

**THE CAYMAN ISLANDS AND
OFFSHORE TAX ISSUES**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED TENTH CONGRESS
SECOND SESSION

—————
JULY 24, 2008
—————



Printed for the use of the Committee on Finance

—————
U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 2008

58-198—PDF

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON FINANCE

MAX BAUCUS, Montana, *Chairman*

JOHN D. ROCKEFELLER IV, West Virginia	CHUCK GRASSLEY, Iowa
KENT CONRAD, North Dakota	ORRIN G. HATCH, Utah
JEFF BINGAMAN, New Mexico	OLYMPIA J. SNOWE, Maine
JOHN F. KERRY, Massachusetts	JON KYL, Arizona
BLANCHE L. LINCOLN, Arkansas	GORDON SMITH, Oregon
RON WYDEN, Oregon	JIM BUNNING, Kentucky
CHARLES E. SCHUMER, New York	MIKE CRAPO, Idaho
DEBBIE STABENOW, Michigan	PAT ROBERTS, Kansas
MARIA CANTWELL, Washington	JOHN ENSIGN, Nevada
KEN SALAZAR, Colorado	JOHN E. SUNUNU, New Hampshire

RUSSELL SULLIVAN, *Staff Director*

KOLAN DAVIS, *Republican Staff Director and Chief Counsel*

CONTENTS

OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance	1
Grassley, Hon. Chuck, a U.S. Senator from Iowa	3

WITNESSES

Brostek, Michael, Director, Tax Issues, Government Accountability Office, Washington, DC	5
Ng, Frank, Director, Large and Mid-Sized Business, Internal Revenue Service, Washington, DC	7
Blum, Jack, counsel, Baker and Hostetler, Washington, DC	8

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max: Opening statement	1
Blum, Jack: Testimony	8
Prepared statement	33
Brostek, Michael: Testimony	5
Prepared statement with attachments	41
Bunning, Hon. Jim: Prepared statement	123
Grassley, Hon. Chuck: Opening statement	3
“A Question of Calculation,” <i>Chronicle of Philanthropy</i> article by Peter Panepento and Grant Williams, February 7, 2008	124
Ng, Frank: Testimony	7
Prepared statement	130

COMMUNICATION

Maples and Calder	145
-------------------------	-----

THE CAYMAN ISLANDS AND OFFSHORE TAX ISSUES

THURSDAY, JULY 24, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Kerry, Salazar, and Grassley.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; John Angell, Senior Advisor; Josh Odintz, Tax Counsel; and Mary Baker, Detailee. Republican Staff: Ellen McCarthy, Tax Counsel; and Nick Wyatt, Tax Staff Assistant.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

The American poet Ella Wheeler Wilcox once wrote, "Feast, and your halls are crowded; fast, and the world goes by."

Today we will take a look at some ostensibly crowded halls, those of the Uglund House in the Cayman Islands. That is a remarkable 5-story building that the GAO tells us has some 18,857 tenants. Today we will examine whether many of those tenants are feasting at America's taxpayers' expense.

The last time that the press and the Senate looked at the Uglund House in 2004, it had 12,748 tenants. We asked GAO to go down and look for itself. Remarkably, in the last 4 years the Uglund House has found room for 6,000 new tenants without even adding a new floor.

GAO found some interesting things about the Cayman Islands. The Cayman Islands have a mutual fund or hedge fund for every five residents. The Caymans have two registered companies for every resident. And the Caymans have \$41 million in bank assets for every resident.

Plainly, there is a lot of financial activity in the Caymans. There is a virtual feast going on down there, and that has led to some crowded halls in the Uglund House. Up to half of those Uglund House tenants, about 9,000 entities, are Americans.

Of course, those Americans are not physically in the building. They are represented by computer files, some documents, and a handful of lawyers. Today we will hear a lot of complicated reasons for why those 9,000 Americans chose to conduct business out of the

Ugland House in the Cayman Islands, and today we will also hope to get some straight answers from witnesses about why they do so.

The answers have a lot to do with tax evasion. Offshore tax evasion costs Americans tens of billions of dollars every year, and that contributes to our Nation's \$345-billion annual tax gap, the difference between the taxes legally owed and the taxes timely paid.

We owe it to hardworking, honest taxpayers to make sure that their tax burden does not increase because sophisticated tax cheats moved dollars offshore. It is sometimes tough to identify which activity is legal and which is not. Transparency in offshore financial transactions is severely limited. The IRS is hobbled by limited resources, and tax haven countries are reluctant to dig into the activities of their offshore entities.

Good law enforcement can ferret out offshore tax evasion. For example, German investigators paid around \$7.5 million to an informant to provide a list of tax evaders in Liechtenstein, and the Department of Justice is mounting a strong effort to unveil the offshore holdings of dozens of U.S. citizens who have held assets overseas in the Swiss-based UBS Bank. We cannot just depend on good luck or foreign law enforcement. The IRS needs better tools to identify and shut down offshore tax evasion.

I am pleased to say the Finance Committee has already acted this year to shut down offshore tax abuse. We found that U.S. companies, companies like Kellogg, Brown, and Root, were using foreign shell corporations to avoid paying employment taxes. Under this scheme, the foreign shell "hires" American employees to provide services on behalf of the U.S. parent, i.e., Kellogg, Brown, and Root.

Because of its foreign status, the foreign shell company is not required to withhold or pay Social Security or Medicare taxes. This practice gives companies who do not play by the rules an undeserved competitive advantage. It leaves employees in the lurch at tax time because they have not been paying the taxes they owe during the course of the year.

I am pleased to say that this is one scheme that we were able to stop. We did so as part of the military tax bill that we enacted last month. The law not only requires that these foreign shells be treated like American employers, but they must pay their fair share of employment taxes. They cannot take advantage of unintended loopholes in the tax law, and they cannot shortchange workers and the U.S. Treasury.

I also want to thank Senator Kerry in this regard for his help in shutting down this practice. But we need to do more.

Today, Senator Grassley and I are announcing our plan to introduce six new measures that we believe will help curb offshore tax evasion. We should lengthen the statute of limitations, for example, for prosecuting individuals who failed to file a Foreign Bank Account Report; we should give IRS authority to enforce filing requirements for these reports; we should clarify the information that must be included in these reports; we should require taxpayers to file these reports with their individual and corporate income tax returns; we should revise the definition of "ownership" to include "beneficial ownership" of a corporation; and we should include in the tax code a section that causes the statute of limitations not to

expire before 3 years after the taxpayer furnishes the required information.

But we still need to do more. We also need to reform our tax code to make moving business offshore less attractive. That is a tall order, but I intend to focus the Finance Committee on necessary tax reform in the next Congress.

Let us take a look at the crowded halls of the Uglan House. Let us see whether many of its tenants are not feasting at the tax law's expense. Let us do what we can to ensure that the American taxpayers are not stuck holding the bill.

Senator Grassley?

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. Thank you, Chairman Baucus, for holding this very, very important hearing.

This committee has hearings that are enjoyable and productive, and it has hearings that are very enjoyable and very productive. I categorize this one as one of those that is very enjoyable, and I think will be very productive.

I say that from the standpoint that, when we find out that there are problems of people not paying taxes, there might be two reasons. One that is our fault. Maybe we have not written the laws in a finite enough way to make sure that revenues are collected that we intended to have collected, so people can, in a sense, legally avoid taxes. Then the other aspect of it is, those people who owe taxes and are illegally not paying their taxes. In either case, it is kind of regretful. But I feel the worst about the people who would go to the point of cheating 137 million other taxpayers in America by finding out what they can do to illegally not pay taxes.

So this is a very important meeting in regard to the Cayman Islands and offshore tax evasion. We need to give a great deal of thanks to the Joint Committee on Taxation for preparation of a pamphlet on tax evasion in anticipation of this hearing.* The focus today is to discuss the findings of the Government Accountability Office and their investigation into the Uglan House. Chairman Baucus and I asked the Government Accountability Office to investigate this house, a law firm's office building in the Cayman Islands and the registered home of many thousands of corporations.

The hearing will also examine the problems of U.S. tax evasion by taxpayers who hide their assets and incomes in foreign bank accounts and foreign entities. The tax code has reporting requirements to make the IRS aware of foreign activities of U.S. taxpayers; however, these reporting requirements are largely a matter of self-reporting. Since this information is self-reported, its accuracy is dependent upon the accuracy of the self-disclosure, and I would like to say the honesty of the person disclosing.

This is complicated further by the fact that some U.S. persons have been known to hide their assets in complicated webs of foreign companies and trusts. Information exchanged with other jurisdictions such as the Cayman Islands is an important tool for the

*"Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities," Joint Committee on Taxation staff report, July 23, 2008 (JCX-65-08), <http://www.jct.gov/publications.html?func=startdown&id=1274>.

U.S. Government to obtain information on its taxpayers. Our income tax treaties contain an article on information exchange, designed to help the government obtain quality information to enforce our laws.

Taxpayers who know the IRS can get access to tax information from foreign jurisdictions will think twice before willingly failing to satisfy the self-reporting requirements. I have been aggressive in combatting abusive tax shelters and offshore tax evasion. For example, the 2004 JOBS bill shut down the tax benefits for companies that enter into corporate inversions and abusive domestic and cross-border leasing transactions. In 2006, I got legislation passed that would increase rewards for individuals who blow the whistle on tax cheats and create an office at the IRS to coordinate such whistle blower claims.

These improvements were based on my experience with the False Claims Act, which I changed back in 1986, rewarding whistle blowers who helped the government find fraud in government contracting. This allows the IRS to take better advantage of whistle blower information that is often detailed "inside information." This is information the IRS may not otherwise have received.

I am pleased that many at the IRS and the Treasury now recognize the benefits of rewarding tax whistle blowers. It is vital that the IRS take full advantage of those who are willing to blow the whistle on tax fraud.

Now, as ranking member I saw to it that the minimum wage and small business tax relief package that passed the Senate last year also contained anti-tax loophole provisions, including shutting off tax benefits for corporations that inverted, shutting off benefits from abusive foreign leasing transactions, and doubling penalties and interest on offshore financial arrangements.

Finding tax cheats is a bit like a game of cat-and-mouse, only the mouse is hiding its cheese offshore. The IRS needs to be able to stay ahead of the schemers who hide their incomes offshore. Congress needs to continue giving the IRS tools to trap tax cheats. The chairman and I will be releasing a set of proposals that he has already talked about. So, I look forward to continuing this very enjoyable effort of more accurately rewriting our tax laws that we did not write accurately the first time, and then making sure that people who are cheating illegally do not cheat any more.

Thank you.

The CHAIRMAN. Thank you, Senator Grassley.

I now want to welcome our three witnesses. First, we have Michael Brostek, the Director of Tax Issues for the Government Accountability Office. Next, we have Frank Ng, Commissioner of the Large and Mid-Sized Business Division at the Internal Revenue Service. Third, Jack Blum, who is counsel at the law firm of Baker and Hostetler.

I would note that the committee invited UBS to send a representative today to discuss reports that its employees have helped U.S. citizens to hide assets overseas. UBS declined to attend. Next week, I intend to send UBS management a letter asking about their policy in handling the foreign accounts of U.S. citizens.

I thank all the witnesses who did agree to come today. As a reminder, all written statements will be automatically included in

the record, and I ask each witness to hold his remarks to approximately 5 minutes.

So, Mr. Brostek, you are first at the end of the table there to my left, so why don't you begin?

**STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ISSUES,
GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC**

Mr. BROSTEK. Thank you, Mr. Chairman, Senator Grassley, and members of the committee. Thank you for inviting me to discuss U.S. persons' involvement with Uglad House entities, what attracts persons to establish entities in the Cayman Islands, what information is available on U.S. persons' activities there, and the Federal Government's compliance and enforcement efforts.

As that board shows, Uglad House is solely occupied by the Maples and Calder law firm, which provides registered office services to approximately 18,857 entities—I say approximately because the figure changes over time—that are established in the Cayman Islands.

The firm's services are similar to those of corporate service providers in the U.S. Maples's partners estimated that about 5 percent of Uglad House registered entities are wholly U.S.-owned, and between 40 and 50 percent are U.S.-connected in the sense that they have a U.S. billing address.

The concepts of ownership and control are complex for most Uglad House entities because many are related to structured finance and to investment funds. For example, structured finance entities are not typically carried on a company's balance sheet, and ownership can be through a party, like a charitable trust, or spread across investors from around the world.

Investment funds may be established and managed by U.S.-based managers, but the funds are essentially owed by investors, again, possibly from around the world. U.S. persons commonly establish entities in the Caymans to gain business advantages, which can include minimizing taxes.

The Caymans' reputation for stability, a business-friendly environment, a familiar legal system, and prominence as an international financial center, underpin its attractiveness to businesses.

U.S. persons may establish Cayman entities to attract foreign business, such as when, for political, regulatory, or tax reasons, foreign business partners or foreign investors prefer not to do business in the U.S. itself.

U.S. persons can also obtain legal tax advantages by establishing or investing in Cayman Islands entities. For example, U.S.-based corporations may legally reduce their taxes by holding foreign active business income in the Cayman Islands, in Cayman entities, and either not repatriating it or doing so when the income would be minimally taxed in the U.S.

U.S. tax-exempt investors, like pension funds or university endowments, can maximize their investment earnings by investing through a Caymans' corporation because the dividends are not subject to U.S. unrelated business income tax and the Caymans do not tax corporate income. In a small number of the cases that we found, Cayman entities were used for illegal tax evasion by U.S.

persons, but we do not have an estimate of the dollars that were involved.

The U.S. Government has access to several sources of information about U.S. persons' activities in the Caymans. Much of this information is self-reported, and its completeness and accuracy cannot be easily verified. In addition to self-reported information, U.S. officials, when they have sufficient identifying information, can formally request information on U.S. persons' Cayman Islands activities under a recently implemented Tax Information Exchange Agreement and a Mutual Legal Assistance Treaty.

U.S. and Cayman regulatory officials have also coordinated to share financial intelligence information. U.S. officials consistently told us that the Cayman government has been cooperative when they have made requests, and have shared useful suspicious activity information at their own initiative.

Across multiple jurisdictions, IRS has targeted abusive transactions in such areas as hedge funds, offshore credit cards, and promoters of offshore shelters. The extent of Cayman Islands entity involvement is unclear, however, because jurisdiction-specific information is not compiled.

IRS officials did tell us that, in 45 instances over the past 5 years, its field agents have requested information regarding suspected criminal activity of U.S. persons in the Cayman Islands, or involving the Cayman Islands. U.S. officials also said that there were fewer criminal investigations involving the Cayman Islands than for some other offshore jurisdictions.

The use of multiple entities in multiple countries is one of several enforcement challenges that U.S. law enforcement, and the IRS in particular, faces. Others include the amount of time it takes to do investigations when individuals are trying to hide the ball behind multiple foreign entities, and because the IRS cannot seize assets that are in another country.

The Cayman government has taken steps to meet international standards and has been cited by the Caribbean Financial Action Task Force and the International Monetary Fund for its compliance initiatives. Maples's partners told us that they perform the required due diligence and have provided suspicious activity reports in some instances. However, they note that the responsibility for compliance with U.S. tax laws lies with those U.S. taxpayers who create and use Cayman entities.

Before closing, I would like to acknowledge the extensive cooperation and assistance that we did receive from both the Cayman Islands government and from the Maples and Calder law firm. As you know, we were dependent on their cooperation in gathering the information that is presented today, both in my testimony and in the report that is being released at this time.

This concludes my oral statement. I would be happy to answer any questions you have.

The CHAIRMAN. Thank you, Mr. Brostek, very much.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Mr. Ng?

STATEMENT OF FRANK NG, DIRECTOR, LARGE AND MID-SIZED BUSINESS, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. NG. Good morning, Chairman Baucus, Ranking Member Grassley, and members of the committee. My name is Frank Ng, and I am the head of the IRS's Large and Mid-Sized Business Division, responsible for the IRS international administration strategy and programs.

Thank you for the opportunity to appear before you today to discuss an important critical issue of tax administration in this country: the practice of shifting and sheltering income and hiding assets in foreign jurisdictions as a means of avoiding and evading U.S. taxation.

At the IRS, we are very concerned with the recent identified patterns of tax evasion through the use of offshore accounts and firmly believe that it is the responsibility of every taxpayer to properly file and pay their tax obligations. We will continue to take every effort to ferret out offshore tax abuse and evasion. Ensuring compliance with the international aspects of the U.S. tax law is a high priority at the IRS.

We have strengthened our organizational focus to address these tax administration challenges with the development of the first comprehensive service-wide strategy on administration of international matters, one that integrates the international perspective and all of our business unit strategies and processes.

With increasing globalization, virtually every large business return, as well as returns of many small companies and individuals, has international features due to the ease of cross-border transactions. Today, the IRS has approximately 1,500 employees focused primarily on international compliance activities, which include international examiners, economists, attorneys, criminal investigators, and others. Developing a sustainable group of skilled technical employees to handle the wide range of complex international issues is a key priority for the IRS.

The IRS has targeted specific tax issues as an area of emphasis for international tax compliance attention, and these issues are subject to mandatory review by our compliance personnel. For example, five of our corporate priority issues are international issues involving billions of dollars. In addition, we have significant ongoing civil and criminal activities related to individuals failing to properly report income and hiding assets in offshore accounts.

This morning I would like to hit on some of these tools we have in place to combat offshore non-compliance and what Congress could do to help assist us as we move forward.

The first of these tools is tax return and information reporting obtained from tax forms routinely filed by our taxpayers. The second is our qualified intermediary program. This program was created in 2001. Under this program, foreign financial institutions voluntarily agree, by contract directly with the IRS, to act and operate as a withholding agent, subject to the sitting requirements. To date, we have 7,007 QI agreements, of which 5,660 are currently active. The QI program is critically important to sound tax administration in a global economy, but it needs some updates and modifications. My written statement addresses some changes and modifications to the QI program that we are currently considering.

The third tool we utilize is our tax treaties and tax information exchange agreements with other countries. We currently have agreements for information exchange with 73 jurisdictions and have expanded the program in recent years to include offshore jurisdictions such as the Cayman Islands and the Bahamas. We continue to expand the number of countries with which we have agreements, as well as renegotiating other agreements, such as the U.S. Belgian Tax Treaty, to improve information exchange.

A fourth tool that has been particularly effective is the use of informants. Informants have been a valuable source of information for IRS's civil and criminal investigations in the offshore tax evasion area.

The final tool I mentioned to fight offshore evasion is the use of information we will receive from the use of "John Doe" summonses. The IRS generally uses a John Doe summons authority to identify individuals, groups, or classes of U.S. taxpayers whose identity is unknown, who are involved in specific areas of tax non-compliance and cannot be identified through any other means.

Congress has an important role in this arena as well. We urge that the administration's request for the IRS's annual budget be fully funded. We need the necessary resources to continue to address many of the issues that I have discussed.

Another area where Congress could help is to allow more time to help us conclude these investigations. Currently, the statute of limitations is 3 years. However, as you can see, many of these cases are very complex and often take additional time.

Finally, it is important that Congress continue to support and strengthen our network of tax treaties and information exchange agreements. They provide a basis for exchanging critical information.

Mr. Chairman, you and the committee have been on the forefront in pursuing important areas of Federal non-compliance, and we support your efforts. Thank you, Mr. Chairman. I would be happy to respond to your questions.

The CHAIRMAN. Thank you, Mr. Ng.

[The prepared statement of Mr. Ng appears in the appendix.]

The CHAIRMAN. Mr. Blum?

**STATEMENT OF JACK BLUM, COUNSEL,
BAKER AND HOSTETLER, WASHINGTON, DC**

Mr. BLUM. Good morning, Mr. Chairman, Mr. Ranking Member, members of the committee.

I listened to the comments about Uglan House and must say to you that Uglan House represents the best of offshore because the Cayman Islands actually keeps better records than most of the other jurisdictions and has fewer corporations. If you really want to worry about things, look at the British Virgin Islands, with 500,000 corporations, no records on any wall. You cannot go to a place and find an office, because there is none, and no regular records to find out who currently owns the corporation.

You could go to the Island of Nevis, and you will not even be able to find an address for the corporation. There are, on Nevis, nominee shareholders, directors, officers. If you were to take those people, send them to Guantanamo and waterboard them, you could not

find out who owned the corporation or what the corporation was doing.

Now, this would all be kind of an amusing matter but for the fact that there is an industry that is operating that creates structures based on these entities: trusts, offshore corporations, bogus insurance policies. They tell Americans, look, you do not have to pay tax, we will get this sufficiently scrambled up in a sufficient number of places so that nobody will be able to follow the trail.

There are banks that do this for a living, a lot of them, major banks. You have, in the hearings of the Permanent Investigation Subcommittee, laid out very clearly the saga of LGT Bank in Liechtenstein, the kinds of structures that they put in place, the way that their people sat and counseled with the very rich to figure out how to set up a structure that would conceal their assets.

Now, you have to ask, well, how can they do this and how can they get away with it? A lot of this goes back to the common law revenue rule that came about during the Napoleonic wars when a British port decided that it was all right for private parties to cheat French customs without violating British law.

Since that time, around the world that has become enshrined as doctrine. It is in the restatement of laws, it has been repeatedly argued in American courts, it is why no American tax judgment is enforceable anywhere in the world outside of the United States. Now this, in the kind of world we are in, is insane.

The CHAIRMAN. Would you repeat that again, that common law tenet? Repeat that one more time, please.

Mr. BLUM. All right. The revenue rule is that the only time that tax laws are enforced are within the border of one's own country, and that it is perfectly all right to run a business helping people cheat taxes in other jurisdictions. So as a result, we have people in the United States who run the business of helping Mexicans cheat their government of Mexican tax. In a case that I worked on, someone had a problem and wanted to hide money offshore. They went to a Philadelphia law firm that referred the guy to their London office. The London office had no problem setting up the structure.

Now, this is madness in a world where there is instant communication, where there is the opportunity to create virtual entities and a kind of virtual reality, and where information exchange is limited in ways that are quite amazing. So, for example, we have these wonderful MLATs, but they are perfectly useless, because to use an MLAT you have to know what the MLAT would give you.

The CHAIRMAN. Use a what?

Mr. BLUM. They are useless.

The CHAIRMAN. Use a what?

Mr. BLUM. The MLATs, Mutual Legal Assistance Treaties.

The CHAIRMAN. All right.

Mr. BLUM. The deal is, if I know that you have an account in the Cayman Islands, I can go to the Cayman Islands government, only in a criminal case, and say, "Guys, we know that Senator Baucus has an account in the Caymans, get the records," and they will. They might send them even by Federal Express because they are protecting the 20,000 other people whom the IRS does not know about. That is how these treaties have worked. We have an extra-

dition treaty with Liechtenstein. I would bet anything that Mr. Schtagel, who has been indicted in connection with the UBS case, will never be extradited.

This is the kind of problem we have. We have to really begin to look at the revenue rule and begin to look at the full global scope of this problem, because it has implications way beyond the borders of the United States. It is bad enough that we are losing, I would guess, well over \$100 billion a year in revenue, but, if you look at some of the problems on our borders—for example, Mexico, where there is a drug war that is going on, violence all over the place, corruption beyond belief. The Mexicans cannot solve their problems if their people are cheating. There should not be a global industry helping people cheat on tax.

Finally, this is the most profitable area of banking, because the bankers who do this, the private bankers who do this, are able to make more money on people who are hiding money than they can on normal customers. There are much more interesting services that they perform, they can charge much higher fees, and in effect they are capturing some of the lost tax revenue, which is why it is going to be very hard to get some of these banks to give up.

Finally, there is a problem here. The problem goes way beyond the issue of tax. All financial regulation is put in jeopardy by the kind of arrangements we have allowed to come into being. That is the kind of problem we have had with regulating the mortgage markets, regulating the hedge funds. It is a problem of allowing virtual reality to become the rule. That is something we cannot permit. We cannot assume that companies in offshore jurisdictions are real. We have to say, prove to us that there is a management, that there are real people, that there are people who have fiduciary responsibility, and they are doing their jobs, if we are to take a corporation as a valid entity.

Thank you. I will be glad to answer any questions.

The CHAIRMAN. Well, I guess we thank you. [Laughter.] We do thank you.

[The prepared statement of Mr. Blum appears in the appendix.]

The CHAIRMAN. I would like to just hold up a chart here which kind of gets at what you are getting at, Mr. Blum. I know you cannot read it, but I will read it for you. Essentially, this is off the web site of a bank, it might even be in the Caymans. It is Butterfield Bank. They list their services, what they provide, et cetera. One of the services I have highlighted in yellow there—we printed it down at the bottom here—one of their services is to “provide nominee shareholders.” This is to ensure that shares are not registered in the beneficial owner’s name. That is obviously a way to hide the true owner of the assets or the account in the Caymans in a certain bank account.

So, Mr. Blum, I think it sounds like you have a pretty good idea of the scope of the problem here. So the obvious question is, what are some of the solutions? How do we begin to get at this? One, two, three, how do we begin to get at this?

Mr. BLUM. There are some simple steps, the first of which is, never should anyone be allowed to file a W-8 with IRS that has the name of a corporation in one of these tax haven countries and say that that is the beneficial owner of the account, which is what

the law now permits. If you go to the instructions for section 1441, it says that “if a financial institution has actual knowledge or has reason to believe that a false W-8 has been filed”——

The CHAIRMAN. And just to refresh our recollection, what is a W-8?

