear to be plain vanilla investments on the 1040. The structures are designed so that, if the taxpayer dies, the assets will not appear to be part of the estate.

At another level, the lawyers who make up the “asset protection bar” devise plans that would be completely legal if they were fully reported to the Internal Revenue Service. The plans are designed to keep assets away from judgment creditors. The lawyers tell their clients that for the schemes to work there should be no paper trail. They take no responsibility for insuring that the tax reporting is complete and the tax payments are made. Inasmuch as the offshore financial institutions do not report to IRS, the taxpayers know the risk of being caught is very low. I would guess that 95% of the “asset protection” clients would have to pay substantial additional tax if IRS had access to all of their records.

Then there are the promoters who target professionals including doctors, dentists, and lawyers. They offer a range of schemes, most of which are blatantly illegal. To give one example, two years ago I was approached by a dentist who wanted to buy a bank in the Caribbean. He told me that he had heard that, as the owner of the bank, he would not have to pay taxes and he could keep his money there without being questioned about it.

When I questioned him, it became clear that he was being offered a “shell” bank which was merely a piece of paper. The bank would have one customer – the dentist who owned it. I tried to explain to him that, unless the business was a real business with a real offshore operation, he would pay higher taxes than if he invested in the U.S. stock market. The more I explained, the angrier he got. Finally, he told me my advice was useless, and that I did not know what I was talking about.

At the very bottom of the offshore business are web sites which offer access to “offshore” bank accounts and services. These run the gamut from the outright criminal to the merely abusive. In one notorious case I dealt with, that of the European Union Bank of Antigua, the owners of the

bank advertised that they would not report income to the IRS and solicited deposits and accounts through their web site. The bank immediately “lent” all the deposits to its owner, a Bahamas bearer share company. Needless to say, all the money disappeared and the depositors were left holding the bag.

The Internal Revenue Service has a very difficult time dealing with taxpayers who use complex offshore schemes. If the schemes are uncovered because of diligent work by a revenue agent, the follow up work is exceedingly complex. The evasion schemes involve many tax years and many returns. The revenue agent must decide which years to focus on. To make the case the agent must make repeated document requests, most of which are not met or are the subject of repeated delays and appeals. The agents are under pressure to close the cases and produce results. There are few rewards in the system for sticking with a complex offshore case.

Making matters worse is the fact that obtaining a final judgment in the tax court is just the beginning of the process. The IRS must then collect the money. If the funds are tied up in offshore trusts and the assets are securities held by offshore holding companies, there is little the government can do to get the money. US tax judgments will not be enforced by the courts of foreign countries. The irony of this is that unless the taxpayer is stupid – and there are quite a few in that category – the government will have litigated for years to produce no concrete result.

I have worked with IRS revenue agents and lawyers who have pressed these offshore cases. They are among the country’s most dedicated, hard working, and abused employees. I am amazed at their willingness to persevere against impossible odds. They need to be given support, rewards within the system, and tougher tools to insure compliance with subpoenas.

Offshore tax evasion usually involves other crimes. I am currently representing a witness in a criminal case in New York. The case involves a Bahamas mutual fund which called itself Evergreen Securities. The mutual fund was sold through lawyers and accountants who told their clients to take second mortgages on their homes and invest the money in the “tax free” offshore fund which guaranteed a 12% return. They were told that the interest on the second mortgage could be deducted. In fact the money was stolen by the fund promoters who paid themselves extravagant commissions and used the money from new investors to pay off the old ones. As the investigation progressed, it became clear that the operation of the fund was a carnival of criminality. Tax evasion was only one part of the problem.

In another case, a taxpayer siphoned money from his privately held corporation by submitting false invoices from an offshore shell for equipment that was never delivered. The other family members were clearly the victims of fraud. The taxpayer could have been charged with wire fraud and mail fraud. Given the way the system works, if the revenue agents had referred the case for criminal prosecution, it would have kicked around in the system until it died.

The IRS needs a better way to work with the criminal investigators as information is developed about criminal behavior. As matters now stand, civil tax information cannot be shared

with criminal investigative agencies. If the civil side of IRS makes a referral to the criminal side of IRS, the cases take so long to process that they push the statute of limitations. Before a taxpayer can be indicted for a tax crime, the indictment must be subjected to repeated reviews within both the IRS and the Department of Justice.

There are enforcement tools which will work. I believe that every one of the taxpayers who knowingly failed to file the required foreign bank account report on an offshore financial account should be notified that he or she can be charged with a five year felony. The taxpayers should then be given the chance to plead out in exchange for a complete disclosure and payment of back taxes and interest. The Foreign Bank Account Report is required by the anti-money laundering laws. Until now enforcement has been in the hands of Fincen, the financial intelligence arm of Treasury. Fincen's failure to enforce the FBAR requirement is a national scandal. The enforcement should be turned over to IRS and should be placed in the hands of a joint civil criminal task force.

Finally, we need to support, not oppose, the OECD's efforts to close these offshore tax havens, even though the Administration and some very powerful banks and corporations try to keep them open.

The offshore issue is central to the issue of a tax system based on voluntary compliance. If a large number of taxpayers can escape the system this way, we will lose an important component of our national life, the notion of equality under law and equal justice without regard to social status.

I commend the committee for its work in this area and I hope this hearing will be the beginning of a serious review of the issue.