Mr. BLUM. The W-8 is the form that gets filed by a foreign entity so that it can take advantage of tax treaty and foreign tax status.

The CHAIRMAN. All right. So the solution with W-8s is what?

Mr. BLUM. Do not accept shell corporations as beneficial owners. Section 1441, in effect, allows people to fill in the name of a Cayman corporation and say that is the beneficial owner. At that point, IRS is flat stuck. That is idiocy.

The CHAIRMAN. So what do we do to change that?

Mr. BLUM. You very simply say that any corporation that cannot show real business activity in a location cannot file a W-8 as a beneficial owner. You have to then go beyond that and say who owns the corporation. You can make exceptions for public corporations, you can set certain size tests in there, but you really have to get the beneficial ownership.

There are tens of thousands of brokerage accounts in the U.S. in the name of BVI corporations, Nevis corporations, every one of these offshore places that is in the incorporation business. They do their business in the U.S., happy in the knowledge that IRS only has the corporate name and nothing more.

The CHAIRMAN. Can you just kind of outline a little more for us, what could a person, an American citizen, do? One who is not required to disclose beneficial ownership? Why would somebody not want to disclose beneficial ownership?

Mr. BLUM. Well, there are multiple reasons. In the cases—and many of them I have worked—one reason is obviously tax. But in a number of the other cases, it turns out that they are involved in other criminal activity—offshore credit card stock fraud, penny stock manipulation, various confidence schemes. One of the stories that I think is very striking is when I was consulting with IRS on the offshore credit card project. IRS worked out an arrangement with the State of California and the District Attorney’s Office in Manhattan to turn over leads which IRS could not follow up on.

The Manhattan D.A.’s Office got the list of leads and discovered about half of them had outstanding warrants or investigations of various forms of criminal activity and financial fraud. So there are multiple reasons for concealing this ownership. There may be some legitimate reasons, but believe me, the legitimate reasons are far outnumbered by the tax and other motivations.

The CHAIRMAN. You kind of touched on it. Are there any down sides to requiring beneficial ownership disclosure?

Mr. BLUM. Not that I am aware of. I would venture to say that you could bring some people in and ask them, but I cannot see it.

The CHAIRMAN. Why not just go to the heart of the matter and require that any U.S. citizen who transfers assets overseas has to file with the IRS a disclosure form of some kind? All of us have our W-2s.

Mr. BLUM. Yes. Well, we do have that requirement. We have—I cannot remember the form name. I think it is 371, or whatever. But you are required, when you are transferring assets to an off-

shore corporation, to file a form. That, for the most part, is not enforced.

The CHAIRMAN. Why?

Mr. BLUM. How do you do it? How do you match the activity that has been reported with a tax return, and then begin an audit to figure out what has happened? This is just too difficult an undertaking. This is part of the entire tax problem in offshore. The entire U.S. tax system is built on auditing returns that are filed with the U.S. Government. The problem here is not what is on the return, is it correct or not correct. It is what is not on the return.

Those cases are incredibly difficult to build. The way we go about it now is to use all kinds of external information, stuff that comes in through depositions, Information Document Requests, various other forms of discovery, public databases, to get to the people so they understand that they are people who have evaded taxes. That is a very difficult process. To go through and match and put all this together and then begin an investigation without more, is really way too difficult. It is not only in that arena, it is in the arena that requires tax returns from corporations owned or controlled by Americans. I believe there is tremendous under-reporting in that area as well.

The CHAIRMAN. Let me ask this. My time has expired.

Senator GRASSLEY. I would not mind if you continued along this line, if your colleagues over there do not mind, because I think this is very interesting.

The CHAIRMAN. If the Senators will indulge me, I will be very quick here.

What about this as an idea: U.S. entities that transfer funds to foreign accounts on behalf of an individual must issue an information document to the IRS and FinCEN—that is Treasury—and the individual must report the cumulative gross dollar amount of funds transferred during the calendar year.

Mr. BLUM. It is a good idea. The problem here, again, will be enforcing it.

The CHAIRMAN. How do we get around the enforcement problem?

Mr. BLUM. The issue would be getting the financial institutions that do the transferring to file the reports. So, if there is a wire transfer out to an offshore jurisdiction and an offshore entity from an individual, perhaps they file some sort of electronic report of that transfer, and perhaps it should be limited to a certain dollar amount so we do not capture a lot of noise.

The CHAIRMAN. But something along these lines, you think, makes some sense?

Mr. BLUM. Could be, yes.

The CHAIRMAN. All right. Thank you. My time has expired. Thank you.

Senator Grassley?

Senator GRASSLEY. Mr. Ng, during our budget debate we heard arguments that billions of dollars would be raised from tax revenues allegedly hidden in the Uglan House. Your testimony states that you cannot quantify the magnitude of the tax evasion through the use of offshore entities and accounts. So my question: would you not agree that there is no evidence available to base that allegation and to quantify the amount?

Mr. NG. Senator, I would agree that it is very difficult for us to estimate the level and the amount of non-compliance because, keep in mind that many of these organizations and entities operate in the Cayman Islands or in low- or no-tax jurisdictions and, as Mr. Blum commented, do it with us not able to detect the kinds of activities in their reporting.

Under the IRS laws and regulations there are a number of requirements in terms of information reporting, but quite often, when people choose to hide assets and not report income, they do not properly file and report. So what we have chosen to do is really to focus on the kinds of activities in terms of where we believe there is potential compliance risk.

As we look at the Uglund House, when I see 18,000 entities, potentially 9,000 with respect to U.S. companies or U.S. persons, I am concerned, as a tax administrator: why are companies operating in the Cayman Islands?

While we recognize that taxpayers and citizens have the right to operate in global trade, really, at the end of the day, our focus is around: what is the right amount of tax that they are reporting to the U.S. Government? So we look at the size—and not necessarily trying to estimate—looking at specific instances, looking at specific issues, and looking at specific approaches to groups of taxpayers that may choose to minimize their tax administration responsibilities.

When we look at complexity of law and complexity of transactions, in this age today when you have the ability to move funds across borders easily, it raises the question of the ability, the easier ability, to manipulate transactions and to minimize your tax, and in some cases, even evade your taxes.

Senator GRASSLEY. On another point, your written testimony states, Mr. Ng, that an important tool in the IRS arsenal for fighting tax evasion would be for Congress to enact legislation requiring merchant card issuers to report annually on reimbursement to business entities. The Senate passed the merchant card reporting proposal in the Housing Recovery Act earlier this month. Certain groups, however, have claimed that the merchant card reporting proposal is a violation of taxpayers' privacy. Could you comment on whether or not it is an invasion of taxpayers' privacy?

Mr. NG. Senator, I would say that, in terms of third party reporting to the government, it really is a benefit in terms of deterrence to tax avoidance/evasion. And on the issue of the challenge to taxpayer privacy, the answer is no. We would get no information about the cardholders who made the charges or what they purchased with the payment cards. We will be getting aggregated information about a merchant's gross receipts from having accepted payment cards in payment for goods or services.

Senator GRASSLEY. Mr. Brostek?

Mr. BROSTEK. I just thought I would mention that all of us who have W-2 statements that are filed with IRS, or Forms 1099 on our interest or dividend income, have our privacy circumscribed by those requirements. The reporting that is being suggested by the administration on merchant credit card receipts is roughly akin to the kind of reporting that occurs on most individuals now.

Senator GRASSLEY. All right. Mr. Brostek, I have a question for you, and then this will be my last one because my time is up.

GAO found that the large majority of offshore tax evasion is among individuals, small businesses, and promoters rather than large, multinational corporations. Why do you think this is so? Before you answer that, the GAO report also found that multiple entities are frequently used to obscure individual taxpayers' activities and evade taxes. Are you aware of any legitimate reason individual taxpayers would have for forming multiple entities?

Mr. BROSTEK. On the first point, I would be very careful about going too far with our information. What we have are 21 cases that we were able to find that involved Cayman entities where there were some tax or other criminal violations involved. I do not know that the characteristics of those cases are necessarily common for all the types of evasion that might be occurring. They are just the ones that we know about.

Regarding why it would be smaller individuals or entities that are involved, one possibility is that this could be people who have a lot of cash income who would like to not report that to IRS and perhaps not make it available to others for other legal proceedings, like divorce actions. It is also possible that larger organizations, multinational corporations, focus more on legal provisions that can reduce their taxes in order to minimize their taxes, maybe the less certain areas of tax law where they can take an aggressive position that maybe will be challenged by IRS, but maybe not. So those large corporations have other techniques besides hiding the ball to help reduce their taxes.

Senator GRASSLEY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thank you very much for holding this hearing. I think it is critically important.

In a previous life, I was tax commissioner of my State, and for two terms chairman of the Multi-State Tax Commission. During the Reagan administration, I served on a commission on the taxation of multinational corporations. So, I have spent a significant amount of time on these very issues and, during my time as tax commissioner, was responsible for overseeing the audits of hundreds of multinationals.

Somebody might wonder why somebody from North Dakota would be engaged in looking at the books and records of large multinationals. It turns out, North Dakota is a large oil and gas State, so we have a nexus with many large oil and gas companies, as well as grain companies. I can remember very well one audit that we did pursuing a grain company, and we found the grain traded hands about a dozen times before it left the United States, one shell company to another shell company. It finally disappeared offshore. We could no longer pierce the veil when it got to the Caymans. This was not done for a business purpose, this was done for the purpose of avoiding and evading legitimate U.S. tax.

So this is not an academic question to me. I have seen it with my own eyes. I have seen it repeatedly. I have seen it in very, very substantial amounts. I may still be bound by certain settlement agreements that I entered into when I was tax commissioner, so

there are things I cannot say. What I can say is, it was shocking—I mean, absolutely shocking—what I saw going on. There is absolutely no question, none, that this was done to avoid and evade legitimate U.S. tax.

On the question of how big this is, the ranking member of the committee references statements. I think he is probably referring to statements I made on the floor, that there are hundreds of billions of dollars involved here. I do not think there is any question about that, none.

Why do I say that? Well, we have the Permanent Subcommittee on Investigations, who have determined in their belief that it is \$100 billion a year that we are losing. This is just on offshore tax havens. One hundred billion dollars a year. If you pierce the veil, you read this story, they talk about UBS alone having \$20 billion in assets in undeclared accounts for U.S. taxpayers. That is one financial entity that has \$20 billion in undeclared accounts. Why are they undeclared? They are undeclared for a reason. The reason is, they do not want to pay taxes. They do not want to pay their U.S. taxes.

Now, how do we know that? Well, let us go to the Web. It is very instructive to go to the Web. It is amazing what you find. Punch in “offshore tax havens.” Here is what you will find. The last time I gave a speech on the floor, I thought you would get a million hits. Not any more. Now it is almost 2 million offshore tax havens.

And let us go and let us just read what they are telling us. This is not hard to figure out, because they are telling us what they are doing. It is right there for anybody to read who cares. What do they say? “Index of offshore investment resources.” This is my favorite: “Your money belongs to you and that means it belongs offshore.” “Live tax-free and worldwide on a luxury yacht.” “Moving offshore and living tax-free just got easier.” “Live tax-free and worldwide on a luxury yacht.” Then they say, “Exciting stuff.” That is exciting stuff. You know, the problem with it is, all the rest of us, the vast majority of us who pay what we legitimately owe, are getting cheated, and we are getting cheated big-time. This is not academic to me. I have seen it with my own eyes. I know this is going on, and it has grown dramatically since I was in the business of trying to enforce tax laws.

I would ask you, Mr. Blum, do you think this is a minor issue, or do you think there is a hemorrhage going on?

Mr. BLUM. It is a huge issue. There is a hemorrhage going on, there is no question about it. The amazing thing is, even though there have been sporadic attempts to bring it under control and some valiant efforts by people inside IRS, the problem grows rather than shrinks.

The CHAIRMAN. Why does it grow? That is astounding. IRS should be doing their job. I am astounded, frankly, that they have not asked for more tools to do their job better. Why are they allowing it to grow?

Mr. BLUM. It is not that they are allowing it to grow, as much as this—

The CHAIRMAN. In effect, they are.

Mr. BLUM. First of all, very few people are aware that people do get caught and penalized. Because of 3106, all of the civil settle-

ments are kept secret. As a consequence of that, the success of the offshore credit card project, which brought in thousands of people who were cheating offshore, is absolutely hidden from public view. The people who were caught in that have simply gone about their business, and the people who are the purveyors of offshore schemes have said, hey, the project failed, not many people got caught, why do you not go about doing it with us?

So I suggest you amend 3106 to make public settlements involving offshore cheating, period, and not tie this up in secrecy, so that people know, when salesmen come calling, that this is not something you can get away with. Point two—

The CHAIRMAN. I am sorry to intrude on my colleague's time, but why is that not public today?

Mr. BLUM. Because of the secrecy provisions of 3106.

The CHAIRMAN. Well, why were they enacted in the first place, and what is the down side of repealing it?

Mr. BLUM. The secrecy provisions are part of what happened when Richard Nixon politicized the Internal Revenue Service, and that was Congress's response. But the response was quite Draconian. I think it is time to take a look at that, rethink it, and understand the importance of deterrence. Now, deterrence is the name of the game, because there is no way, in law enforcement, you are going to catch everybody. What you have to do is persuade people who would otherwise be tempted to be dishonest that crime does not pay. The way you do that is making public convictions, and in this case, making public various settlements and other agreements with IRS involving offshore schemes. They have to know that—

The CHAIRMAN. Off the top, that sounds like a great idea.

Senator Conrad, I am sorry to have taken your time.

Mr. BLUM. There is a second part.

The CHAIRMAN. Let us get the second part, here.

Mr. BLUM. The second part is, to answer your question, it is growing because there are salesmen who are selling it. Now, you have up there the Bank of Butterfield. I happen to have run into the Bank of Butterfield more than 20 years ago, working for a client, believe it or not, in the Cayman Islands. What I learned was, Butterfield regularly sent salesmen into Florida, selling their services, their offshore services, to U.S. citizens. They regularly called on lawyers all over Florida to tell people, this is how you get around estate tax, this is how you get around gift tax, this is how you get around income tax. At the time, Butterfield was carefully structured—I am not sure where they are today—so that they were in Bermuda, Bahamas, Caymans, Jersey, and had a representative office in the city of London, but clearly out of subpoena reach of the U.S. authorities.

Senator CONRAD. Can I just conclude on my time? In an attempt to answer part of the chairman's question, here is what I found: it is almost impossible to pierce the veil, no matter how skilled your people are, when you have a circumstance in which one company may have hundreds of subsidiaries around the world, and they sell from one, to another, to another, to another and make very little profit in these transactions where there are taxes, but, when they get offshore and they get into tax haven countries, all of a sudden they show substantial profits. What the IRS has to try to do is

recreate arm's-length transactions between all of these entities. I will tell you, it is almost an impossible task.

The CHAIRMAN. Well, I am sorry. This is unconventional, how we are conducting this hearing. How do we answer that one, Mr. Blum?

Mr. BLUM. Which?

The CHAIRMAN. All the layers.

Mr. BLUM. The layers. Well, again, it is: do not recognize them. We have a terrible penchant for accepting bogus entities as real and following paper trails that do not mean anything. I would say, shift the burden so that, if somebody comes in and says, hey, this was the structure and this is how we do business, what they would have to do is demonstrate to the IRS that there is a real business behind whatever the entity happens to be. The minute you do that, the whole thing falls down because, when you look at these offshore corporations and trusts, there is no business.

The directors do not know what the company does, the shareholders have no idea that they are shareholders, and the same 20 people are the directors of all 30,000 corporations registered in Nevis. It really is a bogus set-up, so why do we treat it as real? In the documents, in the Liechtenstein documents, there was actually a list of countries whose corporations would be automatically accepted as real entities. These are corporations that perhaps could be used in their structuring.

Now, why would we accept those corporations as real unless the government involved insists that there be real business entities? We have to just make it plain that shells are shells and we are going to disregard them, no protection.

The CHAIRMAN. Thank you very much.

I apologize to the members here. Senator Kerry, you are next. You have been very, very patient.

Senator KERRY. No, that is fine. I think it is important to get it out.

Mr. Chairman, thank you for having this hearing. I appreciate that you and the ranking member are focusing on this. I appreciate the comments you made in your opening statement about the effort we made to close the abusive offshore havens on the KBR effort. The KBR effort is just a tiny piece at the top of this pyramid. Jack Blum and I worked on this for a long time. I hired him as the counsel to our committee when we looked at this issue in the late 1980s and early 1990s. We then discovered the BCCI Bank, with billions of dollars of fraud. This was the late 1980s.

That effort led to the negotiation of agreements with Panama and Venezuela for banking transactions to try to track some of this money, particularly focusing on drugs, narcotics, and money laundering, but also we discovered back then the name of one Osama bin Laden, who had accounts with that bank. What people do not understand is, this is not just a tax issue, Mr. Chairman. This is a national security issue. It is also an issue that goes to the fundamentals of governance.

I remember, after Mr. Blum came back from some of the discoveries that we put together, I went to meet with the Governor of the Bank of England, precisely because of the problem we had with these offshore havens. The Cayman Islands are British territory,

and they work under their banking rules. Frankly, those laws are soft, unbelievably, purposefully enhancing these kinds of hidings of wealth and havens. Here, you have this island area, 1.5 miles, something like that. It is about the size of Washington, DC. There are 47,000 residents, a lot of water, a lot of sand, not a heck of a lot of production of anything.

Yet, you have, what is it, 277 licensed banks, over 80,000 registered companies, more than 9,000 registered investment funds, 760 captive insurance companies, and, according to the Department of Treasury, U.S. investors held \$376 billion in Cayman-issued securities. Now, what is that about? Do they do something in the Cayman Islands you cannot do in New York, or London, or Singapore, or Shanghai? It is absurd. What Mr. Blum just said is the nub of this. We treat these things with legal justification. There is no fundamental purpose in that, other than hiding wealth, moving it, getting into all these corporate entities where you cannot pierce the corporate veil, and we are trapped. The problem is, the American taxpayer picks up the difference. The average person in this country who cannot do this, who does not do this, does not even know about it, pays the difference. We are losing, unbelievably, billions of dollars of revenue.

Right now, we also need to close—and I hope we can do this before October. Representative Rahm Emanuel and I have a provision to prevent CEOs and hedge fund managers from deferring unlimited amounts of compensation offshore, which is what they do. The sole purpose: evading taxes. So, Mr. Blum, let us kind of get at the heart of this thing.

Mr. Ng, I have to concur with the chairman here. It really bothers me that the IRS—I know you are working behind the 8 ball. You have a budget and you have too few people, and it is very, very tough stuff to track and put together. But I do not see the focus. I do not see the request for the resources. I do not see the sort of urgency of legitimizing the tax structure by which most Americans operate.

What happens when you do not do that—and you know this—is the underground economy in our country grows. More and more people go work off the books, and they find a way to do cash transactions and work off the books because they see everybody at the top able to get away with it. They say, what the hell, I am going to do the same thing. So, how much is the underground economy? Do you know, Mr. Ng?

Mr. NG. Well, our general tax gap number of \$345 billion includes a wide range of potential unreporting of income in all categories.

Senator KERRY. Three hundred and forty-five billion? When was that?

Mr. NG. That is based on the most recent—

Senator KERRY. That is an annual figure?

Mr. NG. Yes.

Senator KERRY. So, if you have an annual figure of \$345 billion, once again, what would that represent, in your best estimate? That taxable income, what would that represent in revenue to the United States?

Mr. NG. Well, Senator, I would put it in the context of this, that the tax gap is kind of just a projected estimate based on some studies that have been done over the years in terms of—

Senator KERRY. It is getting bigger, not smaller.

Mr. NG. I would suspect that it is.

Senator KERRY. You only suspect?

Mr. NG. Well, I believe what we are trying to do in terms of trying to address the issue that the committee is talking about today is really to give you the assurance that we are doing a great deal of activity in trying to tackle this issue.

Senator KERRY. But you see, it is not on the G-8 agenda. If you do not get other countries with major financial centers agreeing to leverage the transparency and accountability, this is just going to remain a game. There is nothing that can be done here if you do not have a global agreement about transparency and accountability.

Is that accurate, Mr. Blum?

Mr. BLUM. I think so. I think there are some things that you can do. So, for example, we have a hedge fund problem. Hedge funds are in Connecticut, the managers are in Connecticut, the shareholders are in the United States, but they are Cayman Islands companies. Excuse me, that is ridiculous. If the business is here, the people are here, and the transactions are here, they ought to be U.S. taxpayers. You should not respect that offshore entity.

So there are things we can do for some of it unilaterally, but I quite agree that the international agreement is essential. This business that I talked about, namely the revenue rule, that is, that it is all right to help people of another country cheat their government, really is something that has to be taken down as an international premise. We have to get to the point where we work together.

I have talked to the revenue commissioners of India and the Finance minister of Mexico in the course of my work. In fact, I was on a panel at the U.N. with the revenue commissioner of India, who was saying this is a huge problem for India because they do not have the revenue for their infrastructure. What happens is, in these countries we make that up with foreign assistance, with World Bank loans, and that money comes flowing into offshore accounts.

Senator KERRY. But once you get a network, you do not need a lot. Once you get a string of places where you have this obfuscation and this ability to create these veiled entities, the commingling of funds becomes very, very complicated because you put—one pot of money comes in and marries another pot of money, which marries another pot of money in another deal, in another country, and then they move it all together under some holding company and put it into another country where you do not have accountability. Then the string goes on.

Mr. BLUM. That was in the Liechtenstein documents, where the plan for moving the money was laid out. We will put it into accounts in a Canadian company because IRS will not suspect Canada, and then we will put it into a concentration account, and then we will move it into the accounts in our bank. It is all laid out.

Senator KERRY. So does that mean that what you really need is some kind of computer tracking ID number that is attached to the movement of any particular money, where you can break it out and there has to be a tracking system? What is the method here?

Mr. BLUM. There are several different areas here. One of them is, on wire transfers from outside the United States, there have to be rules that require the identification of the source of the incoming wire. An incoming wire should never be allowed to say "from one of our valued customers." That is what banks now do to conceal the source of the money coming in.

Second, there are now suspicious activity reports that are filed by banks and brokerage firms, but those suspicious activity reports are not available to the civil side of IRS. That is a huge mistake. That is the best single source of information about offshore tax evasion. That is a very simple thing to fix, and it is an administrative fix. I know that there have been people who have been advocating for it, but for some reason it has not happened.

Senator KERRY. Some people have made an argument—Mr. Blum, I think we ran into this back in that period—that in some countries where you have a particularly brutal dictator or particularly oppressive regime, there may be good folks who have a legitimate reason to want to be able to move some money and hide it and keep it from the bad folks. What do you do in the situations where there may be a human rights and/or other interest in some kind of secrecy?

Mr. BLUM. Well, we have political exceptions and extradition treaties. There are ways to deal with this problem. The problem now is that it is the universally accepted business that you do not report and you keep everything secret. That should be the exception, not the rule. It should be based on the individual case, not as a general principle of, it is all right to help anybody who wants to hide money do it.

The CHAIRMAN. Senator Salazar, you are next.

Senator SALAZAR. Thank you. Thank you very much, Senator Baucus.

Let me also, just at the outset, say that it is a great part of being on this committee to have people like you, Senator Baucus, Senator Grassley, Senator Conrad, and Senator Kerry, who know so much about this very, very important issue. It is an issue obviously that has been around a long time, and it is an issue that obviously is looking for some kind of a cure here.

I want to just say at the outset, having a fair tax system, I think, is something that we can all agree on. It is not a Republican or Democratic issue; it is something that we just need to make sure is there as an underpinning of one of the fundamentals of our tax code here in this country.

Second of all, I have been a supporter of Senator Conrad and his whole effort on pay-go here in this Congress. I think it is the right thing for us to do in order to be fiscally responsible, and I do think that what we have seen in the last 7 years has been, frankly, a very fiscally irresponsible set of policies that have created now what is nearly a \$10-trillion national debt for our country and deficits that go as far as the eye can see, now over half a trillion dollars a year. So, these issues in terms of how we bring in the rev-

enue and balance the books are some things which are very important to me and important, obviously, to my colleagues.

The \$345-billion tax gap, Mr. Ng. I want to ask you about that. Based on some of the questions that Senator Conrad was asking with respect to these offshore tax havens, how comfortable are we that that \$345-billion tax gap is an accurate number? Is it a number we take out of the air and we just say, this is what we think, or what kind of analysis went into getting to that number?

Mr. NG. Well, Senator, the tax gap is based, in part, on a number of studies and audits that project out that estimate. While segments of the tax gap are dated in terms of the studies, that is the best information we have today in terms of the gap.

Senator SALAZAR. How much of the \$345-billion tax gap would you say you could account for with respect to offshore tax havens?

Mr. NG. Unfortunately, the tax gap does not break it down into that specificity in terms of—

Senator SALAZAR. Could it be broken down?

Mr. NG. Probably not, without a great deal of research and activity. I think, as the committee has suggested and people have suggested, there is a great deal of unreported income, hiding, and misleading information provided to the government in terms of trying to develop that.

Senator SALAZAR. I understand that. I understand the cash transactions that Senator Kerry and others were alluding to that occur here in this country which are not reported. But when we start looking at how much of that tax gap may come from the offshore tax havens, do you have any sense at all of what magnitude the problem is? It has to do with the question then of resources because, if 50 percent of the tax gap problem is related to offshore tax havens, then it seems to me that one of the things the IRS ought to be doing is taking a look at whether or not we have the right resources assigned where the problem is. So, do you have a sense of what the magnitude of the problem is and how we are allocating our resources? If not you, Mr. Blum?

Mr. NG. Yes. Our focus in this area—we know this is a significant compliance problem for us. There are billions of dollars involved in terms of transactions. As you can see from the activities that we have ongoing in terms of the audits and the investigations going on and the cases that have gone to indictment and prosecution, it represents billions of dollars of unrecovered taxes. As we begin to identify those pockets of taxpayers that are non-complying, we are able to really move our resources quickly throughout the organization.

Senator SALAZAR. Well, let me ask you this. You have a set number of personnel/investigators/agents/accountants working for the IRS. What percentage of them do you have assigned to dealing with these offshore tax havens?

Mr. NG. Today we do not break it out that narrowly, but we have about 1,500 compliance people that are really focused purely on international kinds of activities.

Senator SALAZAR. Give me a sense of—I have no idea whether that is 1 percent, 50 percent.

Mr. NG. Well, if you look at our compliance personnel, I think it is about 42,000 service-wide.

Senator SALAZAR. So you have 42,000 FTE and you have 1,500 of those dealing with international transactions?

Mr. NG. Yes. And they cover a whole wider range of activity, including the offshore.

Senator SALAZAR. It seems to me, from what my colleagues have said here, that this is a huge problem, as it apparently is. I think everybody here agrees it is. That may be one of our problems, that we are not putting enough attention on this problem itself.

Let me ask another question before my time is up. Senator Kerry talked about agreements that we enter into with other countries that have been involved in some of those transactions on the criminal side. We have extradition agreements with most countries around the world. Why can we not enter into those same kinds of agreements with these nations where we can have the kind of transparency and the kind of compliance that we need?

Mr. NG. Yes. On the tax side, our purview with our colleagues at Treasury is to deal solely with tax treaties and tax information exchange agreements which our jurisdictional authority provides for us. When we have those agreements, they do act as somewhat of a deterrent in terms of taxpayers' willingness to go into those jurisdictions, with the fear that they could be uncovered. We really focus on, as I said in my testimony, the importance of tax exchange information agreements because they do give us a light into information that often is not available to us directly.

Mr. BLUM. Senator, if I may.

Senator SALAZAR. Mr. Blum?

Mr. BLUM. There are two points I would like to make. First, in terms of the number of people assigned to working international problems, it takes a very well-trained, sophisticated revenue agent to work these issues. This is not routine audit work. They have to learn about the offshore jurisdictions, the kinds of entities, the sources of information, the tools that are available to them.

Then the problem that they have, if they are working one of these cases on the civil side, is trying to reconstruct what the tax return should have looked like so they can send the taxpayer a bill and begin a process of collecting the tax. This is very tough, complicated work that requires a lot of training, and it takes a lot of time.

Senator SALAZAR. So has the IRS not created that kind of expertise?

Mr. BLUM. I would say that they are working at it, but they need more money, more people, and more trained people. The emphasis ought to be here instead of doing things like auditing people who have home offices. God help us, there probably is a need to do that too, but this really is a crying need.

Senator SALAZAR. My time is up. I appreciate your responses. Thank you.

Mr. BLUM. Just one final point on the treaties. It is essential that treaties contain provisions for exchange of information in civil cases and that they require a compliance from those subpoenas. Right now, the Swiss government is going to start blocking the UBS information requests.

They are going to say, well, we will give you information if you tell us who the taxpayers are, but we cannot give you information

if you simply say, well, we know there are 19,000 Americans at a particular bank who are cheating on tax. They will read our treaty that way. That is the argument that is being used in the Cayman Islands right now to say that the tax information exchange agreement cannot be breached. They are saying it is only in criminal cases, and only when there is a specific request.

Senator SALAZAR. Thank you.

The CHAIRMAN. Thank you very much, Senator.

Senator Grassley?

Senator GRASSLEY. I just have one question in the second round. Mr. Ng, during a September 26, 2007 hearing on offshore tax issues, we had an expert by the name of Suzanne McDowell testify to the complexities of the unrelated business income regime and the ability of tax-indifferent organizations to circumvent UBIT through the use of blocker corporations. The Government Accountability Office also highlights the use of these entities in its report.

I also note with interest a *Chronicle of Philanthropy* article, which I would like to enter into the record, Mr. Chairman.

[The article appears in the appendix on p. 124.]

Senator GRASSLEY. According to this article, almost 50 percent of the tax-indifferent parties that report unrelated business income do not actually pay any tax on this income. Is the IRS studying the UBIT compliance, including the use of blocker corporations?

Mr. NG. Senator, yes. I think in that reference, in the reference in the GAO report in terms of how tax-exempt organizations use entities in the Cayman Islands, we are aware of this particular transaction. It is an issue that we are looking at. In the Service, we have focused some effort around looking at hedge funds in general, which includes this kind of transaction. So we are exploring and evaluating the nature of this transaction and the impact on tax reporting.

Senator GRASSLEY. All right. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

These suggestions that I had in my opening statement, I would like to just ask you, Mr. Blum, or anybody, how important these might be. Do they help or go to the heart of the matter, or not? Frankly, after I listened to your testimony, Mr. Blum, I think they are a little tepid, but I will ask you anyway. We need to do much more. One is to increase the statute of limitations to 6 years for individuals who failed to file an FBAR.

Mr. BLUM. Absolutely essential.

The CHAIRMAN. Let me ask you, Mr. Ng. Would that help you or not?

Mr. NG. Yes. I think, consistent with the complexity that we have seen in these types of transactions, additional time is something that should be looked at.

The CHAIRMAN. Mr. Brostek?

Mr. BROSTEK. I think it should be broader than just the FBARs. We did some work for this committee where we reported that, when there is an offshore case involved in IRS, it takes, on average, 500 more days than any other case.

The CHAIRMAN. So what else besides FBARs?

Mr. BROSTEK. I think individuals or businesses who are deliberately trying to hide the ball through, in essence, offshore corporations ought to be treated differently than the citizen who makes an error and is susceptible to audit for 3 years.

The CHAIRMAN. All right.

Next is to include a penalty from IRS for failure to file an FBAR.

Mr. BLUM. That is already the law. It is a 5-year felony for failure to file. What you really need to do is clarify the FBAR law and clarify it in a way that does not allow people to say, well, the account is with a U.S. bank or with a U.S. brokerage firm, ergo, it is a domestic account and I did not have to file, even though it is owned by a U.S. bank.

The CHAIRMAN. Right. That is my next point, to clarify the items that must be reported on the FBAR.

Mr. BLUM. You bet.

The CHAIRMAN. All right.

Mr. Ng?

Mr. NG. I would agree. Any clarification or anything that can be done as a deterrent will be useful.

The CHAIRMAN. All right. Here is one: require taxpayers to file the FBAR with their tax return. Right now, as I understand it, the FBAR goes to Treasury, the tax return goes to IRS; they do not see each other.

Mr. BLUM. I think that makes sense.

The CHAIRMAN. Would that help?

Mr. BLUM. I think it should. I think the key part of that, though, is making sure that the FBARs are filed accurately. Right now, one of the things that people do to get around the FBAR is file something, but fill in the spaces incorrectly. Because Treasury was not actually sending it back and saying, this thing has not been filled in properly, people were able to say, when caught, well, I sent in an FBAR, here it is, and of course there was no way to find it, given the way they had been filed.

The CHAIRMAN. All right.

We have already talked about this one: revise the definition of ownership to include beneficial ownership of a corporation. I would like to bore down on that a little bit more. Where do we make that requirement, do you suggest?

Mr. BLUM. Well, it is 1441 that is the problem that suggests that a corporation can be the beneficial owner. Once you have the corporation, that is enough. We do not look behind it. In the area of W-8s, that is completely unacceptable.

The CHAIRMAN. Mr. Ng?

Mr. NG. Yes. I think as we look at it, it is always going to be important that we pierce through the beneficial ownership of who actually owns the asset. With regard to how it should be done, the W-8 today and the filing regime requires that that form be filed with the withholding agent—in many instances, the bank—in a self-certification process. So, as we begin to look at how we pierce that veil of beneficial ownership, I think we need to assess what the impact will be in terms of withholding agent filing and a host of administrative issues that would be—

The CHAIRMAN. Well, wait a minute. You sound like you are throwing up lots of problems. The goal here is to find out who the beneficial owners are.

Mr. NG. Exactly. I share that view. I think we want to do that, but we also recognize that, in our tax regime and in our responsibility in administering the tax, that we have to recognize, today, kind of legal entities in terms of ownership and structures that are legally recognized. So, there needs to be some reconciliation of how a proposal will impact that.

The CHAIRMAN. So how do we do that? If you want to do a good job, and I know you do, how would you do it? What would you recommend so we could get to the heart of the matter and find out who the beneficial owners are?

Mr. NG. I think some of the suggestions are reflected in some of our suggestions that we are making to the QI program in terms of some filters that would help identify the beneficial owner.

The CHAIRMAN. To be honest, Mr. Ng, in your opening statement, when you mentioned that, it sounded kind of bureaucratic. It did not sound like we were getting to the heart of the matter. I do not know. Mr. Blum, what is the QI issue?

Mr. BLUM. I am not a fan of QI. I personally think it ought to be abolished. It is a device for allowing foreigners to put their money in the U.S. in a way that leaves no trail in the U.S. What it does is block the exchange of information with treaty partners. So, if I am British and I want to evade British tax, I can go to a QI bank, open an account through a shell company, and put my money in New York, and IRS has nothing to give the British government. Whereas, if I opened an account with a brokerage firm in New York directly, there would be a 1042 and an exchange of information with the British under a treaty. So, as far as I can tell, what QI does is simply open a door for foreign tax cheats.

The CHAIRMAN. What about that, Mr. Ng?

Mr. NG. Yes. I think our proposed changes to the QI regime will allow us to pierce through to beneficial owners. For example—

The CHAIRMAN. Why do we even need a QI?

Mr. NG. Well, the QI, I think, gives us sight to taxpayers. Without the QI today, we will not know who these investors are or customer account holders. So I think in a broad, global sense of looking at what is going on, the QI regime actually gives us at least a source and a direction to identify who the actual recipients of the income are.

Mr. BLUM. Mr. Chairman, I would respectfully disagree with that. Right now, American brokers and banks are required to know their customer. They are required to get behind the shell entities. The problem is, that information is information that does not go to IRS. I think there is no real purpose to QI at all.

The amount of money that is being collected through QI is minimal because withholding is limited to dividends and interest, and most of the people who play the offshore game do it for capital gains. Now, I would put withholding on all sales and forget the dividends and interests, and put the burden on the withholding agent and make them liable. That would be very self-enforcing, and it would work.

The CHAIRMAN. Another thought here on the list is another statute of limitations proposal which gives the IRS 3 years after they get the correct FBAR information, no matter how long after the 6-year limit referred to above.

Mr. BLUM. If you give incorrect information, you automatically are involved in some kind of fraud, and the statute is extended. So, I do not think that would be a problem.

The CHAIRMAN. Let me go back to the QI. One of the weaknesses in the current QI program, as we have discussed, is the “know your customer” rules. IRS says that UBS helped U.S. investors hide behind the sham officer or corporations to circumvent the “know your customer” rules. Now we learn that Liechtenstein banks may know the true identity of the person opening the account, but interprets the QI “know your customer” rules differently so that banks do not have to file information reports.

Mr. BLUM. Mr. Chairman, I saw all of those Liechtenstein bank documents in the slide shows for the Liechtenstein bankers on how to get around QI. These Power Points were shown to them as QI was coming into effect. An American law firm advised the bank on how to get around QI. That is in the papers as well.

We had also, at the time QI came in, banks around the world that mailed out letters to their customers—and I have seen several of them—saying, here is how you get around QI: open up a shell company at our bank, we will arrange to have somebody open it up, close out your personal account, everything will be fine.

The CHAIRMAN. I am way over time.

Senator Conrad, go ahead.

Senator CONRAD. I thank the chairman.

Mr. Ng, the tax gap number that you quoted, the \$345 billion, what year does that apply to?

Mr. NG. 2001 is when most of the research was done.

Senator CONRAD. 2001.

Mr. NG. Some aspects of it were maybe even older.

Senator CONRAD. And this is 2008. That is not good enough. I mean, that is just not serious.

I will tell you, I have been a big defender of the IRS as chairman of the Budget Committee and as a Senator on this committee. I want the word to go back that my defense of you guys is over. I do not think you are taking this seriously. I do not think the testimony you have given here today demonstrates seriousness. I do not think the effort on tax gap, on offshore tax havens, shows me that there is any kind of serious effort under way, and I am all done defending you.

Mr. Blum, the estimate of the Special Subcommittee on Investments is we are losing \$100 billion a year just on offshore tax havens. Do you believe that is credible?

Mr. BLUM. I believe it is low and conservative.

Senator CONRAD. You believe it is low?

Mr. BLUM. Yes.

Senator CONRAD. And on what basis do you believe it is low?

Mr. BLUM. If you take a look at the amount of money in the private banking world and the analyses that have been put forward of offshore jurisdictions and then estimates of where the people who are using these facilities are—these are all available—the

numbers are enormous. If you look at UBS, \$20 billion and 19,000 customers in one offshore bank—remember, there are hundreds competing for this business—you have to believe that these numbers are very large, indeed.

Senator CONRAD. You mentioned 500,000 companies in the British Virgin Islands.

Mr. BLUM. The Virgin Islands. Yes.

Senator CONRAD. Five hundred thousand?

Mr. BLUM. Yes. I think it is around that number.

Senator CONRAD. What percentage of those are American?

Mr. BLUM. Who knows? What we can—

Senator CONRAD. And we do not know because they do not have reporting?

Mr. BLUM. None.

Senator CONRAD. No reporting?

Mr. BLUM. No reporting.

Senator CONRAD. So at least in the Caymans, we are able to go find out there are 18,000 registered in Uglad House, but we cannot determine, in the British Virgin Islands, that—

Mr. BLUM. You cannot find out much of anything. There are requirements in the Caymans that they file annual corporate reports, and some of that information is kept by the government and kept confidentially so that, on a specific request, information may be available. But that is not the case in the BVI. The BVI prides itself in offering products to help people evade. I listened to some of their sales people, at a conference in Miami, describing a new trust arrangement under which the trustee would have no knowledge of who the beneficiaries were or what the corpus of the trust was, other than the fact that the trust controlled a corporation, about which they knew nothing.

Senator CONRAD. Mr. Ng, is the IRS doing something about that?

Mr. NG. I think, as I said earlier, we look at all the entities that we can identify through our tax return information.

Senator CONRAD. Yes. But how can you identify these entities?

Mr. NG. The only way we can identify them is if there are foreign companies operating in a foreign country and have filing requirements as a controlled foreign corporation, where they answer the foreign bank account questions, or whatever return information that we get in terms of identifying entities in other jurisdictions.

Senator CONRAD. Mr. Blum, what is wrong with that?

Mr. BLUM. Well, there is the source of suspicious activity reporting. The brokerage firms of the banks are required to file reports when they see weird offshore structures, because they do not know, and cannot know, what kind of criminal activity it is being used for. They are required to file SARs if there is suspected tax evasion. The problem I see is, those reports are not made available to the civil side of IRS, and there is absolutely no reason for not doing it.

Senator CONRAD. What are the resources devoted to piercing the veil, Mr. Ng? The British Virgin Islands, 500,000 companies claim they are doing business there. They have people coming to conferences here, openly bragging about how to evade U.S. taxes. What are the resources dedicated to going after what is going on in the British Virgin Islands?

Mr. NG. Well, I think when we look at all the jurisdictions where we believe there may be some tax non-compliance, we take every effort we can in terms of—

Senator CONRAD. No, no, no. That is not my question. I am asking the question, what are the resources devoted specifically to the British Virgin Islands where we have a description here of 500,000 companies, and they are openly saying, come here and we will help you avoid your taxes?

Mr. NG. We have a number of our revenue agents, both doing research and doing compliance.

Senator CONRAD. How many? How many?

Mr. NG. I do not have an exact number because we do not—

Senator CONRAD. Can you get the committee that number?

Mr. NG. We could get some numbers in terms of the broad resources allocated to offshore sort of non-compliance.

Mr. BLUM. Senator, in defense of Mr. Ng, I should say that there were a number of IRS agents at this conference. They heard it, and they are perfectly aware of what is going on. The question will be how to convert that into appropriate leads and ways to follow up to get individual taxpayers who are using it.

Senator CONRAD. Mr. Ng, the estimate of the Permanent Subcommittee on Investigations is that we are losing \$100 billion a year to offshore tax havens. What is your reaction to that number? Do you believe it? Do you disagree with it? Do you think it is high, do you think it is low?

Mr. NG. We believe there is significant non-compliance in the billions. Is it \$100 billion? We do not have studies to calculate that. But we agree that there is a significant compliance problem. It is something that is in the billions of dollars, and we are trying to address all of these issues that we see.

Senator CONRAD. Do you know what disturbs me, honestly? I have defended the IRS for 22 years here, and in this last period of time I have not had you come one time and ask for additional tools to go after this problem. Not once have you come to me, or any representative, and asked for additional tools to go after this problem. Meanwhile, people in the tax world are telling me this problem is growing geometrically. People I know in major accounting firms are telling me this problem has grown like a cancer.

Mr. Blum, do you have any sense of whether or not it is growing?

Mr. BLUM. I think it is.

Senator CONRAD. I just had major partners in major accounting firms tell me, off the record, that this is growing like a cancer.

Mr. BLUM. I think the problem is growing. But again, there is always this difficulty with any kind of criminal activity. They do not file reports with the government. There are no clear statistical markers. There is a great effort under way on all sides not to let people know how big it is. But what I can tell you is, if you look at the growth in private banking, the emergence of new "private banks" that suddenly spring up and have offices everywhere, you know something is happening. I just think that it is obvious. If we cannot put our arms around it, we have a tax system that works for people who actually have money withheld and who get 1099s and not for everybody else.

Senator CONRAD. If you just go to the Web, I find I can learn more on the Web about what is going on here because they are advertising.

Mr. BLUM. If you go to the Web and look at the websites for some major law firms, and for that matter major American brokerage firms, look under “wealth preservation” and read the rather cryptic, but not-so-cryptic descriptions of the services.

Senator CONRAD. Descriptions.

Mr. BLUM. You will get an idea that this problem is not limited to foreign institutions.

Senator CONRAD. Yes. This is huge. Offshore tax havens. As I said, we punched it in. I did this maybe 3 years ago, and it was a million. Now it is 1.9 million hits. You start reading them. They are not even subtle about it. They just are blatant: come out here and you will not pay any taxes. Well, I guess what gets my ire more than anything is, the significant majority of people in this country pay what they owe. I think the vast majority of people pay what they owe. Then to have these people dodging what they owe and sticking all the rest of us with the bill, I mean, that really angers me. I think, as people learn about this, it is going to anger the American people.

And Mr. Ng, I have to say, I do not want to beat up on you personally, because I think you are a very fine person, but the agency itself, I must say, I am incredibly disappointed in because there has just been no—I am known as somebody who could help them. There has been absolutely no attempt to get something done. I mean, it is just beyond me, what is going on there.

I thank the chairman.

The CHAIRMAN. Thank you, Senator.

Let me ask kind of a different set of questions. What are other countries doing? They must be facing the same problem. I mean, the U.K., for example, the E.U., maybe Japan, I do not know. But is that an issue or not, and what are they doing about it?

Mr. BLUM. It is a huge issue. The European Union has put pressure on Switzerland, Luxembourg, and Liechtenstein. They got a withholding agreement out of Switzerland. The withholding agreement, I think, is rather pathetic because it is limited to interest income. Switzerland said, we will order our banks to withhold on accounts held by your Nationals in our banks, but we are not going to tell you who they are and we will just give you a check for the full amount.

Now, that sort of gets around the whole issue of capital gains and other elements of tax, so it is not a very effective program. But they did force Switzerland to come up with that part. It is a worldwide problem. The dilemma is huge. Gordon Brown—the British have a system under which non-domiciliaries do not pay tax in the U.K., so as a result lots of people live in the U.K. but claim they are not domiciled there.

The consequence of that has been massive evasion and huge problems, so Gordon Brown said, we are not going to do that anymore. The city of London came in and put all kinds of pressure on them, and they backed down and said, well, what we are going to do is charge a flat tax on all the so-called “non-doms” of 30,000

pounds a year. If you pay that, you do not have to pay anything else. It was a terrible compromise. But this is a global problem.

The Mexicans have it, the Brazilians have it, the Indians have it; everybody has it. That is why the point here is, we have to get around this business of a revenue rule and saying it is all right for bankers in country X to help citizens of country Y cheat their government. That, as an international law proposition, is ghastly.

The CHAIRMAN. The problem with this too is, with advances in technologies, communications technologies, and other technologies, people who want to make a buck are way ahead of governments, of Congress, who are trying to find ways to catch up.

Mr. BLUM. To be blunt about it, the problem is that we have a system of law that is built on national jurisdiction and a world economy that is seamless.

The CHAIRMAN. Right.

Mr. BLUM. The functional situation is that we have—the analogy I use in my statement is, it is like an Autobahn without a speed limit and a bunch of cops on bicycles trying to keep law and order. It does not work.

That is also true in the area of financial regulation. The SEC is up against the same problems. All of the financial regulatory agencies are up against the same problems. The Cayman entities in Uglad House were some of the entities in the Enron mess. The offshore off-the-books accounts of various banks are, again, some of those very same entities.

So the problem cuts across bank regulations, securities regulations, tax; every form of financial regulation dependent on national law runs up against these issues. We cannot have a seamless global economy with national borders as barriers to any kind of regulation. It is at the heart of our current economic crisis.

The CHAIRMAN. Well, we are going to have borders for Americans.

Mr. BLUM. Well, we are going to have borders, but that does not mean we cannot come up with ways to work around the problem cooperatively. The beginning point of any solution to this is real public discussion, a real public airing of the whole issue of cooperation and what it ought to entail, and not one cooperation, case-by-case cooperation, but really a rethink of how this global enterprise is to work.

Now, we have certain institutions that are supposed to be doing that, the G-8, the Bank for International Settlements in Basel, there is a group of tax authorities who work together. But this has to be done at a whole different level, with new urgency and new resources.

The CHAIRMAN. It is a challenge. I thank all of you very, very much. This has been very provocative, and you have given this committee many very good ideas. I intend to follow up vigorously. I do not know how long it is going to take, but we are going to find a way to make a huge, big dent in this problem, and hopefully more than a dent, so we can finally begin to solve it. But it is going to take a lot of work. It is going to take the cooperation of a lot of Senators, take a lot of ingenuity from very bright people to help us figure out how to do it responsibly, reasonably, but just helping

American taxpayers make sure they get their dollars' worth and stop this tax evasion.

Thank you very much. The committee is adjourned.

[Whereupon, at 11:45 a.m., the hearing was concluded.]

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

**BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE**

The Cayman Islands and Offshore Tax Issues

July 24, 2008

Jack A. Blum
Of Counsel
Baker & Hostetler
1050 Connecticut Avenue, NW
Suite 1100
Washington, DC 20036

My name is Jack A. Blum. I am a Washington DC attorney with long experience in dealing with the issues of offshore tax evasion, money laundering, and related financial crime. I am testifying today on my own behalf at the invitation of the Committee.

My experience includes, investigating offshore centers for the Senate Foreign Relations Committee, working with private clients who had concealed offshore accounts and who wanted to settle with IRS, working with cooperating witnesses in evasion cases, working with IRS as an expert on offshore evasion issues, and working with banks and brokerage firms on anti-money laundering compliance issues.

Offshore tax evasion is a serious and growing problem. In a world of freely moving capital, instant money transfers, and instant global communication, it is possible to create complex international structures with the click of a mouse. As the ability to move capital has speeded up the ability of tax collectors and law enforcement has not kept pace. The regulators are in the position of police on a freeway without a speed limit using bicycles to stop Ferraris.

The tax avoiders and tax cheats see national borders as their friends and freely use secrecy jurisdictions and jurisdictions with lax trust, corporation and insurance laws to create structures that hide money from tax collectors and law enforcement.

Some jurisdictions have developed specialties in providing these products. The British Virgin Islands, for example, is the place to go for quick, cheap, anonymous incorporation. It has more than 500,000 shell companies. It has also developed a new trust "product" that allows a "trust" to be the owner of a corporation without the trustee having any knowledge about the operation of the corporation. Under U.S. law this is not a "trust."

It is important to understand that the structures are mere pieces of paper with no commercial reality. They are backed by formalities that allow them to pass paper checklists in other jurisdictions including the United States. For example, the island of Nevis, part of the Federation of St. Kitts and Nevis, is home to tens of thousands of corporations, all of which have boards of directors. When banks and brokerage firms ask about the control of the corporation for AML purposes, the person opening the account furnishes the passport photos of the nominee shareholders, officers and directors. The same twenty people are the nominees for thousands of corporations. They have no knowledge of, or fiduciary responsibility for the corporation's business.

If the nominee directors and officers were water-boarded they could not tell you what the corporation was doing or who owned it. They do not participate in "corporate" decisions and keep no records relating to corporate activities. They do not even know where the records are.

BVI is not the only jurisdiction which has legalized "sham" trusts. Other jurisdictions have passed trust laws that leave the trustee with little or no responsibility. In Belize you can be the grantor, the trustee, and the beneficiary, and have the trust considered valid. You can include provisions allowing you to redraw the trust instrument and add a flee clause which allows a change in situs for the trust in case of criminal or tax investigation. Jersey trusts can be administered outside of Jersey by non-citizens, and with no records kept in Jersey.

Jurisdictions in search of financial services business are engaged in a race to the bottom to provide tools for people trying to hide money.

It should be noted that hidden money frequently is associated with criminal activity beyond tax evasion. Most often the money is tied to some form of financial fraud such as penny stock manipulation, options backdating, insider trading, and other confidence schemes.

How the Tax Code Makes it Worse

Section 1441 of the IRC) requires IRS to treat shell corporations as real and accept them as the "beneficial owner" of assets in accounts opened in their names. This loophole has allowed thousands of Americans to open accounts at banks and securities firms in the United States while filing perfectly legal W-8BEN forms identifying the beneficial owner of the account as foreign. Section 1441 accepts the corporation, shell or not, as the "beneficial" owner. If the purpose of the W-8BEN is to identify the true owner of an account, why should this loophole be allowed?

The W-8's are accepted without question even though the financial firms know, based on customer contacts, that the beneficial owners are U.S. citizens or residents. In my view if the withholding agent knows the customers is a U.S. person for tax purposes and accepts a W-8 the withholding agent should be responsible for paying the customer's tax, interest, and penalties.

Ironically, the instructions to withholding agents and Section 1441 of the code are inconsistent on the issue of knowledge. The instructions say that if the withholding agents have actual knowledge or reason to believe that the beneficial owner of an account claiming to be foreign is owned by a U.S. person they must seek a W-9 or begin withholding. The law -Section 1441-says that the foreign corporations must be recognized as the legitimate beneficial owner.

Even if the law required the withholding agent to identify an American taxpayer as the beneficial owner of an offshore shell, the issue of enforcement would remain. The penalty would be that the account is withheld. Under present law the withholding required is limited to dividends and interest. The offshore portfolios I have seen have very little interest and dividend income. Most of them are focused on capital gains and short term trading. The bank would not be obliged to report the taxpayer to IRS.

Moreover, W-8 forms are not filed with the IRS, but rather with the financial institutions. IRS does not get a copy of the forms unless it asks. If it does ask, once the forms are received, IRS must do serious investigative work to determine the identity of the U.S. beneficial owner. To my knowledge there has never been a fraud case based on deliberate misstatements on a W-8.

Holding the financial institution liable for the withholding and including capital gains in the withholding requirement would mean the financial institution would police W-8 compliance with a vengeance.

The Qualified Intermediary Program

The qualified intermediary program was introduced in 2001 with the stated purpose of allowing IRS to get access to information about foreigners investing in the U.S. who were subject to withholding on interest and dividends. In fact, the program has become a device for concealing the identity of both Americans and foreigners who are cheating on taxes. If the identity of foreign investors was reported to IRS, the information would be subject to the U.S. network of tax

information exchange agreements. We would have to report the foreign tax cheats to their home governments. Because the taxpayer information is kept by the bank in the secrecy haven, our government has no information to exchange.

Making matters worse, because of Section 1441, the foreign banks have used shell corporations to walk around the Q.I. requirements. In the months before the effective date of the program, hundreds of tax haven banks wrote to their U.S. customers telling them how to get around the reporting requirements. I have seen several variations of the letter.

The Swiss Bankers Association wrote to its members saying that the solution to the problem was to have U.S. customers use shell corporations.

Most of the banks offered to help their customers to make the necessary arrangements. They offered the services of related trust companies and corporation formation agents. The solution was simple – have the account held in the name of a corporation so the bank could report the corporation as a “beneficial owner.”

Some banks were quite diligent in making certain that the loophole would work. Large U.S. law firms were invited to help advise and train bank staff on how to beat the Q.I. system. Some of the LGT documents now in the hands of the Permanent Investigations Subcommittee underscore the cynical way in which haven banks viewed the entire program.

I believe that the program as currently set up serves no useful purpose. It is a window for haven banks to access the U.S. financial market on behalf of tax evading clients of all nations including the U.S. Fixing it so that the program is limited to foreign tax cheats does not solve the basic issue. The U.S. should not be financing itself by opening the door to foreign tax cheats and giving them assurance their information will not be shared with their home governments, treaty obligations notwithstanding.

The Withholding Requirement

At present, withholding is required on U.S. connected dividends and interest. Most of the offshore accounts have little or no dividend and interest income. The offshore accounts are used by active traders to accumulate capital gains free of tax.

If the withholding requirement is to have any impact it must be extended to capital transactions.

The Revenue Rule

The problems of offshore tax evasion are exacerbated by the longstanding “revenue rule,” which, put crudely, is a common law rule that says no government should help enforce the tax laws of another government. The rule had its origins in English common law. The English courts upheld contracts between private parties that were designed to help evade high French customs duties. In the context of the 18th century the common law rule was understandable.

The original rule then expanded to become a basic principle of common law enshrined in the Restatement of Laws, that the courts need not give effect to the penal or revenue laws of other states. Each nation state, it is said, is responsible for enforcing the criminal laws and tax laws within its own borders. Other states are under no obligation to help.

A corollary to this rule is that tax judgments are unenforceable outside of the United States. Thus even if IRS wins a huge judgment it may not be able to collect a cent because the money remains in an offshore bank.

Here is what the revenue rule has spawned.

- In a New Jersey case, I became privy to documents which showed how a husband, trying to avoid paying alimony and child support as well as income tax went to a Philadelphia law firm for advice. The Philadelphia lawyer told him he could not help, but he sent him to the London office of the firm where a UK solicitor worked out an offshore evasion scheme involving trusts and shell companies. This was designed to avoid paying the wife and to avoid IRS.
- Working on compliance issues with a financial institution I became aware of a New York law firm that specializes in helping Mexican citizens evade Mexican tax. This activity involved no violation of U.S. law or U.S. ethical standards. The law firm's activities were not suspicious because all they were doing was helping Mexican evade tax.
- Working on compliance issues with an offshore trust company I was told that helping U.S. citizens evade taxation was legal under the laws of the country that was the site of the trust company. Further, I was told that the only compliance issues the firm was concerned with were drug money and terrorism money.
- As an expert witness in an IRS case I saw documents which showed a foreign bank altering documents and revising trusts to avoid the disclosure of the bank's customer's tax evasion. The bank viewed the behavior as routine help for a client.
- A client of mine, a former compliance officer at a private bank in an offshore jurisdiction, tried to question a transaction which appeared to be a scheme to evade U.S. tax. Her bosses told her the transaction would go through because, "that is what private banks are for."
- An offshore Caribbean bank I investigated for a client has been sending sales people into the U.S. for at least thirty years. These salesmen service U.S. lawyers and their clients in setting up offshore "structures" to hide money from the IRS. One of the points the sales people made was that even if the clients were caught and a judgment was levied against them it could not be enforced if the money was offshore.

I could go on with other examples, but the point is clear – the revenue rule gives professionals and financial institutions the idea that helping people evade the taxes they owe their own governments is a legal and indeed honorable business as long as you are not in their country.

That proposition has no place in today's world. Mexico cannot pay its police enough to keep them honest because it lacks the tax revenue. We have an all out drug war on the Mexican border and little hope that the Mexican government can end it. Helping Mexicans avoid Mexican tax is not benign. It has a direct impact here. Likewise, having an offshore industry ready to serve U.S. tax cheats is not benign.

I do not argue that solving this problem will be simple. My point is that the time has come to discuss the issue. If the situation continues as it is today, national tax systems will be limited to collecting money from people who work for a living and are withheld at the source, and people who keep their money in the U.S. in institutions that report dividends, interest, and gross sales of securities to the federal government.

The FBAR Problem

A person who has signature authority over a foreign bank or securities account that had a balance over \$10,000 is required by the anti-money laundering laws check a box on his tax return and to file a Foreign Bank Account Report form with the Treasury Department.

Enforcement of this law is spotty at best. Although FBAR filings are up even a cursory glance at the totals by jurisdiction shows that the filings are not even close to the number one would expect given the number of offshore entities in the particular jurisdiction. Many of the forms are filed in a deliberately inaccurate way so that the filer can argue that he complied at the same time the information on the form is insufficient to properly identify the account or the entity involved. Incomplete and obviously inaccurate forms should be the subject of follow-up by Treasury.

For years the FBAR enforcement job belonged to FINCEN which ignored the problem until the statute of limitations was almost up at which point they gave the case to IRS CID. Much of the enforcement responsibility has now been given to IRS, but the problem is that the Justice Department views the language as difficult for an effective prosecution. To give you a sense of the problem, Justice is unwilling to say that a U.S. citizen who controls a foreign trust or corporation which in turn opens a U.S. bank account need to file an FBAR. The reason—the account is with a U.S. institution. The result is absurd in the extreme and defeats the purpose of the law. I urge the Committee to give these issues a full airing and resolve them.

Shifting the Burden

The current code and current IRS policy puts form over substance. That stance is crippling. The offshore jurisdictions sell form. They will create sham entities energetically and in endless variety. I have seen cases where an offshore corporation was owned by an annuity insurance policy the beneficiary of which was an offshore trust. Each of the entities was in a different jurisdiction and each lacked any substance. The problem was that the burden was on IRS to prove they were shams.

I believe that burden must be shifted. Because of the scope of the sham problem, if a taxpayer wants to argue that the property or the income belong to a BVI corporation owned by a Nevis trust with a bank account in Anguilla, let him prove that the corporation has a real management and a real board of directors that actively runs the business. Let him prove that the trustee exercises real fiduciary responsibility and that he, not the owner of the property makes the key decisions.

I strongly support Senator Levin's bill S. 681. Substance over form should be the rule.

Secrecy and Deterrence- The 6103 Problem

Wealthy taxpayers must learn that offshore evasion is dangerous. They must have a sense that offshore evaders are caught and face penalties. At the moment most of them think the danger is a lot smaller than it actually is. The reason is that most of the offshore cases are handled as civil matters and are eventually settled. Under Section 6103 Civil cases which are settled are completely confidential.

As a result, the results of very successful IRS programs such as the offshore credit card project are hidden from view. Salesmen for private banks and offshore service companies scoff at the idea that clients can be caught and continue pushing their products.

All prosecutors will tell you that deterrence is the most important aspect of prosecution. Unless the cases are public there will be no deterrent effect. I believe that all settlements involving offshore schemes for amounts in excess of \$1,000,000 should be excluded from the restrictions of 6103 so the general public becomes aware of the risks associated with offshore evasion.

Other Enforcement Issues

At the present time, a person transferring money offshore to a corporation he owns or controls must file a report of the transfer on form 926 and must file forms 5471 or 5472 for the corporation. Although the law requires that the forms be filed, compliance with these requirements is minimal. IRS lacks the resources and the capacity to go after non-filers.

Even more embarrassing is the fact that IRS cannot tell whether a U.S. LLC has complied with the tax laws. A single member LLC can be treated as a pass through entity and can operate without a taxpayer identification number. Taxpayer ID numbers are essential for matching returns with specific entities and to identify entity filings with individuals. In my view, all U.S. corporate entities should be required to have TINs. If this requirement is not imposed Delaware and other states that keep no records of entity ownership, will be the best purveyors of "offshore" entities.

Offshore tax cases are frightfully complex. In the typical case, key facts are not on the individual's tax return. The Revenue Agent may know there is an offshore account, but may not have much more to go on. Building the offshore case requires third party summonses, depositions, and repeated IDR's. Each set of requests typically leads to the need for even more information. Given the nature of these cases and the time involved in gathering information the statute of limitations needs to be extended to at least six and perhaps ten years.

Beyond that, agents must be given the assurance that they will not be pressured into giving up on a case because of short term IRS performance goals. All too often professional success inside IRS has been measured by numbers such as how many cases have been closed and how much money has been collected in a given one year period. In the offshore world these performance measures are inappropriate in fact are counter productive.

Adequate staffing is a major problem. Offshore cases are labor intensive and require a specially trained team. Revenue Agents must know how offshore works. They must be taught the methods offshore evaders have used in the past. They need to learn the tools available to them to get information. For example, agents have to learn how to research and use MLATS and tax treaties. These requirements mean more time for training and more money for staff.

Under the anti-money laundering laws financial institutions are required to file suspicious activity reports if they suspect that there has been activity which may constitute a violation of any U.S. Law or regulation. As I read the law and as I have advised clients, this requirement includes suspicion of tax evasion. I am certain that brokers have filed thousands of suspicious activity reports relating to suspected tax evasion.

The problem is that these reports are not made available to the civil side of IRS because of a policy decision at the highest levels of the service. Most offshore cases are civil cases because of their complexity. Thus, one of the best tools for identifying offshore evaders is unavailable to the people who need it most.

To summarize, offshore evasions is a massive threat to the integrity of the U.S. tax system. We cannot continue to treat entities without substance or purpose as real and expect our tax authorities to navigate their way around the obstacles. We must close the loopholes foreigners use to put money in the U.S. market without leaving a trail. We must recognize that all of us have a stake in tax compliance world-wide and that the "revenue rule" should be consigned to the dust bin.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EDT
Thursday, July 24, 2008

CAYMAN ISLANDS

Business Advantages and Tax Minimization Attract U.S. Persons and Enforcement Challenges Exist

Statement of Michael Brostek,
Director
Strategic Issues



July 24, 2008

CAYMAN ISLANDS**Business Advantages and Tax Minimization Attract U.S. Persons and Enforcement Challenges Exist**

Highlights

Highlights of GAO-08-779T, a testimony to Chairman and Ranking Member, Committee on Finance, U.S. Senate

Why GAO Did This Study

The Cayman Islands is a major offshore financial center and the registered home of thousands of corporations and financial entities. Financial activity there is in the trillions of dollars annually. One Cayman building—Ugland House—has been the subject of public attention as the listed address of thousands of companies.

To help Congress better understand the nature of U.S. persons' business activities in the Cayman Islands, GAO was asked to study (1) the nature and extent of U.S. persons' involvement with Ugland House registered entities and the nature of such business; (2) the reasons why U.S. persons conduct business in the Cayman Islands; (3) information available to the U.S. government regarding U.S. persons' Cayman activities; and (4) the U.S. government's compliance and enforcement efforts. GAO interviewed U.S. and Cayman government officials and representatives of the law firm housed in Ugland House, and reviewed relevant documents. The full report on GAO's review is GAO-08-778, being released at the same time as this testimony.

What GAO Recommends

GAO makes no recommendations in this testimony or the accompanying report. The Commissioner of Internal Revenue, the Secretary of the Treasury, and the Leader of Government Business of the Cayman Islands were provided a draft of the accompanying report and GAO incorporated their comments as

To view the full product, including the scope and methodology, click on GAO-08-779T. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

The sole occupant of Ugland House is Maples and Calder, a law firm and company-services provider that serves as registered office for the 18,857 entities it created as of March 2008, on behalf of a largely international clientele. According to Maples partners, about 5 percent of these entities were wholly U.S.-owned and 40 to 50 percent had a U.S. billing address. Ugland House registered entities are often participants in investment and structured-finance activities, including those related to hedge funds and securitization.

Gaining business advantages, such as facilitating U.S.-foreign transactions or minimizing taxes, are key reasons for U.S. persons' financial activity in the Cayman Islands. The Cayman Islands' reputation as a stable, business-friendly regulatory environment also attracts business. This activity is typically legal, such as when pension funds and other U.S. tax-exempt entities invest in Cayman hedge funds to maximize their investment return by minimizing U.S. taxes. Nevertheless, as with other offshore jurisdictions, some U.S. persons may use Cayman Island entities to illegally evade income taxes or hide illegal activity.

Information about U.S. persons' Cayman activities comes from self-reporting, international agreements, and less formal sharing with the Cayman government. Because there is often no third-party reporting, self-reported information may be vulnerable to being inaccurate or incomplete. U.S. officials said the Cayman government has been responsive to taxpayer-specific information requests.

The Internal Revenue Service has several initiatives that target offshore tax evasion, including cases involving Cayman entities, but oversight and enforcement challenges related to offshore financial activity exist. U.S. officials said that cooperation with the Cayman Islands government has been good. Also, Maples partners said that ultimate responsibility for compliance with U.S. tax laws lies with U.S. taxpayers.

Ugland House, George Town, Grand Cayman Island

- Sole tenant is Maples and Calder law firm, which provides registered office services to companies established in the Cayman Islands
- 18,857 registered entities at the Ugland House address
 - Very few have a significant physical presence in the Cayman Islands
 - Five percent wholly U.S. owned
 - Fewer than 50 percent have a U.S. billing address



Source: GAO photograph and statistics obtained from the Cayman Islands government and Maples.

Chairman Baucus, Senator Grassley, and Members of the Committee,

I appreciate this opportunity to discuss offshore financial activity in the Cayman Islands and the challenges posed for both tax policy and administration. International financial activity is common in our increasingly global economy, and is encouraged or facilitated by various federal policies. Nevertheless, financial activity across foreign jurisdictions poses challenges for both tax policy and administration.

Recognizing the serious problems posed by offshore tax evasion, you asked us to study what is known about the business activities of U.S. taxpayers involving Uglan House in the Cayman Islands. Specifically, you asked us about the extent, motives, and tax implications of these activities, as well as the extent to which the U. S. government has looked into these taxpayer activities. The report we are issuing today¹ focuses on these activities. The objectives of our report were to determine (1) the nature and extent of U.S. persons' involvement with Uglan House registered entities, and what business, if any, these entities carry on in Uglan House and in the Cayman Islands²; (2) what reasons attract U.S. persons to conduct business in the Cayman Islands; (3) what information is available to the U.S. government regarding U.S. persons' Cayman Islands activities, including which are associated with U.S. taxpayers; and (4) for tax noncompliance and other related illegal activities, describe the U.S. government's compliance and enforcement efforts, and any related activity on the part of the Cayman Islands government.

To address our objectives, we reviewed and analyzed U.S. government and private-sector documents; interviewed U.S. and Cayman Islands officials as well as partners of Maples and Calder, the law firm that occupies Uglan House; and examined data from sources in the U.S. and Cayman Islands related to Uglan House and the Cayman Islands. For more information on our methodology, please see the report we are issuing today in conjunction with this testimony. We conducted our work from July 2007 to July 2008 in accordance with generally accepted government

¹ See *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-08-778 (Washington, D.C.: July, 2008).

² Under the Internal Revenue Code, a United States person is (1) a citizen or resident of the United States, (2) a partnership created or organized in the United States or under the law of the United States or of any State, (3) a corporation created or organized in the United States or under the law of the United States or of any State, or (4) any estate or trust other than a foreign estate or foreign trust.

auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The Cayman Islands is a United Kingdom Overseas Territory located in the Caribbean Sea south of Cuba and northwest of Jamaica, with a total land area approximately 1.5 times the size of Washington, D.C., and a population of 47,862. While geographically small, the Cayman Islands is a major offshore financial center (OFC) with no direct taxes that attracts a high volume of U.S.-related financial activity, often involving institutions rather than individuals.³ Although not easily defined, OFCs are generally described as jurisdictions that have a high level of nonresident financial activity, and may have characteristics including low or no taxes, light and flexible regulation, and a high level of client confidentiality. The Cayman Islands reports that in 2008 it had 277 licensed banks, over 80,000 registered companies, more than 9,000 registered investment funds, and 760 captive insurance companies. According to the Department of the Treasury, U.S. investors held approximately \$376 billion in Cayman-issued securities at the end of 2006, making it the fifth most common location for U.S. investment in foreign securities. As of September 2007, U.S. banking liabilities to the Cayman Islands were the highest of any foreign jurisdiction, at nearly \$1.5 trillion. As of June 2007, U.S. banking claims on the Cayman Islands stood at \$940 billion, second only to the United Kingdom.

U.S. Persons Are Frequently Associated With Uglund House Registered Entities

The international law firm of Maples and Calder, with its associated businesses - Maples Corporate Services Limited and Maples Finance Limited - is the sole occupant of Uglund House. Its business is to facilitate Cayman Islands-based international financial and commercial activity for a clientele of primarily international financial institutions, institutional investors, and corporations. Similar to corporate service providers in the United States, Maples Corporate Services Limited provides registered-office services, using Uglund House as a registered address, to entities it establishes. Registered-office services include activities such as

³ Direct taxes are taxes on income, and may take the form of taxes on personal and corporate income, social security contributions, and payroll taxes.

maintenance of certain entity records and filing of statutory forms, resolutions, notices, returns, and fees. Cayman Islands law requires company-service providers like Maples and Calder to adhere to specific Anti-Money Laundering (AML) and Know-Your-Customer (KYC) requirements. For example, they must verify and keep records on the beneficial owners of entities to which they provide services, the purpose of the entities, and the sources of the funds involved.

Very few Uglad House registered entities have a significant physical presence in the Cayman Islands or carry out business in the Cayman Islands. According to Maples and Calder partners, the persons establishing these entities are typically referred to Maples by counsel from outside the Cayman Islands, fund managers, and investment banks. As of March 2008 the Cayman Islands Registrar reported that 18,857 entities were registered at the Uglad House address. Approximately 96 percent of these entities were classified as exempted entities under Cayman Islands law, and were thus generally prohibited from carrying out domestic business within the Cayman Islands.

Maples and Calder senior partners told us that approximately 5 percent of the entities registered at Uglad House were wholly owned by U.S. persons, while 40 to 50 percent were related to the U.S. in that they had a billing address in the United States. A U.S. billing address does not necessarily imply ownership or control. According to the partners, U.S. persons associated with Uglad House registered entities are often participants in investment and structured-finance activities, including those related to hedge funds and securitization. Entities associated with these activities are not generally directly owned or controlled. For instance, investment-fund entities are often established as partnerships and are essentially owned by the fund's investors. Structured-finance entities are not typically carried on a company's balance sheet, and ownership can be through a party other than the person directing the establishment of the entity, such as a charitable trust, or spread across many noteholders or investors, such as in deals involving securitization. The entities created by Maples and Calder that are directly owned or controlled include corporate subsidiaries, such as those used by multinational corporations to conduct international business.

**Several Factors
Influence U.S.
Taxpayers' Decisions
to Conduct Financial
Activity in the
Cayman Islands**

U.S. persons who conduct financial activity in the Cayman Islands commonly do so to gain business advantages, including tax advantages under U.S. law. Although such activity is typically legal, some persons have engaged in activity in the Cayman Islands, like other jurisdictions, in an attempt to avoid detection and prosecution of illegal activity by U.S. authorities.

The Cayman Islands may attract U.S.-related financial activity because of characteristics including its reputation for stability and compliance with international standards, its business-friendly regulatory environment, and its prominence as an international financial center. For instance, because the Cayman Islands' legal and regulatory system is generally regarded as stable and compliant with international standards, U.S. persons looking for a safe jurisdiction in which to place funds and assets may choose to carry out financial transactions there. Additionally, establishing a Cayman Islands entity can be relatively inexpensive—an exempted company can be created for less than \$600, not taking into account service-provider fees. Further, U.S. persons may also be attracted to the Cayman Islands because it is proximate to the United States, operates in the same time zone as New York, and is English speaking.

Another frequent reason for doing business in the Cayman Islands is to obtain tax advantages, such as through reduction or deferral of U.S. taxes. For instance, U.S. tax-exempt entities, such as university endowments and pension funds, may invest in hedge funds organized in the Cayman Islands in order to avoid the unrelated business income tax (UBIT). The investment income of U.S. tax-exempts may be subject to UBIT if earned by an investment vehicle organized as a U.S. partnership, a formation common among U.S.-based hedge funds. However, tax-exempts that invest in hedge funds organized as foreign corporations in jurisdictions like the Cayman Islands can be paid in dividends, which are not subject to UBIT.

Additionally, some U.S. persons may use Cayman Islands entities to defer U.S. taxes. For example, a U.S.-based multinational business may create a Cayman Islands subsidiary to hold foreign earnings, which are not generally taxed in the United States unless or until repatriated. Because the Cayman Islands, like some other OFCs, has no direct taxes, Cayman subsidiaries do not incur additional taxes owed to the Cayman Islands government. One indication of the extent to which U.S. companies use Cayman entities to defer taxes is their reaction to a recent tax law. In 2004,

Congress approved a received dividend reduction for certain earnings of foreign subsidiaries of U.S. companies repatriated for a limited time.⁴ Approximately 5.5 percent of the nearly \$362 billion repatriated between 2004 and 2006 came from Cayman Island controlled foreign corporations.

Lastly, as with other offshore jurisdictions, some U.S. persons may establish entities in the Cayman Islands to illegally evade taxes or avoid detection and prosecution of illegal activities. The full extent of illegal offshore financial activity is unknown, but risk factors include limited transparency related to foreign transactions,⁵ and difficulties faced by U.S. regulators and the courts in successfully prosecuting foreign criminal activity. Voluntary compliance with U.S. tax obligations is substantially lower when income is not subject to withholding or third-party-reporting requirements. Because U.S.-related financial activity carried out in foreign jurisdictions is not subject to these requirements in many cases, persons who intend to evade U.S. taxes are better able to avoid detection. Persons intent on illegally evading U.S. taxes may be more likely to carry out financial activity in jurisdictions with no direct taxes, such as the Cayman Islands, because income associated with that activity will not be taxed within those jurisdictions.

**The U.S. Government
Has Access To Several
Information Sources
Regarding U.S.
Taxpayers' Business
Activities in the
Cayman Islands, but
Most Information is
Self Reported**

Individual U.S. taxpayers and corporations are generally required to self-report their taxable income to the Internal Revenue Service (IRS). Similarly, publicly owned corporations traded on U.S. markets are required to file annual or quarterly statements with the Securities and Exchange Commission (SEC). When an individual or corporation conducts business in the Cayman Islands, there is often no third-party reporting of transactions, so disclosures to IRS and U.S. regulators are dependent on the accuracy and completeness of the self-disclosure. Cayman Islands financial institutions are often not required to file reports with IRS concerning U.S. taxpayers. This makes it more likely that there would be inaccurate reporting by U.S. taxpayers on their annual tax returns and SEC required filings.

⁴ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1515-20 (Oct. 22, 2004).

⁵ Cayman Island government officials said that this is a common problem when one country seeks information on activities within another country.

In addition to the information that both IRS and SEC receive from filers of annual or quarterly reports, the U.S. government also has formal information-sharing mechanisms by which it can receive information from foreign governments and financial institutions. In November of 2001, the United States signed a Tax Information Exchange Agreement (TIEA) with the government of the United Kingdom with regard to the Cayman Islands. The TIEA provides a process for IRS to request specific information related to taxpayers. IRS sends TIEA requests to the Cayman Islands based on requests from inside the agency. In addition to the TIEA, the U.S. government and the Cayman Islands also entered into a Mutual Legal Assistance Treaty (MLAT) in 1986. The MLAT enables activities such as extraditions, searches and seizures, transfer of accused persons, and general criminal information exchange, including in relation to specified tax matters.

Since the TIEA began to go into effect, IRS has made a small number of requests for information to the Cayman Islands. An IRS official told us that those requests have been for either bank records of taxpayers or for ownership records of corporations.⁶ The IRS official also told us that the Cayman Islands government has provided the requested information in a timely manner for all TIEA requests. Since the MLAT went into effect and through the end of 2007, the Department of Justice told us that the U.S. government has made over 200 requests for information regarding criminal cases to the Cayman Islands.

Some financial intelligence information on U.S. persons' Cayman activities is available to U.S. regulators. The U.S. government's financial intelligence unit, FinCEN,⁷ works to gather information about suspected financial crimes both offshore and domestic. As part of its research and analysis, FinCEN can make requests of its counterpart in the Cayman Islands, the Cayman Islands Financial Reporting Authority (CAYFIN). CAYFIN can and does make requests to FinCEN as well. FinCEN and CAYFIN routinely share suspicious activity information.

In fiscal year 2007 CAYFIN made 25 suspicious activity information requests to FinCEN to follow up on potential new as well as existing Cayman Islands-generated suspicious activity reports (SARs), while

⁶ The TIEA has been in effect for criminal cases since 2004 and for civil cases since 2006.

⁷ FinCEN, an intelligence and analysis organization, is part of the U.S. Department of the Treasury's Office of Terrorism and Financial Intelligence.

FinCEN made 6 requests to CAYFIN. According to CAYFIN, financial institutions primarily filed suspicious activity reports on U.S. persons for suspicion of fraud related offenses. Other offenses leading to the filing of suspicious activity reports included drug trafficking, money laundering, and securities fraud, which mostly consisted of insider trading.

In addition to the formal information sharing codified into law between the U.S. government and Cayman Islands government and financial institutions represented by TIEA and MLAT requests and SARs, Cayman Islands officials reported sharing with and receiving information from federal agencies, state regulators, and financial institutions.

U.S. and Cayman Officials Have Taken Steps to Address Illegal Activity, but Enforcement Challenges Exist

To address the challenges posed by offshore illegal activity, IRS has targeted abusive transactions in areas related to transfer pricing, hedge funds, offshore credit cards, and promoters of offshore shelters. IRS officials said that some abusive transactions identified through these initiatives involved Cayman Islands entities, although the exact extent of this involvement was unclear because it does not maintain jurisdiction-specific statistics regarding abusive transactions.

While the full extent of Cayman involvement in offshore illegal activity is unclear, U.S. officials were able to point to specific criminal investigations and prosecutions involving the Cayman Islands. Over the past five years IRS field agents have requested information regarding suspected criminal activity by U.S. persons in 45 instances pertaining to taxpayers or subjects in the Cayman Islands. We analyzed 21 criminal and civil cases to identify common characteristics of legal violations related to the Cayman Islands. Among these cases, the large majority involved individuals, small businesses, and promoters, rather than large multinational corporations. While they were most frequently related to tax evasion, other cases involved securities fraud, money laundering, and various other types of fraud. In most instances, Cayman Islands bank accounts had been used, and several cases involved Cayman Islands companies or credit-card accounts.

IRS and Department of Justice (DOJ) officials stated that particular aspects of offshore activity present challenges related to oversight and enforcement. Specifically, these challenges include lack of jurisdictional authority to pursue information, difficulty in identifying beneficial owners due to the complexity of offshore financial transactions and relationships among entities, and lengthy processes involved with completing offshore examinations.

Despite these challenges, U.S. officials consistently report that cooperation by the Cayman Islands government in enforcement matters has been good. Further, both the International Monetary Fund (IMF) and the Caribbean Financial Action Taskforce (CFATF) have cited the Cayman Islands for its efforts to comply with international standards, such as those related to anti-money-laundering and terrorist-financing activities. However, Cayman Islands government officials and senior partners from Maples and Calder stated that their role in helping the U.S. ensure compliance with U.S. tax laws is necessarily limited. Cayman Islands government officials stated that they cannot administer other nations' tax laws and are not aware of any jurisdiction that undertakes such an obligation as a general matter. Senior partners from Maples and Calder stated that complying with U.S. tax obligations is the responsibility of the U.S. persons controlling the offshore entities, and that they require all U.S. clients to obtain onshore counsel regarding tax matters before they will act on their behalf. Cayman officials told us that until a request is made by the U.S. for tax-related assistance, the Cayman Islands government is "neutral" and does not act for or against U.S. tax interests.

Concluding Observations

Ugland House provides an instructive case example of the tremendous challenges facing the U.S. tax system in an increasingly global economy. Although the Maples and Calder law firm provides services that even U.S. government-affiliated entities have found useful for international transactions and the Cayman Islands government has taken affirmative steps to meet international standards, the ability of U.S. persons to establish entities with relatively little expense in the Cayman Islands and similar jurisdictions facilitates both legal tax minimization and illegal tax evasion. Despite the Cayman Islands' adherence to international standards and the international commerce benefits gained through U.S. activities in the Cayman Islands, Cayman entities nevertheless can be used to obscure legal ownership of assets and associated income and to exploit grey areas of U.S. tax law to minimize U.S. tax obligations. Further, while the Cayman Islands government has cooperated in sharing information through established channels, as long as the U.S. government is chiefly reliant on information gained from specific inquiries and self-reporting, the Cayman Islands and other similar jurisdictions will remain attractive locations for persons intent on legally minimizing their U.S. taxes and illegally avoiding their obligations.

Balancing the need to ensure compliance with our tax and other laws while not harming U.S. business interests and also respecting the

sovereignty of the Cayman Islands and similar jurisdictions undoubtedly will be a continuing challenge for our nation.

Chairman Baucus, Senator Grassley, and members of the committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

Contact and Acknowledgments

For further information regarding this testimony, please contact Michael Brostek, Director, Strategic Issues, on (202) 512-9110 or brostekm@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include David Lewis, Assistant Director; Perry Datwyler; S. Mike Davis; Robyn Howard; Brian James; Danielle Novak; Melanie Papasian; Ellen Phelps Ranen; Ellen Rominger; Jeffrey Schmerling; Shellee Soliday; Andrew Stephens; Jessica Thomsen; and Jonda VanPelt.

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



**Cayman Islands: Review of Cayman Islands and U.S. Laws
Applicable to U.S. Persons' Financial Activity in the Cayman
Islands, (GAO-08-1028SP), an E-supplement to GAO-08-778,
July 2008)**

Read the Full Report: *Cayman Islands: Business and Tax Advantages Attract U.S. Persons but Enforcement Challenges Exist* (GAO-08-778)

Background Information

The Cayman Islands is a major center for financial activity and entities such as corporations, partnerships, and trusts can all play roles in those activities. U.S. taxpayers have a range of relationships to those entities, including as owners, as investors, as partners, and as beneficiaries of trusts. The activities of Cayman Islands entities can have tax consequences under U.S. law. To understand more about the nature of financial activity in the Cayman Islands and its consequences under U.S. tax law, we examined relevant portions of Cayman Islands and U.S. law. This supplement discusses four areas of Cayman Islands and U.S. law. Part I is an overview of Cayman Islands law governing corporations, partnerships, and trusts. It also discusses the function of the registered office under Cayman Islands law. Part II presents an overview of Cayman Islands law governing the sharing of information by the Cayman Islands government with the U.S. government. Part III discusses certain Cayman Islands monetary authority and anti-money-laundering laws and compares specific Cayman Islands and United States regulations designed to combat money laundering. Finally, Part IV describes some of the obligations that can arise under U.S. tax law for Cayman Islands entities and for U.S. owners of Cayman Islands entities.

Part I: Cayman Islands Law Governing Corporations, Partnerships, and Trusts

The law governing Cayman Islands corporations, partnerships, and trusts is derived from English common law, but is now largely statutory. Under Cayman Islands law, each entity form has a variety of types which are described below.

A. Corporations

The fundamental feature of a corporation under Cayman Islands law, like in the United States, is the limited liability of its shareholders, who are referred to as "members" under Cayman Islands law. A corporation is a legal person that must be created in conformance with formal statutory requirements including registration with the government. All Cayman Island corporations are governed by the Cayman Islands Companies Law (2007 Revision). To form a corporation, a memorandum of association must be filed containing the name of the proposed corporation, the location in the Cayman Islands of its registered office, the number of shares each shareholder takes, and the objects or purposes of the corporation. The memorandum of association is filed with the Cayman Registrar.

All Cayman Islands corporations must have a registered office in the Cayman Islands. U.S. states typically have similar requirements for registered offices or registered agents. Cayman Islands law, like many U.S. states' laws, does not require or presume that any business activity of the corporation occurs at the registered office other than the receipt of service or other notices and keeping of certain records. The requirements of a registered office are discussed in further detail below in Part I(D) of this supplement.

All Cayman Islands corporations must maintain certain records, although not all must be filed with the Registrar or kept at the registered office, as discussed below. A Cayman Islands corporation must maintain a register of shareholders, a register of mortgages and charges, a register of directors, proper books of account, and minutes of all proceedings and resolutions of its shareholders, directors, or managers. Proper books of accounts must be able to give a true and fair view of the state of the corporation's affairs and explain its transactions.

Cayman Islands corporations can be ordinary, exempted, or foreign companies. The differences among these types of companies are explained below.

(1) Ordinary companies

Ordinary companies are subject to both the Cayman Islands Companies Law and the Local Companies (Control) Law (1999 Revision). The name of ordinary companies must include "Limited" or "LTD." Each year the company must file with the Registrar its list of shareholders and directors and hold a general meeting of shareholders. The list of shareholders must include the names, addresses, and number of shares held by each shareholder. In addition, ordinary companies must keep a register of shareholders including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders. This register must be open to the public during certain hours every business day at the registered office of the ordinary company upon payment of certain fees. The register of directors and officers must also be kept at the registered office.

Ordinary companies can be resident or non-resident. An ordinary resident company is usually formed to engage in business in the Cayman Islands. An ordinary resident company may conduct business in the Cayman Islands but an ordinary non-resident company may not. A resident company may become a non-resident company if the Cayman Islands Financial Secretary is satisfied that the corporation will not conduct business in the Cayman Islands and grants a certificate of non-residence to the corporation. While both ordinary resident and non-resident companies must file a list of shareholders annually with the Registrar, ordinary

resident companies must also file an annual list of shares held by Cayman Islands residents with the relevant Cayman Islands Immigration board to enforce the Local Companies (Control) Law requirement that 60 percent of shares of an ordinary resident company have Cayman Islands ownership.

(2) Exempted companies

When being formed, any Cayman Islands corporation can apply to the Registrar to be an exempted company. Unless granted a license under Local Companies (Control) Law, an exempted company is prohibited from engaging in business in the Cayman Islands except in furtherance of the business of the corporation carried on outside the Cayman Islands, and must make annual declarations to that effect. This restriction does not prevent exempted companies from making contracts in the Cayman Islands or from offering goods, services, or information over the Internet. An exempted company cannot offer stock to the Cayman public unless it is listed on the Cayman Islands Stock Exchange.

An exempted company is excluded from a number of requirements applicable to ordinary corporations. An exempted company is required to keep a register of shareholders, including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders. The names and addresses of directors and officers must be maintained at the registered office and filed with the Registrar. However, unlike an ordinary company, an exempted company need not open this register to the public, keep it in the Cayman Islands,¹ or send the list of shareholders to the Registrar. Additionally, an exempted company need not hold an annual general meeting of shareholders.

An exempted company may issue shares in bearer form, a type of share whose certificate does not record the owner's name and that is owned by whoever holds the certificate. However, since April 2001 Cayman Islands law has sharply curtailed the use of bearer shares; they may only be issued to or held by licensed or recognized custodians such as a holder of companies service license. As of April 2002, all companies, unless granted an extension, were to ensure that all bearer shares were deposited with a custodian or the shares would become null and void.

An exempted company may also apply to be registered as an exempted limited duration company. The exempted limited duration company form was created mainly to qualify for partnership tax treatment in other jurisdictions; however, the special features of the exempted limited duration exempted company are no longer necessary to qualify for partnership treatment under the U.S. Internal Revenue Code. The memorandum of association of exempted limited duration companies must limit the duration of the corporation to 30 years or less. An exempted limited duration company is considered to have commenced a voluntary winding up and dissolution when the period of duration is complete, when the members pass a special resolution to wind up voluntarily, or 90 days from certain events such as the death, resignation, or bankruptcy of a member. An exempted limited duration company must have at least two members and include "Limited Duration Company" or "LDC" in its name.

Exempted companies, including exempted limited duration companies, and any company applying to be an exempted company, can also apply to be a segregated portfolio company. Some of the assets and liabilities of a segregated portfolio company are divided into separate "portfolios"; assets in one portfolio are not available to meet liabilities and creditors of other portfolios. Assets of a segregated portfolio company not assigned to a portfolio are general assets and are available to meet the liabilities of any portfolio. A portfolio is not a separate legal entity. To apply to be a segregated portfolio company, a corporation must file with the Registrar a statement setting out the assets and liabilities of the company and recent transactions or events causing material changes to the assets or liabilities; the name of each portfolio; which assets and liabilities will be held

¹ The registered office of an exempt corporation may be compelled to produce this or other records held outside the Cayman Islands by Cayman Islands authorities.

by which portfolio; assurances that each portfolio will be solvent; and the written consent of all creditors of the company to the creation of segregated portfolios.² A segregated portfolio company must include "SPC" or "Segregated Portfolio Company" in its name. In addition to the normal annual fees paid to Cayman Islands authorities, a segregated portfolio company must pay a special segregated portfolio company fee and fees for each portfolio.

(3) Foreign companies

Foreign companies are companies that are organized under the law of a jurisdiction other than the Cayman Islands, but have chosen to register with the Cayman Registrar.³ Any corporation incorporated under the law of another jurisdiction which establishes a place of business or commences in carrying on a business in the Cayman Islands must register in the Cayman Islands as a foreign company. To register in the Cayman Islands, a foreign company must pay an annual fee and provide the Registrar a certified copy of its organizing instrument in English; a list of directors; and the name and address of a registered agent present in the Cayman Islands.⁴ Service of legal process or notice on the registered agent of a foreign company is deemed legally sufficient.

B. Partnerships

Partnerships, other than limited partnerships discussed below, are different from corporations in that their existence does not depend on registration with the government. Under Cayman Islands Partnership Law, a partnership exists between two or more persons carrying on a for-profit business in common unless the business is incorporated. In general, under both U.S. and Cayman law, a fundamental difference between partnerships and corporations is that the liability of partners in a partnership is not limited.

Cayman Islands law also allows for limited partnerships, a familiar concept in many U.S. states. Limited partnerships have at least one general partner with unlimited liability and at least one limited partner with limited liability. Unlike an ordinary partnership, a limited partnership must register with the Cayman Islands Registrar. The registration documents must include the name of the partnership, the general nature of the business, the principal place of business, the names and residences of the general partners, the term of partnership if any, a statement that the partnership is limited, and the contribution of each limited partner. Cayman Islands law prohibits limited partners from engaging in some activities, such as management of the partnership, that general partners can undertake.

Cayman Islands law also allows limited partnerships to register as exempted limited partnerships. An exempted limited partnership is prohibited from undertaking business with the public in the Cayman Islands except in furtherance of carrying on business outside the Cayman Islands and is governed by the Exempted Limited Partnership Law (2007 Revision). Corporations and partnerships can be partners in an exempted limited partnership. However, at least one general partner must be an individual resident of the Cayman Islands or a corporation or partnership registered in the Cayman Islands. A non-Cayman Islands corporation can satisfy this requirement by registering as a foreign company with the Cayman Islands Registrar. Exempted limited partnerships must register with the Cayman Islands Registrar just like ordinary limited partnerships.

² As an alternative to all creditors consenting in writing, the applicant can send written notice to all creditors having a claim against the corporation exceeding \$1,000. The consent of creditors holding 95 percent of the liabilities of the corporation is then sufficient.

³ One reason a corporation might choose to register as a foreign company is to be a general partner in a Cayman Islands partnership. Cayman Islands law requires exempted limited partnerships to have at least one general partner registered in the Cayman Islands.

⁴ Foreign companies have registered agents. Other types of entities, including ordinary companies, exempt companies, and exempt partnerships have registered offices.

Limited partnerships must have a registered address and maintain at that office the names and addresses of each partner and the partners' contributions to and receipts from the partnership.

C. Trusts and trust companies

Trusts are a unique legal concept originating in the common law, and are recognized in both the United States and the Cayman Islands. A trust is a fiduciary relationship rather than a separate legal entity. A trust is created when the settlor, or creator of the trust, transfers property to the trustee to be held for the benefit of the beneficiary. A trust is sometimes said to divide ownership of the trust property into two parts: legal ownership, which goes to the trustee, and beneficial ownership, which goes to the beneficiary. A trustee under Cayman Islands law has the same power as an ordinary owner of property to sell, transfer, mortgage, invest, insure, or take any other action with respect to the trust property, subject to the trustee's fiduciary duties. A trustee has a fiduciary duty to act with the highest degree of honesty and integrity with respect to the trust property and the beneficiary, and is liable for violations of this duty.

Trusts in the Cayman Islands are governed by the Trusts Law (2007 Revision). Like partnerships and unlike corporations, the existence of a trust, other than an exempted trust as described below, does not depend on registration with the government. Under Cayman Islands law, a settlor can reserve the power to revoke or amend a trust, give binding directions to trustees, appoint or remove trustees or beneficiaries, and restrict the powers and discretion of trustees. A settlor of a trust also can be a beneficiary of the trust and a director or officer of a company owned by the trust. Courts in the Caymans Islands, when determining which jurisdiction's law governs a trust, will first look to the terms of the trust and the intentions of the parties regardless of whether the property in question is present in the Cayman Islands. A clause of a trust document that expressly selects the laws of the Cayman Islands to govern a trust is valid, effectively and conclusively, regardless of any other circumstances. A trust governed by Cayman Islands law will not be invalid in the Cayman Islands because of a foreign law that does not recognize the legal concept of a trust, or because the trust avoids or defeats rights of other persons in the trust property under foreign laws based on personal relationships or heirship.⁵

Cayman Islands trusts can be ordinary, exempted, or special. An exempted trust differs from an ordinary trust in that it may be given a tax-exemption certificate from the Cayman Islands government stating that no Cayman Islands tax or duty relating to income, capital gains, inheritance, or estate, should such tax be introduced in the future, would apply to the trust property for 50 years. As is the case in relation to all persons, current Cayman Islands law imposes no such tax or duty on either ordinary or exempted trusts. Unlike ordinary trusts, an exempted trust must be registered with the Registrar. Registration includes the filing of trust documents with the Registrar and the payment of a fee. The Registrar's file on an exempted trust is open to inspection by trustees or other persons authorized by the trust documents to inspect the file, but not to the general public. Also, an exempted trust cannot have any beneficiaries who are domiciled in or residents of the Cayman Islands.⁶

A special trust, also called a STAR trust, differs from an ordinary trust in several ways. First, a beneficiary of an ordinary trust has the right to seek enforcement of terms of the trust in court, while a beneficiary of a special trust does not have such a right. Instead, a special trust has one or more persons called "enforcers" who are either named in the trust documents or appointed by the court. Enforcers may be beneficiaries, but need not be, and are generally presumed to have a fiduciary duty for the proper execution of the trust. An enforcer of a special trust has the same rights as a beneficiary of an ordinary trust to bring administrative and

⁵ Personal relationship means any relationship by blood or marriage, including former marriage. Heirship right means any right, claim, or interest in or against property of a person because of that person's death other than a right created by a will or other voluntary disposition.

⁶ This excludes objects of charitable trusts and non-resident companies and exempt companies registered under the Companies Law.

other legal actions, make applications to the court, be informed of the terms of the trust, receive information concerning the trust and its administration from the trustee, and inspect and copy trust documents.

Second, a trustee of a special trust has the power to resolve uncertainties as to the trust's objects or mode of execution, while a trustee of an ordinary trust must seek judicial intervention to resolve such uncertainties. Reciprocally, Cayman Islands courts can vary or revoke an ordinary trust or enlarge the power of trustees upon application by certain beneficiaries, whereas they do not have such power over special trusts. However, trustees of special trusts can apply to Cayman Islands courts under some circumstances to reform the trust.

In addition, every special trust must have at least one trustee which is a trust company licensed under the Cayman Islands Bank and Trust Companies Law (2007 Revision). Finally, a special trust cannot hold real estate in the Cayman Islands, but may hold an interest in a corporation, partnership, or other entity which owns land in the Cayman Islands. A special trust may also apply to be an exempted trust.

Anyone can serve as a trustee of a trust. However, under Cayman Islands law, any company engaged in the business of acting as a trustee, executor, or administrator must be licensed and regulated as a trust company and is subject to Cayman Islands anti-money-laundering and know-your-customer requirements. To be licensed, a trust company's principal office must be in the Cayman Islands and have a Cayman Islands corporation or two Cayman Islands residents as local agents. There are two types of trust company licenses in the Cayman Islands. A holder of an unrestricted trust company license can act as trustee for any trust. A holder of a restricted trust company license is restricted to the activity specified in its approved business plan and can only be a trustee for trusts listed on the license application, typically limited to 20 trusts or less. A nominee trust company is a wholly owned subsidiary of a licensed trust company whose sole purpose is to act as the trust company's nominee. All license holders must have annual audits by a professionally qualified audit firm approved by CIMA.

D. Registered offices and company management businesses

Cayman Islands corporations and exempted limited partnerships must have a registered office located in the Cayman Islands, whose address is publicly available from the Registrar. U.S. states have similar requirements. The registered office is the place where all official communication with the entity must be sent, including any legal writ, notice, order, or other legal document. Proper service by another party, such as a creditor, of legal documents on a corporation or exempted limited partnership, a necessary step in legal proceedings, can be accomplished by delivery of the documents to its registered address. Other documents that can be sent to the corporation's registered office include a creditor's demand for payment, shareholder proxies and powers of attorney, and a shareholder statement of dissent from winding up. A primary function of a registered office under Cayman Islands law is the protection of creditors of a corporation.

Cayman Islands law does not require or presume that any business activity of the entity occurs at the registered office other than the handling of the communications discussed above and keeping of some records. Specifically, under Cayman Islands law, all corporations must keep at their registered offices (1) a register of all mortgages on the property of the corporation, which is open to members and creditors of the corporation; and (2) an up-to-date list of the names and addresses of directors and officers of the corporation. Ordinary companies must keep a register of shareholders, including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders at the registered office. This register must be open to the public during certain hours every business day upon payment of certain fees. Limited partnerships must have a registered address and maintain at that office the names and addresses of each partner and the partners' contributions to and receipts from the partnership.

There are businesses in the Cayman Islands that provide registered office services for a fee; there are corporate service providers in the United States that provide similar services. In the Cayman Islands, as in the United

States, the address of the firm providing registered office services is usually the registered address for the firm's clients. Under the Companies Management Law (2003 Revision), a business that provides registered office services must be licensed by the Cayman Islands Monetary Authority (CIMA). These company service providers must also follow the requirements of Cayman Islands law with regard to anti-money-laundering and "know-your-customer" laws, which are discussed in Part III of this supplement. In brief, Cayman Islands law requires company service providers to keep records of the beneficial ownership of entities to which they provide services.

Under Cayman Islands law, there are two types of company management licenses: a corporate services license and a companies management license. The holder of a corporate services license may only act as a company formation agent; provide registered office services; file statutory forms, resolutions, returns, and notices; and accept legal service of process for a foreign company. The holder of a companies management license can provide for their clients all the services of a corporate services license and, in addition, can provide nominee shareholders and officers and directors; act as a custodian of bearer shares; and control all or a substantial part of the assets of the corporation. Nominee shareholders are individuals whose names appear on the corporate forms filed with the Registrar but are not the beneficial owners. The existence of nominees does not relieve the company service provider from its obligation to know the beneficial owner under Cayman Islands anti-money-laundering and know-your-customer rules.

In addition to holders of corporate services licenses and companies management licenses, holders of trust company licenses, insurance managers licenses, and mutual fund licenses may provide registered office and other services consistent with the terms of those licenses.

Providing such services without a license is a criminal offense and can result in fines and imprisonment. To receive a license, the applicant must satisfy CIMA that it has sufficient expertise to carry on the business and that the business will be conducted by persons who are "fit and proper" for their roles as directors, officers, or managers. To assess whether a person is fit and proper, the statute requires CIMA to assess the person's honesty, integrity, and reputation; competence and capability; and financial soundness. License holders undergo annual audits by a CIMA-approved auditor who is a member of a major auditing professional organization. Every year the license holder must also submit to the regulator copies of its accounts and the results of the audit. CIMA has the power to conduct reviews, including on-site reviews, of the business of any license holder. CIMA can also inspect the records of anyone it reasonably suspects of carrying on a company management business without a license.

Part II: Cayman Islands Law Governing Sharing of Information With Foreign Governments

A. MLAT and implementing statute

In July 1986, the United States and the United Kingdom, including the government of the Cayman Islands, signed a Mutual Legal Assistance Treaty (MLAT) that requires the United States and the Cayman Islands to provide legal assistance to each other at the request of the other party in criminal matters. However, assistance is generally not provided under the MLAT if the request deals with alleged criminal activity relating to the imposition, calculation, and collection of taxes, or if the criminal matter is not punishable by at least one year of imprisonment. Assistance can be provided under the MLAT if the alleged criminal activity concerns willfully or dishonestly obtaining assets by committing fraud in connection with benefits available under tax laws or concerns willful or dishonest false statements about a tax matter concerning the unlawful proceeds of a criminal offense. Legal assistance may include taking testimony of individuals, providing documents or other evidence, locating persons and transferring persons in custody, executing searches and seizures, and freezing assets. Additionally, if one party has reason to believe the proceeds of a criminal offense are located in the territory of the other party, assistance may include forfeiture of the proceeds of the criminal offense, payments

of restitution to the victim, and the collection of fines. Requests for assistance must originate from the Attorney General or his designees in the United States and from the Cayman Mutual Legal Assistance Authority in the Cayman Islands.

Senate ratification of the MLAT did not occur until October 1989, with the treaty entering into force under U.S. law in March 1990. However, the Cayman Islands began providing legal assistance immediately after the September 1986 enactment of their implementing statute, known as the Mutual Legal Assistance (United States of America) Law (1999 Revision). This law established the Chief Justice, or another Judge of the Grand Court, as the designated Cayman Mutual Legal Assistance Authority. Additionally, the statute gives the Cayman Authority the power to compel persons to testify or produce documents, and it requires confidentiality from individuals who are involved in a legal assistance request. Failure to produce documents or maintain confidentiality can result in criminal penalties.

Subsequent to the MLAT agreement with the United States, the Cayman Islands enacted in 1997 what is now titled the Criminal Justice (International Cooperation) Law (2004 Revision), thereby permitting the Cayman Islands to provide similar legal assistance to most countries in the world. Under the law, mutual legal assistance may be provided if there is a criminal offense under Cayman Islands law or if there is conduct which would have constituted a criminal offense had it occurred within the Cayman Islands. Upon receiving a request for assistance, Cayman Islands authorities may take statements, serve documents, execute searches and seizures, provide evidence and documents, identify and examine objects and sites, freeze assets, and assist in proceedings related to forfeiture and restitution.

B. TIEA and implementing statute

In November 2001, the United States and the United Kingdom, including the government of the Cayman Islands, signed a Tax Information Exchange Agreement (TIEA) designed to facilitate the exchange of tax information between the United States and the Cayman Islands. Each party agreed to provide, at the request of the other, information relating to the administration and enforcement of domestic federal income tax laws, although other types of tax laws may also be included by later agreement. Each party to the agreement is required to ensure it has the domestic legal authority to obtain information from financial institutions regarding nominees, trustees, beneficial owners, units of interests of investment funds, and other similar information. While requests can be made concerning the activities of any individual regardless of residency or nationality, the request must be specific enough to identify the taxpayer and the tax purpose for which the information is sought, as well as state the reasonable grounds for believing the information is in the territory of the other party. In some circumstances, representatives from one party may enter the territory of the other party in order to interview persons and examine records. Requests for information must originate from the Secretary of the Treasury or his designees in the United States and from the Tax Information Authority in the Cayman Islands. All information provided or received by either party must be kept confidential and may only be used for the enforcement of tax laws. The agreement entered into force for criminal tax evasion matters on January 1, 2004, and for all other noncriminal tax matters on January 1, 2006.

The U.S. Department of Treasury performs U.S. obligations under the agreement pursuant to existing authority in U.S. law. In March 2005, the Cayman Islands passed a domestic implementing statute, the Tax Information Authority Law, 2005. Under this law, the Cayman Islands Financial Secretary was designated the Tax Information Authority. His functions and powers under the Law were formally delegated to an administrative unit of the same name, including the power to take testimony, provide evidence, serve documents, and execute searches and seizures. Individuals who fail to produce required information or maintain confidentiality are subject to criminal penalties.

Part III: Cayman Islands Monetary Authority Law; Cayman Islands and U.S. Anti-Money-Laundering Laws

A. CI Monetary Authority Law

In 1997, the Monetary Authority Law (2004 Revision) established the Cayman Islands Monetary Authority (CIMA) as the Cayman Islands primary financial services regulatory body. Led by a Board of Directors, CIMA has four primary areas of functional responsibility. First, pursuant to its monetary functions, CIMA is the sole issuer of the legal tender of the Cayman Islands and manages the country's Currency Reserve. The Monetary Authority Law specifies that the official currency is the Cayman dollar, the value of which is tied by order to the American dollar. Second, CIMA regulates and supervises financial services businesses, monitors compliance with anti-money-laundering regulations, issues and amends rules and statements of guidance including relating to money laundering, and performs other regulatory duties. The Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands are considered to be issued under this grant of authority. Third, CIMA is responsible for providing assistance to overseas regulatory authorities. In deciding whether to provide assistance, CIMA is instructed to consider whether corresponding assistance would be given by the requesting party, whether the request relates to a breach of law which has an equivalent within the Cayman Islands, and other factors. If it provides assistance to an overseas regulatory authority, CIMA may disclose information within its possession as well as direct any other person that it considers has relevant information to provide specific information, documents, or other assistance as may be needed. Fourth, CIMA provides an advisory function by advising the government on the regulatory laws and cooperative functions.

As part of its general powers, CIMA may open and maintain accounts with banks, purchase and sell foreign currencies and foreign Treasury bills, purchase and sell securities and other investments, borrow money, and more. CIMA activities are led by a Board of Directors and a Management Committee, and CIMA is fully and solely responsible for all licensing and enforcement activity. The Governor-in-Cabinet appoints all directors and may provide general directions on policy as it may consider necessary in the public interest, after consultation with the Board. The Monetary Authority Law includes a schedule of fees for certain CIMA activities, including fees for the issuance of letters that confirm the registration and licensing of regulated entities.

B. Anti-Money-Laundering Laws

The Proceeds of Criminal Conduct Law (2007 Revision) was first enacted in 1996 and, along with the Terrorism Law, 2003, forms the basis of the Cayman Islands anti-money-laundering and antiterrorist financing legal framework. Under the Proceeds of Criminal Conduct Law, criminal "money laundering" involves the possession, use, concealment, or transfer of the proceeds of criminal conduct, or an act which assists another retain the proceeds of criminal conduct. Proceeds from criminal conduct performed outside the territory of the Cayman Islands also fall within the definition if the act would have been an offense had it been performed within the Cayman Islands.

Additionally, "tipping off" an individual that he or she is being investigated for money laundering or is the subject of a suspicious activity report (SAR) constitutes a criminal offense, as does the failure to report a case of suspected money laundering unless the information was obtained under privileged circumstances.⁷ The law also establishes a financial intelligence unit called the Financial Reporting Authority which is responsible for the receiving, analyzing, and onward disclosure of information related to proceeds of criminal conduct. The

⁷ These relate to the provision of legal advice to a client or to any person in contemplation of legal proceedings or for the purposes of such proceedings, except where a criminal purpose is being furthered.

Financial Reporting Authority must retain information for a minimum of 5 years and may enter into agreements with overseas financial intelligence units.

Pursuant to the authority granted in the Proceeds of Criminal Conduct Law, regulations were promulgated to further strengthen the money laundering framework. Known as the Money Laundering Regulations (current version is the 2006 Revision), these regulations were first enacted in April 2000 and apply to all relevant financial business as defined by the Financial Action Task Force Recommendations, such as those involved in banking, trust business, insurance, mutual funds, company formation and registered office services, and other designated activity in the Cayman Islands. To facilitate interpretation of the requirements this law imposes on financial institutions and other relevant financial business, CIMA has also issued supplementary enforceable Guidance Notes that provide further clarification on what is required to be compliant with the Regulations.

The Regulations and Guidance Notes include a number of important provisions designed to combat money laundering and terrorist financing.⁸ For example, the Regulations require financial businesses to know the identity of their customers⁹ and to maintain identity records for at least 5 years. The Guidance Notes indicate that to comply with the Regulations, the information obtained should include name, address, date and place of birth, nationality, occupation, purpose of the account, estimated level of turnover for the account, the source of funds, and, in some cases, a reference from another financial institution. In relation to legal entities, underlying beneficial ownership and control must be identified and verified as must, in relation to trusts, the settler and any ascertainable beneficiaries¹⁰ and the source of trust property. The Regulations also require financial businesses to create an internal report if there is knowledge or a suspicion that an individual is engaged in money laundering or terrorist financing. If, after considering all information and following certain procedures, the financial business knows or suspects money laundering, then a suspicious activity report must be submitted to the Cayman Islands Financial Reporting Authority. The Guidance Notes offer examples of potentially suspicious activity and a sample Suspicious Activity Reporting Form used to report such activities to the Financial Reporting Authority. There is no monetary threshold for reporting where there is knowledge or suspicion of money laundering or terrorist financing—any such knowledge or suspicion must be reported, regardless of the amount of money involved.¹¹

These laws are similar to U.S. regulations, which require financial institutions to implement Customer Identification Programs intended to allow the institutions to form a reasonable belief as to the true identity of each customer. Under U.S. regulations, financial institutions must verify the identity of customers by collecting certain information, maintain identification records for at least 5 years, and cross-reference customers against lists of known or suspected terrorists. Additional enhanced procedures apply for accounts held by non-U.S. persons, such as mandatory attempts to ascertain the beneficial owners of accounts, the source of funds deposited into accounts, and additional procedures for monitoring accounts for evidence of money laundering.

Cayman Islands regulations also require financial businesses to create an internal report if they have knowledge or suspicion that an individual is engaged in money laundering. If, after considering all information

⁸ Cayman Island regulators refer to these requirements as AML/CFT or anti-money-laundering/combating the financing of terrorism regulations. Both the anti-money-laundering and the combating terrorism financing tracks include know-your-customer requirements.

⁹ Identity needs to be proven (1) where the parties form an ongoing business relationship, (2) where there is a one-off transaction and the person handling the transaction suspects money laundering, (3) where there is a one-off transaction in the amount of \$15,000 or more, or (4) where there are two or more one-off transactions which appear linked and which total \$15,000 or more.

¹⁰ Some trusts will not have immediately ascertainable beneficiaries such as in cases where the beneficiaries have not yet born.

¹¹ Cayman Island regulations also cover cross-border cash transactions of more than \$15,000 and contain specific know-your-customer rules for wire transfers.

and following certain procedures, the financial business knows or suspects money laundering, then a suspicious activity report must be submitted to the Cayman Islands Financial Reporting Authority. The Guidance Notes offer examples of potentially suspicious activity and a sample Suspicious Activity Reporting Form used to report such activities to the Financial Reporting Authority.

In the United States, financial institutions are required to file two different types of reports with the Department of the Treasury. The first, Currency Transaction Reports (CTRs), are required for a single cash transaction of more than \$10,000, or multiple smaller cash transactions that appear to be related and total more than \$10,000. The second, type of report, a Suspicious Activity Report (SAR), is triggered by transactions that involve, in the aggregate, at least \$5,000 if the financial institution has reason to suspect that the transaction involves funds derived from illegal activities, is designed to evade the law, or is unusual for the customer and there is no reasonable explanation for it. Financial institutions are not permitted to disclose to any person involved in the transaction that a SAR has been filed regarding the transaction.

Part IV: U.S. Tax Obligations and Cayman islands Entities

In general, the U.S. Internal Revenue Code (the Code) taxes income earned worldwide by U.S. citizens, U.S. residents, and U.S. corporations wherever earned. Nonresident aliens and foreign corporations are subject to U.S. taxation on certain amounts received from sources within the United States and income which is effectively connected with a trade or business in the United States.

U.S. income tax obligations exist in relation to entities organized in the Cayman Islands in two main circumstances. The first is when the activities of the entity trigger U.S. income tax obligations, such as when a Cayman Islands corporation earns income that is effectively connected to a trade or business in the United States. The second circumstance is when earnings of an entity trigger obligations on behalf of its owners, such as when a Cayman Islands corporation makes a dividend payment to a U.S. taxpayer.

A. Classification of entities for U.S. tax purposes

How a Cayman Islands entity is classified for purposes of the U.S. tax system affects its obligations. A business entity organized as a corporation or a partnership under Cayman Islands law may be treated as such or may elect to be treated otherwise under U.S. tax law. Similarly, Cayman Islands trusts may or may not be treated as trusts for purposes of U.S. tax law, as discussed below.

Whether an entity is treated as a partnership or a corporation is determined by the Department of the Treasury's "check-the-box" regulations. 26 C.F.R §§ 301.7701-1 to -4. Under these regulations, eligible entities,¹² both foreign and domestic, may choose their classification as a corporation, partnership, or a single member entity.¹³ Only business entities are governed by the "check-the-box" rules. Some business and investment trusts meet the definition of a business entity. Eligible entities with two or more members may choose to be treated as partnerships or corporations. Eligible entities with only one member may choose to be treated as single member entities or corporations. Certain entities are not eligible to choose their classification; they are always taxed as corporations.

Corporations are separate legal entities and the United States imposes the U.S. corporate income tax on their profits. Partnerships and other disregarded entities are generally not taxed; the income earned by the entity is

¹² Certain types of entities, including some foreign entities, are per se corporations and do not have the option to be treated as partnerships or single member entities.

¹³ A single member entity is a disregarded entity similar to a partnership for tax purposes, but has only one member. The activities of disregarded entities are taxed in the same manner as a sole proprietorship, branch, or division of the owner.

taken into account on the owners' tax returns. The tax obligations of trusts¹⁴ are handled separately by the Code and will be discussed below.

B. Taxation of entities

(1) Corporations

If a foreign corporation conducts a U.S. trade or business, the income that is effectively connected to that trade or business (ECI) is taxed as if the corporation was a U.S. corporation. 26 U.S.C. § 882. Foreign corporations that own and operate businesses in the United States that sell services, products, or merchandise, are, with certain exceptions, engaged in a U.S. trade or business. Generally, any income from such a business is considered to be ECI and subject to the U.S. corporate tax. Foreign source income attributable to an office or fixed place of business in the United States, such as rents and royalties for the use of certain intangible personal property, is treated as ECI. Foreign corporations engaged in a trade or business in the United States must file a tax return every year even if they have no ECI. 26 U.S.C. § 6012.

(2) Partnerships

Partnerships, whether foreign or domestic, are not taxed on partnership income; the partnership is disregarded and the income is imputed to the partners, who owe taxes on their share of the partnership income at their own applicable rates. In general, a domestic partnership must file a Form 1065, the "U.S. Return of Partnership Income," reporting on the partnership's income, but a foreign partnership only files a Form 1065 if it has ECI or income derived from sources in the United States. 26 U.S.C. § 6031(e).

(3) Withholding taxes on investments

Foreign corporations and non-U.S. partners may also be subject to a tax on U.S.-source investment income not effectively connected to a trade or business. Fixed or determinable annual or periodical gains, profits, and income (called investment income or FDAP income) from U.S. sources earned by a nonresident not in connection to a trade or business is typically subject to a 30 percent tax.¹⁵ 26 U.S.C. §§ 871(a), 881. Since this tax may be difficult to enforce against a foreign taxpayer with few assets in the United States, the U.S. payer of such income may be required to withhold 30 percent to pay this tax. 26 U.S.C. §§ 1441, 1442. A withholding agent who fails to withhold becomes personally liable for the tax and any penalties or interest. The withholding tax on FDAP income is a tax on gross income, unlike the tax on income effectively connected to a U.S. trade or business, which is a tax on net income. A non-U.S. recipient of FDAP income must file a form with the payer (for example, a W-8BEN) stating the amount to be withheld.

(4) Transfer pricing

The Internal Revenue Service (IRS) is authorized to allocate gross income, deductions, credits, and allowances between related taxpayers to the extent necessary to prevent the evasion of taxes or to clearly reflect the income of the taxpayers. 26 U.S.C. § 482. This authority applies both to domestic and foreign taxpayers. IRS examines transfer prices between related taxpayers using the arm's length standard (i.e. in comparison to what transfer prices between unrelated taxpayers for comparable transactions would be), so the transfer pricing rules are governed by complex economic and legal principles. In the case of any transfer or license of intangible property between related tax payers, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible. In some cases, taxpayers and IRS negotiate

¹⁴ The Internal Revenue Code has a limited definition of trust. Some trusts organized under Cayman Islands law may not be taxed as trusts, but as business entities under the "check-the-box" rules.

¹⁵ The level of withholding may be reduced by applicable income tax treaties with certain foreign jurisdictions. However, no such treaty exists between the Cayman Islands and the United States.

advance pricing agreements. The Advance Pricing Agreement Program provides a voluntary process whereby the IRS and taxpayers may resolve transfer pricing issues (under section 482 of the Code, the regulations thereunder, and relevant income tax treaties) on a prospective basis.

C. Taxation of owners

(1) Corporations

As stated above, the United States generally taxes U.S. taxpayers on their worldwide income. When a U.S. taxpayer owns part of a Cayman Islands corporation, distributions, such as dividends to the owner, are part of the owner's taxable income. In general, the United States does not tax or place reporting burdens on foreign corporations solely because they have U.S. taxpayers as shareholders. If a shareholder of a Cayman Islands corporation is a U.S. taxpayer, that U.S. taxpayer is obligated to report any income earned from the Cayman Island corporation, typically dividends. Shareholders may also earn capital gains from the sale of stock. Unless an exception applies, as discussed below, a shareholder is not taxed on earnings of a corporation in which he owns shares until the corporation makes a distribution, such as a dividend. This can allow some taxpayers to defer some tax obligations.

The Code has a number of exceptions to the general rules regarding the taxation of U.S. shareholders of foreign corporations, including the accumulated earnings tax, the controlled foreign corporations (CFC) rules, and the passive foreign investment companies (PFIC) rules. Some of these exceptions treat the foreign corporation as a disregarded entity or partially disregarded entity and impute the earnings of the foreign corporation to the U.S. taxpayer. Other exceptions allow for the deferment of income but impose additional tax penalties or burdens by converting capital gains into ordinary income or by charging interest.

In addition to the ordinary corporate tax, Cayman Islands corporations may be subject to an accumulated earnings tax of 15 percent tax, in addition to the ordinary corporate income tax, on accumulated earnings "beyond the reasonable needs of the business". 26 U.S.C. § 531. This accumulated earnings tax will apply to a Cayman Islands corporation that meets several conditions. First, the corporation must be formed for the purpose of avoiding shareholders' income tax by permitting earnings and profits to accumulate instead of being divided or distributed; and it must not be a personal holding company, tax-exempt corporation, or passive foreign investment company. Second, the foreign corporation's shareholders must be subject to U.S. tax on the distributions of the corporation because they are U.S. citizens or residents, nonresident alien individuals receiving FDAP, or foreign corporations owned directly or indirectly by any shareholder described above. Further, the accumulated income tax applies to income derived from sources within the United States.

Cayman Islands corporations may also meet the definition of a PFIC. Generally, a foreign corporation is a PFIC if 75 percent of the corporation's income is passive income or if 50 percent of the corporation's assets are passive assets. 26 U.S.C. § 1297. Unlike other types of foreign corporations discussed herein, the definition of a PFIC does not depend on any level of stock ownership. Each U.S. shareholder of a PFIC can choose to be taxed in one of two (or, in the case of marketable stock, one of three) ways. A U.S. shareholder of a PFIC may make a qualified electing fund election or, with respect to marketable stock, a mark to market election with respect to the PFIC. U.S. shareholders of qualified electing funds are taxed currently on the PFIC's earnings. Alternatively, U.S. shareholders of a qualified electing fund may choose to defer the tax on the PFIC's earnings but will pay an interest charge. U.S. shareholders of marketable stock who make a mark to market election are taxed annually on the appreciation in the value of the stock, or are allowed a deduction in the case of depreciation in the value of the stock, but only to the extent that they have had prior year inclusions under the mark to market election. Special rules prevent an amount that is taken into account under the qualified electing fund or mark to market elections from being taken into account again upon a payment of a dividend by the PFIC or a disposition of the PFIC stock by the U.S. shareholder. A U.S. shareholder of a PFIC that does not make a qualified electing fund election or a mark to market election is not taxed until the PFIC makes a

distribution or until the U.S. shareholder disposes of the PFIC stock, but is taxed at top rates and is charged interest.

A Cayman Islands corporation may be considered a CFC. 26 U.S.C. §§ 951, 957. Certain U.S. shareholders of CFCs are taxed on their pro rata share of certain income and other amounts of the CFC immediately, not when the CFC makes a distribution. An entity is a CFC if "U.S. shareholders" own more than 50 percent of the total combined voting power of its stock or more than 50 percent of the stock's total value. To be considered a "U.S. shareholder" for the purposes of this definition, a U.S. person must own at least 10 percent of the total combined voting power of the corporation's stock.¹⁶ In calculating ownership, the statute considers direct, indirect, and constructive ownership. U.S. persons are deemed to own stock held by their wholly owned subsidiaries or by certain related persons. If a Cayman entity is a CFC, then each U.S. shareholder owning 10 percent or more of the voting stock must include in income his share of certain income of the CFC. The income of the CFC to be includible to the U.S. shareholder includes the income defined in subpart F (often called Subpart F income) and earnings of the CFC invested in U.S. property. Major types of Subpart F income include income from passive investments, income from transactions with entities related to the CFC, and insurance income. There are special rules discussed below that alter the definition of CFC for foreign insurance companies making it more likely that foreign insurance companies will qualify as CFCs.

Certain individual or corporate shareholders, officers, and directors of foreign corporations are required to file Form 5471, the "Information Return of U.S. Persons with Respect To Certain Foreign Corporations." U.S. persons who control a foreign corporation or U.S. shareholders of a CFC must file a Form 5471. Direct and indirect PFIC shareholders must file a Form 8621, the "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," if they (1) recognize gain on the sale of PFIC stock, (2) receive a PFIC distribution, or (3) make an election on Form 8621. For stock of a CFC that is also a PFIC, PFIC shareholders do not have to file Form 8621 if they include in income subpart F income, which is generally done by filing Form 5471.

(3) Partnerships

U.S. taxpayers who are partners in a Cayman Islands partnership will owe taxes on their share of the partnership income no matter what the source of the income is. Foreign partners of a Cayman Islands partnership will only owe tax on the portion of the partnership income that is ECI. Partners in a partnership are engaged in a U.S. trade or business if the partnership is so engaged. A partnership is engaged in a U.S. trade or business if a partner is so engaged and is acting as an agent of the partnership. Partnerships that have ECI must pay a withholding tax generally at a rate of 35 percent for corporate partners and 35 percent for other partners on the ECI allocable to those partners. If the partnership fails to withhold, any general partner can be liable.

(4) Tax-exempt entities

There are also tax consequences for U.S. tax-exempt entities, such as pension funds and university endowments, who are shareholders in Cayman Islands corporations. In general, if a tax-exempt entity is a partner in a for-profit partnership engaged in a trade or business unrelated to the tax-exempt entity's purpose, then the tax-exempt entity is subject to the unrelated business income tax (UBIT) on income from that partnership. 26 U.S.C. § 512. However, tax-exempt entities that are minority shareholders in corporations are generally not subject to UBIT on dividends. While domestic corporations are subject to the U.S. corporate income tax, which decreases the amount available to be paid out to shareholders, foreign corporations are generally not subject to U.S. corporate income tax on income that is not effectively connected to a U.S. trade or

¹⁶ If 11 unrelated U.S. shareholders hold all the shares of a foreign corporation equally, that corporation is not a CFC because no shareholder is considered a "U.S. shareholder."

business. Therefore, U.S. tax-exempt entities may secure tax advantages with respect to dividend income from foreign corporations that is not ECI.

(5) Insurance

The Code contains special rules for the treatment of foreign corporations' insurance income. 26 U.S.C. § 953. First, insurance income is a type of subpart F income, which means that U.S. shareholders of foreign corporations qualifying as CFCs are taxed on the CFC's insurance income. Second, foreign insurance companies are more likely to be considered CFCs because the definition of a CFC is different in the context of insurance. A foreign corporation not otherwise considered a CFC may qualify as a CFC if U.S. shareholders own 25 percent or more (rather than more than 50 percent) of the corporation's stock and it receives 75 percent of its premium-type income from insuring risks outside the Cayman Islands. Third, foreign corporations that insure the risks of related persons, such as captive insurance companies, are even more likely to be considered CFCs because for these companies, the definition of "U.S. shareholder" is different. In the normal determination of whether a foreign corporation is a CFC, only U.S. shareholders directly or indirectly owning 10 percent or more of the corporate stock are counted. However, for insurance companies insuring related parties, any U.S. shareholder is counted. The altered definition of "U.S. shareholder" further means that the subpart F income of the CFC will be included to all U.S. shareholders, not just those owning 10 percent or more. Certain foreign corporations may choose to pay U.S. corporate taxes on related-party insurance income to save their U.S. shareholders from owing tax on included income. IRS has also contested payments made to captive insurance companies under section 162 as not being actual insurance payments, but capital contributions.

Trusts

Distributions paid by foreign non-grantor trusts to U.S. beneficiaries are generally taxable income to the beneficiaries. Income earned by a grantor trust is taxed to the grantor; the Code disregards the trust as a separate taxable entity. Some foreign trusts may be business entities to which the "check-the-box" rules apply, and will be taxed as partnerships or corporations.

Transfers by a U.S. person to a foreign non-grantor trust are treated under the Code as a sale, which means that the U.S. person will owe tax on any capital gains and the basis in the property is adjusted. 26 U.S.C. § 684. However, there are exceptions to this rule.

Generally, any U.S. person who, during the tax year, creates a foreign trust or transfers money or property to a foreign trust must file a Form 3520, the "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts." The return must be filed whether or not the trust has a U.S. beneficiary and whether or not the trust has a U.S. owner. Foreign trusts with U.S. beneficiaries are required to file Form 3520-A, the "Annual Information Return of Foreign Trust with a U.S. Owner," although a foreign trustee outside the jurisdiction of IRS might not file.

U.S. "owners" of foreign trusts must file a Form 3520 on their trusts for each tax year or partial tax year in which they own the trust (including tax years in which they do not create the trust or transfer property to the trust). For foreign trusts with U.S. beneficiaries, any portion of a trust attributable to a gratuitous transfer by a U.S. taxpayer is considered to be owned by the taxpayer. 26 U.S.C. §§ 671, 679. One purpose of this rule is to prevent U.S. taxpayer from deferring income tax through foreign trusts.

United States Government Accountability Office

GAO

Report to the Chairman and Ranking
Member, Committee on Finance, U.S.
Senate

July 2008

CAYMAN ISLANDS

Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist



GAO-08-778

July 2008

CAYMAN ISLANDS

Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist

Highlights

Highlights of GAO-08-778, a report to the Chairman and Ranking Member, Committee on Finance, U.S. Senate

Why GAO Did This Study

The Cayman Islands is a major offshore financial center and the registered home of thousands of corporations and financial entities. Financial activity in the Cayman Islands is measured in the trillions of dollars annually. One Cayman building—Ugland House—has been the subject of public attention as the listed address of thousands of companies.

To help Congress better understand the nature of U.S. persons' business activities in the Cayman Islands, GAO was asked to study (1) the nature and extent of U.S. persons' involvement with Ugland House registered entities and the nature of such business; (2) the reasons why U.S. persons conduct business in the Cayman Islands; (3) information available to the U.S. government regarding U.S. persons' Cayman activities; and (4) the U.S. government's compliance and enforcement efforts. GAO interviewed U.S. and Cayman government officials and representatives of the law firm housed in Ugland House, and reviewed relevant documents.

What GAO Recommends

GAO makes no recommendations in this report. The Commissioner of Internal Revenue, the Secretary of the Treasury, and the Leader of Government Business of the Cayman Islands were provided a draft of this report for review and comment. GAO received technical corrections which were incorporated as appropriate.

To view the full product, including the scope and methodology, click on GAO-08-778. To view the E-supplement, click on GAO-08-1028SP. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

The sole occupant of Ugland House is Maples and Calder, a law firm and company-services provider that serves as registered office for the 18,857 entities it created as of March 2008, on behalf of a largely international clientele. According to Maples partners, about 5 percent of these entities were wholly U.S.-owned and 40 to 50 percent had a U.S. billing address. Ugland House registered entities included investment funds, structured-finance vehicles, and entities associated with other corporate activities.

Gaining business advantages, such as facilitating U.S.-foreign transactions or minimizing taxes, are key reasons for U.S. persons' financial activity in the Cayman Islands. The Cayman Islands' reputation as a stable, business-friendly environment with a sound legal infrastructure also attracts business. This activity is typically legal, such as when pension funds and other U.S. tax-exempt entities invest in Cayman hedge funds to maximize their return by minimizing U.S. taxes. Nevertheless, some U.S. persons have used Cayman Island entities, as they have entities in other jurisdictions, to evade income taxes or hide illegal activity.

Information about U.S. persons' Cayman activities comes from self-reporting, international agreements, and other sharing with the Cayman government. The completeness and accuracy of self-reported information is not easily verified. While U.S. officials said the Cayman government has been responsive to information requests, U.S. authorities must provide specific information on an investigation before the Cayman government can respond.

The Internal Revenue Service has several initiatives that target offshore tax evasion, including cases involving Cayman entities, but tax evasion and crimes involving offshore entities are difficult to detect and to prosecute. Cayman officials said they fully cooperate with the United States. Maples partners said that ultimate responsibility for compliance with U.S. tax laws lies with U.S. taxpayers. U.S. officials said that cooperation has been good and that compliance problems are not more prevalent there than elsewhere offshore.

Ugland House, George Town, Grand Cayman Island

- Sole tenant is Maples and Calder law firm, which provides registered office services to companies established in the Cayman Islands
- 18,857 registered entities at the Ugland House address
 - Very few have a significant physical presence in the Cayman Islands
 - Five percent wholly U.S. owned
 - Fewer than 50 percent have a U.S. billing address



Source: GAO photograph and statistics obtained from the Cayman Islands government and Maples.

Contents

Letter		1
	Results in Brief	3
	Background	6
	U.S. Persons Are Frequently Associated with Uglan House Registered Entities	10
	Several Factors Influence U.S. Taxpayers' Decisions to Conduct Financial Activity in the Cayman Islands	26
	The U.S. Government Has Access to Several Information Sources Regarding U.S. Taxpayers' Business Activities in the Cayman Islands, but Most Information Is Self-Reported	34
	U.S. and Cayman Officials Have Taken Steps to Address Illegal Activity, but Enforcement Challenges Exist	40
	Concluding Observations	49
	Agency and Cayman Islands Government Comments	50
Appendix I	Comments from the Cayman Islands Government	51
Appendix II	GAO Contacts and Staff Acknowledgements	52
Figures		
	Figure 1: Cayman Islands Demographics and Financial Industry Statistics	7
	Figure 2: Uglan House	11
	Figure 3: Uglan House Entities by Type, March 2008	13
	Figure 4: U.S. Persons' Involvement in Cayman Master-Feeder Hedge Fund Structure	18
	Figure 5: U.S. Persons' Involvement in Cayman Structured Investment Vehicles	21
	Figure 6: U.S. Persons' Involvement in Cayman Aircraft Financing Special Purpose Vehicles	23
	Figure 7: U.S. Persons Reporting Cayman Islands Foreign Bank Accounts, 2002-2007	36
	Figure 8: U.S.-Related SARs Disclosed to FinCEN by CAYFIN in 2006-2007 by Type of Offense	44

Abbreviations

AML	Anti-Money Laundering
ABS	Asset-backed securities
CFATF	Caribbean Financial Action Taskforce
CIMA	Cayman Islands Monetary Authority
CAYFIN	Cayman Islands Financial Reporting Authority
Justice	Department of Justice
Treasury	Department of Treasury
Ex-Im	Export-Import Bank
FinCEN	Financial Crimes Enforcement Network
IRS	Internal Revenue Service
IOSCO	International Organization of Securities Commissions
LMSB	IRS Large and Mid-Sized Business Division
SBSE	IRS Small Business/Self-Employed Division
KYC	Know-Your-Customer
OPIC	Overseas Private Investment Corporation
OFC	Offshore financial center
MBS	Mortgage-backed securities
MOU	Memorandum of Understanding
MLAT	Mutual Legal Assistance Treaty
FBAR	Report of Foreign Bank and Financial Accounts
SEC	Securities and Exchange Commission
SPEs	Special Purpose Entities
SPVs	Special Purpose Vehicles
SIVs	Structured Investment Vehicles
SAR	Suspicious Activity Report
TIEA	Tax Information Exchange Agreement
SPC	Segregated Portfolio Company
UBIT	Unrelated business income tax

This is a work of the U.S. government and is not subject to copyright protection in the United States. This published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



United States Government Accountability Office
Washington, DC 20548

July 24, 2008

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The Cayman Islands is a major center for financial services, with nearly 2 trillion dollars in banking assets as of September 2007. International financial activity is common in our increasingly global economy, and is encouraged or facilitated by various federal policies. Nevertheless, financial activity across foreign jurisdictions poses challenges for both tax policy and administration.

Recognizing the serious problem posed by offshore tax evasion, you asked us to study what is known about the business activities of U.S. taxpayers involving Uglend House in the Cayman Islands. Specifically, you asked us about the extent, motives, and tax implications of these activities, as well as the extent to which the U. S. government has looked into these taxpayer activities. This report focuses on these activities. Our objectives were to determine (1) the nature and extent of U.S. persons' involvement with Uglend House registered entities, and what business, if any, these entities carry on in Uglend House and in the Cayman Islands;¹ (2) what reasons attract U.S. persons to conduct business in the Cayman Islands; (3) what information is available to the U.S. government regarding U.S. persons' Cayman Islands activities, including which are associated with U.S. taxpayers; and (4) for tax noncompliance and other related illegal activities, the U.S. government's compliance and enforcement efforts, and any related activity on the part of the Cayman Islands government.

To address our objectives, we reviewed and analyzed U.S. government and private sector documents and reports related to international finance,

¹ Under the Internal Revenue Code, a United States person is (1) a citizen or resident of the United States, (2) a partnership created or organized in the United States or under the law of the United States or of any State, (3) a corporation created or organized in the United States or under the law of the United States or of any State, or (4) any estate or trust other than a foreign estate or foreign trust.

offshore jurisdictions and tax havens, tax evasion and money laundering, and the tax gap. With regard to U.S. government knowledge related to Cayman Islands activities, we reviewed documentation from the Internal Revenue Service (IRS), Securities and Exchange Commission (SEC), the Department of the Treasury (Treasury) Financial Crimes Enforcement Network (FinCEN)² and International Affairs Office, the Department of Justice (Justice), the Overseas Private Investment Corporation (OPIC), and the Export-Import (Ex-Im) Bank of the United States. We also interviewed officials from these agencies, and examined agency data for records related to Uglund House and the Cayman Islands. In addition, we identified 21 civil and criminal cases involving the Cayman Islands from DOJ, SEC, and IRS, as well as through searches of legal databases. We asked officials from the agencies to provide any cases known to them involving Cayman Islands and/or Uglund House entities. Our database searches looked for cases where recent Cayman Islands activity was central to the matter in question, including those with an Uglund House or Maples and Calder connection. The 21 cases ranged from cases in their investigatory stage to cases that were fully resolved. At the time of our review, none of the resolved cases had resulted in the subject of the investigation being exonerated. In order to describe the characteristics of these cases, they were separately reviewed by two individuals.

To determine the number of SEC filers located in the Cayman Islands, we searched SEC's EDGAR database, a publicly available online database that allows searches based on a number of criteria. To determine the number of controlled foreign corporations that filed tax returns with IRS in tax year 2004, we analyzed IRS's database of Controlled Foreign Corporations.

Finally, we traveled to the Cayman Islands and interviewed Cayman Islands government officials, including the Cayman Islands Solicitor General, the Cayman Islands Financial Secretary, and officials from the Cayman Islands Financial Reporting Authority, Tax Information Authority, General Registry, and Monetary Authority, as well as senior partners with the law firm of Maples and Calder (Maples). While in the Cayman Islands we also collected and reviewed documentation from the Cayman Islands government and Maples. We also reviewed a total of 133 instances of new business contacts that Maples received over a period of 2 separate weeks—41 from December 2007 and 92 from March 2008—that could have

² FinCEN, an intelligence and analysis organization, is part of the U.S. Department of the Treasury's Office of Terrorism and Financial Intelligence.

led to the formation of a Cayman Islands entity. A summary of relevant U.S. and Cayman Islands laws and regulations can be found in the E-supplement to this report, CAYMAN ISLANDS: Review of Cayman Islands and U.S. Laws Applicable to U.S. Persons' Financial Activity in the Cayman Islands³. We determined that the data from the various sources were sufficiently reliable for purposes of this report. We conducted our work from July 2007 to July 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

The international law firm of Maples and Calder, with its associated businesses—Maples Corporate Services Limited and Maples Finance Limited—is the sole occupant of Uglan House. Similar to corporate service providers in the U.S., Maples Corporate Services Limited provides registered office services, using Uglan House as a registered address, to entities that Maples and Calder establishes. Registered office services include activities such as maintenance of certain entity records, and filing of statutory forms, resolutions, notices, returns, or fees. Very few Uglan House registered entities have a significant physical presence in the Cayman Islands, or carry out business in the Cayman Islands. According to Maples and Calder partners, the persons establishing these entities are typically referred to Maples by counsel from outside the Cayman Islands, fund managers, and investment banks. As of March 2008 the Cayman Islands Registrar reported that 18,857 entities were registered at the Uglan House address. Maples and Calder senior partners told us that approximately 5 percent of those entities were wholly owned by U.S. persons and 40 to 50 percent were U.S.-related in that their billing address was in the United States. A U.S. billing address does not necessarily imply U.S. ownership or control. Uglan House registered entities are often participants in investment activities, such as those related to hedge funds or private-equity funds, and structured finance activities, such as securitization or aircraft finance. Other Uglan House registered entities

³ GAO, *Cayman Islands: Review of Cayman Islands and U.S. Laws Applicable to U.S. Persons' Financial Activity in the Cayman Islands*, GAO-08-1028SP (Washington, D.C.: July 2008), an E-supplement to this report.

involve corporate subsidiaries and holding companies, such as those used by multinational corporations to conduct international business.

U.S. persons who conduct financial activity in the Cayman Islands commonly do so to gain business advantages, such as facilitating U.S.-foreign transactions or minimizing taxes; while much of this activity is legal, some is not. Factors that attract U.S.-related financial activity to the Cayman Islands include its reputation for stability and compliance with international standards, its business-friendly regulatory environment, and its prominence as an international financial center. Examples of the wide variety of business reasons for conducting financial activity in the Cayman Islands include attracting foreign investors or taking advantage of the Cayman Islands insolvency laws, which provide specific protections for creditors and investors. Another frequent reason for doing business in the Cayman Islands is to obtain tax advantages. The Cayman Islands is an offshore financial center (OFC) that has no direct taxes and attracts a high volume of nonresident financial activity from the United States and elsewhere. U.S.-based corporations may legally use Cayman entities to minimize U.S. taxes in a number of ways, for instance by creating Cayman entities to earn amounts from active business transactions with unrelated persons, which are not generally taxed in the United States unless repatriated. Approximately 5.5 percent of the nearly \$362 billion repatriated between 2004 and 2006 was from Cayman Islands controlled foreign corporations. As another example, U.S. tax-exempt entities, such as university endowments and pension funds, may invest in hedge funds organized in the Cayman Islands because doing so allows them to legally maximize their investment return by minimizing U.S. taxes. Lastly, as with other offshore jurisdictions, some U.S. persons may establish entities in the Cayman Islands to illegally evade taxes or avoid detection and prosecution of illegal activities, as illustrated by 21 criminal and civil cases we analyzed involving U.S. persons suspected of offenses including tax evasion, money laundering, and securities fraud. Because U.S. regulators have limited means of collecting information regarding foreign entities, some persons intent on breaking U.S. law may create such entities to obscure their activities.

The U.S. government has access to several information sources about U.S. persons' business activities in the Cayman Islands, although limitations exist regarding the nature of information available and its completeness because it is self-reported. Some information on U.S. persons' Cayman Islands activities is reported to U.S. regulators such as SEC and IRS. For example, for tax year 2004, U.S. taxpayers reported about 1,400 controlled foreign corporations incorporated in the Cayman Islands to IRS. In fiscal

year 2007, 732 companies traded on U.S. stock exchanges reported to SEC that they were incorporated in the Cayman Islands. However, SEC and IRS information is largely self-reported and, like other self-reported information, its completeness and accuracy cannot be easily verified. When they have adequate identifying information, U.S. officials can formally request information regarding U.S. persons' Cayman Islands activities through established channels such as the Tax Information Exchange Agreement (TIEA), which IRS has used a small number of times since it went into effect in 2004 to exchange information related to civil and criminal tax investigations or the Mutual Legal Assistance Treaty (MLAT), which has been used over 200 times since 1990 to exchange information related to criminal violations. Cayman Islands and U.S. officials also have other channels for information sharing, such as coordination among regulatory officials and sharing of financial intelligence information on activities involving U.S. persons. U.S. officials from multiple agencies said that the Cayman Islands government has been cooperative in responding to U.S. requests, and shared useful information at their initiative related to questionable financial activities that involve U.S. connections.

The U.S. and Cayman Islands governments have taken steps to address instances of U.S. persons' use of Cayman Islands entities to perpetrate illegal activity, but enforcement challenges exist. While not limited to the Cayman Islands, "hiding income offshore" is number 5 on IRS's list of 12 most egregious tax schemes and scams for 2008. To address the challenge posed by this activity, the IRS Large and Mid-Sized Business (LMSB) and Small Business/Self-Employed (SBSE) divisions have targeted abusive transactions in areas such as hedge funds, offshore credit cards, and promoters of offshore shelters in numerous jurisdictions. Although the full extent of Cayman involvement is unclear, U.S. officials also described several criminal investigations and prosecutions involving the Cayman Islands. For example, in 45 instances over the past 5 years IRS field agents have requested information regarding suspected criminal activity involving the Cayman Islands from the IRS official responsible for the Caribbean. An IRS official said that there were fewer criminal investigations involving the Cayman Islands than in some other offshore jurisdictions. IRS officials told us that concealing ownership and income often occurs through the use of a combination of entities spread across multiple jurisdictions, which can hinder detection efforts. This multijurisdictional and multientity character of some offshore activity presents one of several enforcement challenges. Despite these challenges, U.S. officials consistently report that cooperation by the Cayman Islands government in enforcement matters has been good. In addition to collaborating in support of U.S. efforts, the

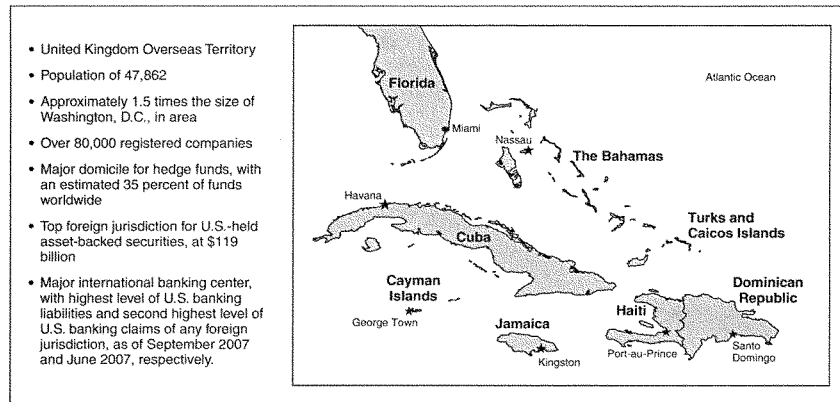
Cayman Islands government has also taken steps to address illegal activity by U.S. persons. For instance, the Cayman Islands was cited by the Caribbean Financial Action Task Force (CFATF), an international task force, as having a "strong compliance culture" related to combating financial crimes and terrorist finance and has implemented a regulatory regime that the International Monetary Fund (IMF) has deemed to be generally in compliance with a broad range of international standards. Maples and Calder partners noted the responsibility of U.S. owners of offshore entities to comply with U.S. tax laws, and Cayman government officials said that the Cayman Islands is "neutral" concerning U.S. tax issues until it receives a request for assistance from the United States.

We provided a draft of this report to the Commissioner of Internal Revenue, the Secretary of the Treasury, and the Leader of Government Business of the Cayman Islands for review and comment. IRS and the Cayman Islands government provided technical comments, which we incorporated as appropriate.

Background

The Cayman Islands is a United Kingdom Overseas Territory located in the Caribbean Sea south of Cuba and northwest of Jamaica, with a total land area approximately 1.5 times the size of Washington, D.C., and a population of 47,862, as seen in figure 1. While geographically small, the Cayman Islands is a major offshore financial center (OFC) with no direct taxes that attracts a high volume of U.S.-related financial activity, often involving institutions rather than individuals.⁴ According to Treasury, U.S. investors held approximately \$376 billion in Cayman-issued securities at the end of 2006, making it the fifth largest destination for U.S. investment in foreign securities. Although not easily defined, OFCs are generally described as jurisdictions that have a high level of nonresident financial activity, and may have characteristics including low or no taxes, light and flexible regulation, and a high level of client confidentiality.

⁴ Direct taxes are taxes on income, and may take the form of taxes on personal and corporate income, social security contributions, and payroll taxes.

Figure 1: Cayman Islands Demographics and Financial Industry Statistics

Source: Map resources; U.S. and Cayman Islands government, and private industry statistics.

Types of Financial Activity Conducted in the Cayman Islands

As a major international financial center, the Cayman Islands attracts a high volume of financial activity in sectors related to banking, hedge-fund formation and investment, structured finance and securitization, captive insurance, and general corporate activities.

The Cayman Islands is a major international banking center, with nearly \$2 trillion in banking assets as of December 2007, according to the Cayman Islands Monetary Authority (CIMA), the jurisdiction's financial regulatory agency. CIMA reports that as of March 2008, 277 banks were licensed to operate on the island, of which 27 percent were based in the United States. CIMA also reported that 97 percent of the \$2 trillion held by these banks as

of December 2007 was from institutions rather than individual investors.⁵ Treasury statistics indicate that, as of September 2007, U.S. banking liabilities to the Cayman Islands were the highest of any foreign jurisdiction at nearly \$1.5 trillion, and as of June 2007, banking claims on the Cayman Islands were the second highest (behind the United Kingdom), at \$940 billion.

The Cayman Islands is also a major domicile for hedge funds. According to CIMA, 9,018 mutual funds⁶ were registered in the Cayman Islands in the registered funds category as of the first quarter 2008, the vast majority of which were hedge funds. Although there is no statutory or universally accepted definition of hedge funds, the term is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers and that often engage in active trading of various types of securities and commodity futures and options contracts. While there is no universally accepted definition of a hedge fund, private-industry sources cited by the Joint Committee on Taxation estimate that there were approximately \$1.5 trillion in assets managed by hedge funds worldwide as of the end of 2006, and approximately 35 percent of funds were organized in the Cayman Islands.⁷ Funds organized in the Cayman Islands may be managed in the United States. According to the same source, the United States was by far the leading location for hedge-fund managers, who managed an estimated 65 percent of hedge-fund assets in 2006.

In addition to being a prominent domicile for hedge funds, the Cayman Islands also carries out a high volume of structured finance activity. While structured finance can encompass a number of financing strategies, it often involves securitization, the process of pooling similar types of financial assets, such as current or future cash flows from loans, and

⁵ As of March 2008, 19 banks were licensed to conduct banking business with domestic clients, while 258 were licensed to carry out primarily international activities. U.S. banks are required to obtain permission from U.S. regulators to establish a foreign branch or subsidiary and are subject to consolidated supervision by both U.S. and host country regulators. According to CIMA, other countries have similar requirements and CIMA will not license a foreign bank absent these prerequisites.

⁶ The definition of a mutual fund under Cayman Islands law includes funds with small numbers of investors.

⁷ Estimates are from International Financial Services, London.

transforming them into bonds or other debt securities.⁸ Securitization involves isolating a group of assets to serve as the basis of financing that is intended to be legally remote from the bankruptcy risks of the former owner, and is generally designed to move those assets off of the owner's balance sheets. In the Cayman Islands, asset-backed securitization has been used widely to turn self-liquidating assets, such as receivables from mortgages, into debt securities that can be offered and sold on capital markets. Treasury data show that as of the end of 2006, U.S. investors held more asset-backed securities issued by the Cayman Islands, at about \$119 billion, than asset-backed securities issued by any other foreign jurisdiction.

The Cayman Islands is also a major domicile for the captive insurance industry. In its basic form, captive insurance is a method by which companies can self-insure against various types of risk rather than purchasing insurance from an insurance company.⁹ In a traditional arrangement, a parent company will establish a subsidiary to act as a captive insurer. Other types of captive insurance arrangements exist as well, such as those in which a single captive insures, and is owned by, multiple companies. According to CIMA, the Cayman Islands was home to 760 licensed captive insurance companies as of April 2008, with nearly \$34 billion in total assets and \$7.6 billion in premiums. Ninety percent of these companies insured risks in North America. Slightly over a third were related to healthcare.

Lastly, a wide range of corporate-related activities are carried out in the Cayman Islands. According to the Cayman Islands Registry of Companies, over 80,000 companies were registered in the Cayman Islands as of May 2008.

⁸ More broadly, structured finance can refer to a wide variety of strategies designed by investment bankers and others to help clients obtain funding on desirable terms and in some cases with favorable economic, accounting, and tax characteristics.

⁹ According to CIMA, captive insurance arrangements enable companies to lower the cost of insurance or obtain coverage not readily available in the commercial insurance market.

**U.S. Persons Are
Frequently Associated
with Uglan House
Registered Entities**

Many of the 18,857 entities registered at Uglan House are U.S.-connected. These entities most frequently involve investment funds and structured finance vehicles.

**Maples and Calder, an
International Law Firm
and Provider of Registered
Office Services, Is the Only
Occupant of Uglan House**

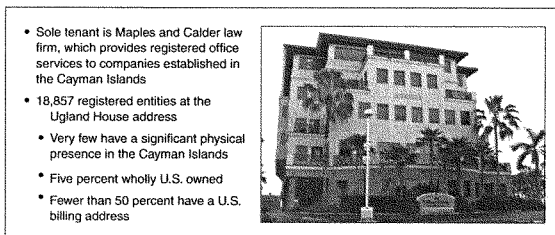
Uglan House, shown in figure 2, is located at 301 South Church Street, George Town, Grand Cayman, Cayman Islands. It houses the international law firm of Maples and Calder; Maples Corporate Services Limited, a licensed trust company owned by Maples and Calder which provides registered office services to clients of Maples and Calder; and Maples Finance Limited, a licensed trust company and mutual fund administrator owned by Maples and Calder which provides fiduciary and fund administration services.¹⁰ Maples business is to facilitate Cayman Islands-based international financial and commercial activity for a clientele of primarily international financial institutions, institutional investors, and corporations. Maples is the only occupant of Uglan House.

Maples provides registered office services to companies, using the Uglan House address.¹¹ A registered office¹² is required by Cayman Islands law for corporations registered in the Cayman Islands. States in the United States have similar statutory requirements. Registered office services include activities such as accepting any service of process or notices, maintenance of certain entity records, and filing of statutory forms, resolutions, notices, returns, or fees. As is the case with many U.S. states' laws, Cayman Islands law does not require or presume that any other business activity of the corporation occurs at the registered office.

¹⁰ Maples and Calder, Maples Corporate Services Limited, and Maples Finance Limited are collectively referred to in this report as "Maples."

¹¹ For discussion of the role and requirements of businesses that provide registered office services under Cayman Islands law, see the E-supplement to this report, GAO-08-1028SP.

¹² For discussion of services required of a registered office under Cayman Islands law see the E-supplement to this report, GAO-08-1028SP.

Figure 2: Uglad House

Source: GAO photograph and statistics obtained from the Cayman Islands government and Maples.

Cayman Islands law requires company service providers that establish entities and provide registered office services to adhere to specific Anti-Money Laundering (AML) and Know-Your-Customer (KYC) requirements.¹³ For example, as a company service provider, Maples must verify and keep records on the beneficial owners of entities to which they provide services, the purpose of the entities, and the sources of the funds involved. If suspicion arises in relation to any of these types of inquiries, the company service provider is required to make a suspicious activity report (SAR) to the Cayman Islands Financial Reporting Authority (CAYFIN). Cayman Islands law allows for nominee shareholders and the provision of officers and directors.¹⁴ The use of nominees, though, does not relieve the company service provider from its obligation under Cayman Islands law to know the beneficial owner under AML-KYC rules. In contrast, state laws which govern the creation of corporations in the United States generally do not require company formation agents to collect ownership information

¹³ Cayman regulators refer to these requirements as "AML/CFT" (anti-money laundering/combating the financing of terrorism). For discussion of AML-KYC requirements under Cayman Islands law see the E-supplement to this report, GAO-08-102SSP.

¹⁴ Maples and Calder partners stated that they provide directors to certain Cayman Islands companies, principally to structured finance companies and investment funds, but do not provide nominee shareholder services.

on the entities they register.¹⁵ The Cayman Islands has taken steps to restrict the use of bearer shares to obscure ownership or control of an entity. Use of bearer shares in the Cayman Islands is restricted to cases where they are immobilized through deposit with an authorized or recognized custodian who must keep a register of owners and perform the required beneficial ownership verification.¹⁶

The Uglad House Address Was Used by 18,857 Entities as of March 2008, and Very Few of These Have a Significant Physical Presence in the Cayman Islands.

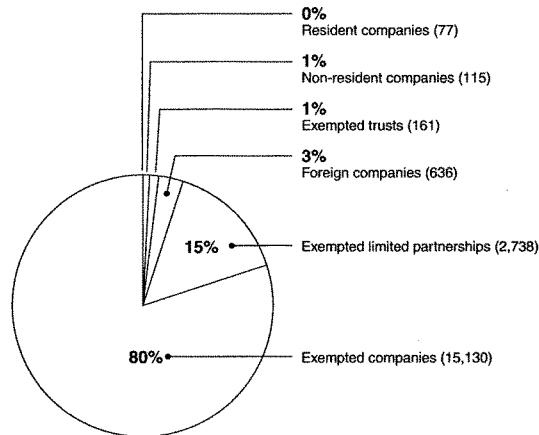
According to the Cayman Islands Registrar, as of March 6, 2008, 18,857 active entities used Uglad House as a registered office, and based on the nature of these entities very few have a significant physical presence in the Cayman Islands. As displayed in figure 3, approximately 96 percent of Uglad House entities are exempt companies, exempt limited partnerships, and exempt trusts.¹⁷ Exempted companies are prohibited from trading in the Cayman Islands with any person, firm, or other corporation except in furtherance of their business that is carried on outside the Cayman Islands. Exempted limited partnerships exist under the same criteria and must have at least one general partner that is resident or incorporated in the Cayman Islands. Requirements for exempt trusts are that they must register with the Cayman Islands Registrar and have no beneficiary that is domiciled in or resident of the Cayman Islands. A Maples and Calder partner indicated that some exempted companies occasionally maintain minimal sales or marketing staff in the Cayman Islands to facilitate business conducted elsewhere, but most have no staff or facilities in the Cayman Islands and none, except for Maples group companies, is run out of Uglad House. According to Cayman Islands government officials, the domestic trading prohibition on exempted companies and exempted limited partnerships, is intended to protect the small domestic market from being flooded by outside competitors. Thus, exempted entities that wish to trade in the local market must receive a special license to do so under the Local Companies (Control) Law.

¹⁵ See GAO *Company Formations: Minimal Ownership Information Is Collected and Available*, GAO-06-376 (Washington, D.C.: Apr. 7, 2006). The lack of requirements for beneficial ownership information in the United States was cited by the Financial Action Task Force as a weakness in U.S. anti-money laundering regulations. See *Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism*, (Paris, France: June 23, 2006).

¹⁶ For discussion of the use of nominees and bearer shares see the E-supplement to this report, GAO-08-1028SP.

¹⁷ For discussion of exempt, nonresident, resident, and foreign companies under Cayman Islands law see the E-supplement to this report, GAO-08-1028SP.

Figure 3: Uglad House Entities by Type, March 2008



Source: GAO presentation of Cayman Islands Registrar information.

According to Cayman Islands Companies Law, nonresident companies are a category of entity similar to an exempted entity in that neither can conduct business in the Cayman Islands. Foreign companies are organized under the laws of a jurisdiction other than the Cayman Islands, but have chosen to register with the Cayman Islands Registrar to conduct business in the Cayman Islands, such as to become a general partner in a Cayman Islands exempted limited partnership. Finally, less than 1 percent of Uglad House entities are "resident" companies that are registered to conduct their business in the Cayman Islands. According to a Maples and Calder partner, the persons establishing entities at Uglad House are typically referred to Maples by counsel from outside the Cayman Islands, fund managers, and investment banks. A Maples and Calder partner also said that the make-up of entities in Uglad House was reflective of the nature of their business and largely international, institutional client base, and was not necessarily representative of the types of entities registered with other company service providers in the Cayman Islands.

**Ugland House Registered
Entities Often Involve
Investment and Structured
Finance Business**

According to Maples and Calder partners, their business primarily involves two areas: investment funds and structured finance.¹⁸ Specifically, they estimated that approximately 38 percent of the Cayman Islands companies and limited partnerships that have a registered office at Ugland House are formed to act as various types of hedge funds or private-equity funds¹⁹ (together referred to as “investment funds”), and generally involve institutional and high net-worth investors. Approximately 24 percent of entities formed related to structured finance/capital markets and project finance business, such as securitization or aircraft finance, and 38 percent are of a “general corporate” nature. The general corporate business was described as being a “catch-all” category that may involve some overlap with the other two areas of entity formation. Maples and Calder partners explained that their general corporate business involves entities such as trading companies, joint ventures, holding companies, wholly owned subsidiaries, and captive insurance companies.

To obtain a more detailed understanding of Maples business, we reviewed a total of 133 instances of new business instructions that could have led to the formation of a Cayman Islands entity. These contacts occurred over a period of 2 separate weeks in December 2007 and March 2008. We found that approximately 74 percent of all instructions involved investment-fund-related business. Approximately 17 percent of the instructions involved general corporate business, and approximately 11 percent involved structured finance business. While this business distribution is somewhat different than what Maples and Calder partners estimated, the activity undertaken in these 2 weeks may not be representative of Maples’ registered office business as a whole. Maples and Calder partners commented that activity in the weeks that we reviewed may reflect the recent decline in structured finance work caused by the “credit crunch.”

¹⁸ Investment fund entities, structured finance entities, and general corporate entities mentioned in the overview here are also discussed in greater detail in the E-supplement to this report, GAO-08-1028SP.

¹⁹ Hedge and private-equity funds are similar in that they are pooled investment vehicles that do not register with the SEC and attract sophisticated investors. However, unlike hedge funds, private-equity funds tend to invest in long-term highly illiquid assets.

Five Percent of the Entities Registered at Uglad House Are Wholly Owned by U.S. Persons and Fewer than 50 Percent Are U.S.-Related

Maples and Calder partners estimated that 5 percent of the overall number of Uglad House entities are wholly owned by U.S. persons.²⁰ The partners also said that fewer than 50 percent, likely in the 40 to 50 percent range, of all Uglad House entities are U.S.-related in that their billing address is in the United States. This distribution of relationships is due to the nature of the entities registered in Uglad House.

Other than for those entities which are wholly owned or controlled, the concepts of ownership and control are complex for most of the entities registered in Uglad House. According to the partners, because a significant amount of Maples' registered entities are related to structured finance or investment fund transactions, direct ownership or control by a U.S. person is only representative of a small number of entities registered at Uglad House. For example, structured finance entities are not typically carried on a company's balance sheet, and ownership can be through a party other than the person directing the establishment of the entity, such as a charitable trust, or spread across many noteholders or investors in deals involving securitization. U.S. persons' involvement with structured finance entities is therefore of a different nature, and may include arranging or participating in deals without clear U.S. ownership or control. Similarly, while investment fund entities are often established, controlled, and managed at the direction of investment managers, such entities are generally established as partnerships and are essentially owned by the fund's investors. In addition, one investment fund or structured finance transaction can involve more than a dozen separate legal entities, thereby increasing the number and complexity of relationships involved.

For those instances for which Maples and Calder has a U.S. billing address for an Uglad House entity, U.S. involvement often takes the form of providing services to Cayman Islands entities, as opposed to wholly owning or controlling the entity. For example, the partners explained that many of the recipients of invoices include U.S. investment banks, paying agents, securities trustees, law firms, placement agents, and administrators for private-equity funds and hedge funds. The partners gave as an example of a tenuous connection a situation where a U.S. bank was the billing address for an Uglad House registered entity established for a Brazilian company to raise funds within Brazil for a Brazilian project.

²⁰ Maples and Calder partners noted that this estimate was generated at our request and was made without systematic research.

New business instructions received by Maples that we reviewed provided additional detail regarding the type and role of U.S. persons involved. Among these instructions, approximately 60 percent involved U.S. persons, mostly through managerial, promoter, or advisory roles. Four percent involved U.S. subsidiaries or holding companies. U.S. investment firms were involved in approximately 44 percent of the transactions we reviewed, generally in the role of investment advisor, manager, or promoter. U.S. companies and banks were the second most common type of U.S. persons involved, with U.S. banks frequently directing the establishment of investment-related entities. U.S. persons were participants in a joint venture or were partners in a transaction in approximately 5 percent of the instructions. Maples and Calder partners said that major onshore commercial law firms or in-house legal counsel instruct Maples to form the entities, although we could not verify this in the new business instructions that we reviewed. The partners also said that onshore lawyers advise their clients on all onshore legal, regulatory, and tax issues for their home jurisdictions.

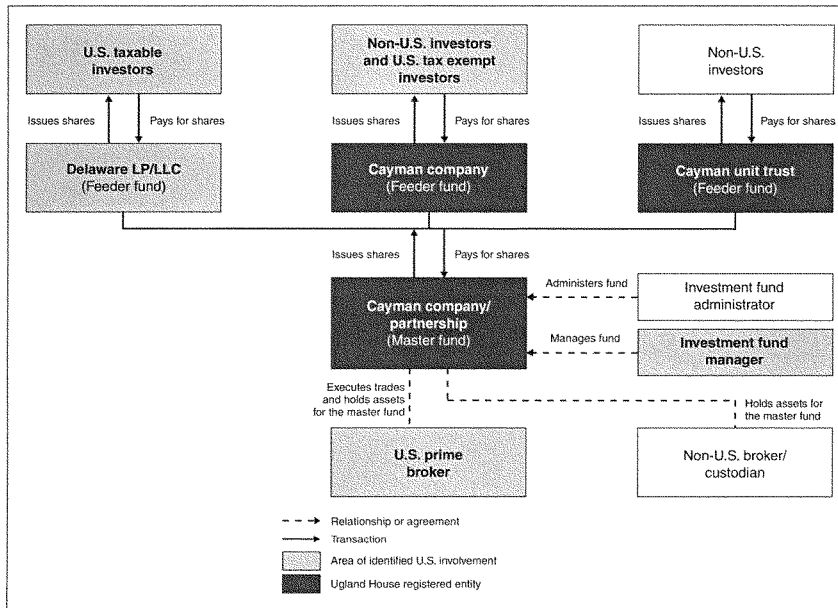
Ugland House Investment Entities Are Hedge and Private-Equity Funds, and U.S. Investors Are Largely Institutional, such as University Endowments and Pension Funds

The Cayman Islands is a major domicile for global hedge funds. Maples investment funds business is largely hedge-fund related, and also includes private-equity funds. Maples said that their investment fund clients are predominantly large investment banks or investment management firms, or the funds arranged by such firms for institutional and high-net-worth investors. Documentation provided by Maples indicated that persons establishing and investing in investment funds included investment banks, pension funds, insurance companies, and university endowments. According to Maples and Calder partners, Cayman Islands funds are used to facilitate significant investment in the United States by non-U.S. investors. They said that one reason that many non-U.S. investors prefer not to invest directly into the United States is because of perceived litigation risk, and that the ability of U.S. fund managers to manage Cayman Islands funds, therefore, helps U.S. fund managers compete globally.

An understanding of the structure and function of hedge funds and private-equity funds provides additional insight into the nature of the entities registered at Ugland House. Hedge funds are private investment funds that are actively traded by a fund manager. Hedge funds are "open ended," in that investors are generally allowed to invest additional money or redeem shares at designated dates. Maples explained that hedge funds often are composed of a "master-feeder" structure wherein "feeder" fund entities are established that receive subscriptions from different investor groups and

invest in a "master fund" entity. The master fund entity is established for holding assets and making investment instructions. In this way, economies of scale can be maximized while allowing for simplified trading and reconciliation of portfolios of the assets invested. According to Maples, when U.S. investors invest in offshore funds in the Cayman Islands, they typically prefer doing so through a "feeder" entity that is formed in a U.S. state such as Delaware. Figure 4 displays a common "master-feeder" hedge-fund structure. As figure 4 depicts, the fund is managed and administered, and fund managers can be U.S. persons. Also, Maples and Calder partners stated that U.S. and non-U.S. brokers/custodians offer services such as centralized securities and trade execution for the fund.

Figure 4: U.S. Persons' Involvement in Cayman Master-Feeder Hedge Fund Structure



Source: GAO presentation of Maples and Calder information.

The other type of investment entities registered at Ugland House are private-equity funds. In contrast to hedge funds, private-equity funds are generally private funds involving long-term, "closed" investments that do not involve an actively traded portfolio of stocks. Private-equity funds typically make 7- to 10-year concentrated investments in a company and often seek to create value by providing management support or consulting

services to the portfolio companies. According to officials from OPIC,²¹ one-third to half of private-equity funds in which it has invested have been organized in the Cayman Islands. According to Maples and Calder, private-equity funds are usually formed as limited partnerships rather than as corporations.

Ugland House Structured Finance Entities Are Largely Off-Balance-Sheet Special Purpose Vehicles Involving Securitization, Asset Transfer, or Risk Isolation

Structured finance entities are companies that are formed for a specific and, in some cases, finite purpose. Commonly referred to as Special Purpose Entities (SPEs) or Special Purpose Vehicles (SPVs),²² these companies can be used in many different types of business transactions. Maples and Calder partners told us that structured finance entities using Ugland House as a registered office are largely related to transactions such as securitization, aircraft finance, and other deals involving isolating risk and raising capital. In the case of SPVs, these transactions generally involve an SPV holding assets of some type, with the SPV being isolated from the bankruptcy risks of the former owner of the assets—typically the “sponsor” of the SPV. Because of this feature of SPVs, they are not generally represented on the sponsor’s balance sheet. According to a 2007 CFATF evaluation, interest in SPVs in the Cayman Islands has increased in the 2 years prior to the reports issuance. Maples and Calder partners stated that their clients for these types of entities are often large investment banks and institutions, including many well-known multinational companies.

Maples and Calder partners reported that part of their structured finance business involves Structured Investment Vehicles (SIVs), which are SPVs that use structured investments to make a profit from the difference between short-term borrowing and longer-term returns. Unlike some SPVs, SIVs can be established to continue their operations for an indefinite period. SIVs often invest in structured finance products such as asset-backed securities, which include bonds backed by auto loans, student loans, credit card receivables, and mortgage-backed securities. These structures are also used to facilitate major capital inflows from foreign investors into the United States, according to Maples. SIV use in the Cayman Islands originated as the use of structured finance techniques

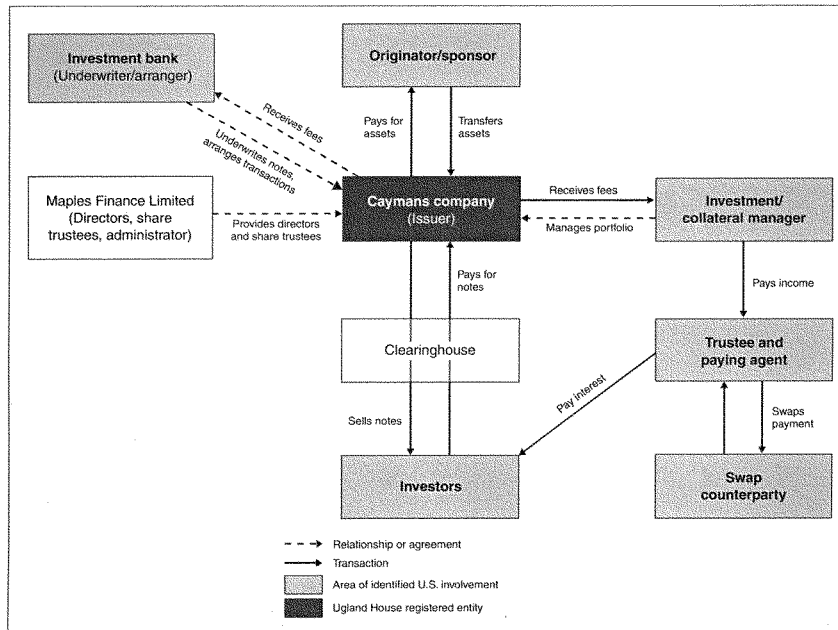
²¹ OPIC is a U.S. government agency that helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, complements the private sector in managing risks associated with foreign direct investment, and supports U.S. foreign policy.

²² From this point forward SPV will be used to represent the SPE term as well.

evolved in financial markets, with the first Cayman SIV launched in 1988. These financial instruments received heightened interest following the financial market crisis in 2007 after problems surfaced related to bank-sponsored SIVs.

As shown in figure 5, SIVs are sponsored by an institution, such as a bank, and an investment manager is appointed to provide investment advice together with funding and operational support. In addition, the SIV can be underwritten and arranged by an investment bank. As figure 5 depicts, the SIV sponsor, investment manager and underwriter/arranger can be U.S. persons. The SIV sells notes to investors through a clearinghouse, and investors are paid interest through a trustee and paying agent. Finally, a swap counterparty can enable additional investors to participate in the SIV in a different currency and interest rate than the underlying asset being financed. Figure 5 shows that SIV investors, trustee and paying agents, and swap counterparties can also be U.S. persons.

Figure 5: U.S. Persons' Involvement in Cayman Structured Investment Vehicles

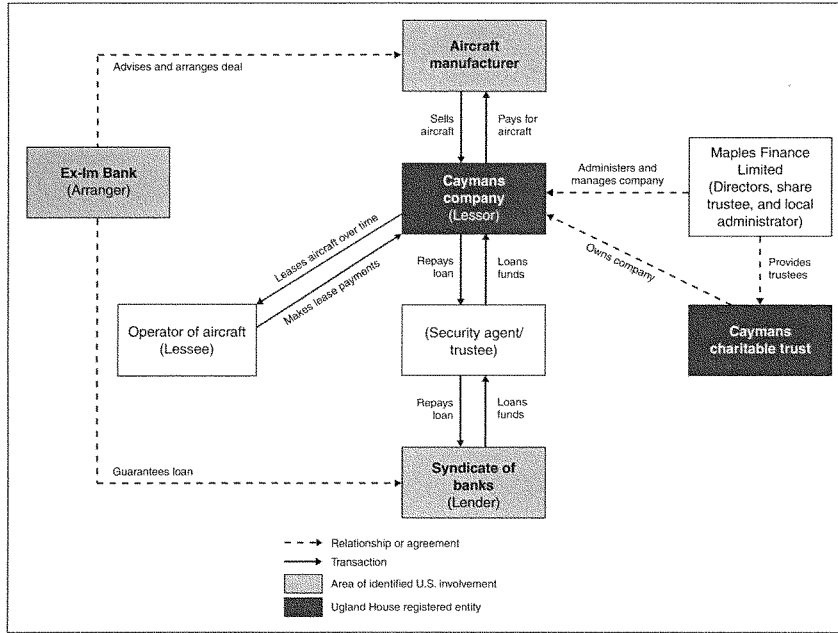


Source: GAO presentation of Maples and Calder information.

A second type of Maples SPV activity includes transactions involving asset transfer, such as aircraft leasing deals. Maples and Calder partners explained that aircraft financing deals using Ugland House registered structured finance vehicles have involved Boeing, a U.S. airplane manufacturer, as well as a non-U.S. aircraft manufacturer. As shown in figure 6, these deals involve the creation of an SPV whose shares are owned by a Cayman Islands charitable trust, and managed by a company

service provider such as Maples Finance Limited. Aircraft involved in the deal are sold by the aircraft manufacturer to the SPV, which then leases the aircraft to the party that will operate the aircraft, such as a government or private entity from another country. The whole transaction is arranged by a third-party financial institution that backs the deal. Over time, the operator of the aircraft makes payments to the SPV while using the aircraft, and within approximately 5-8 years the aircraft are effectively paid for and the titles are transferred from the SPV to the aircraft operator. This structure reduces the credit risk involved and enhances the ability of financiers to repossess the aircraft if default occurs.

Figure 6: U.S. Persons' Involvement in Cayman Aircraft Financing Special Purpose Vehicles



Source: GAO presentation of Maples and Calder information.

Maples and Calder partners said that the Ex-Im Bank had facilitated aircraft sales involving SPVs registered at the Ugland House address. Ex-Im officials confirmed that it has been involved in supporting 42 aircraft financing deals involving the Cayman Islands since 2003, with 24 entities involving Maples as counsel. Ex-Im Bank officials reported that one nonaircraft deal had been conducted involving the Cayman Islands, and that Maples served as counsel to the borrower in that deal. They said that

since 2006 there has been less frequent use of Cayman Islands entities in U.S. aircraft financing deals since the United States ratified the Cape Town Treaty in 2006. That treaty established common international protocols and standards for cross-border aircraft financing and leasing. The United Kingdom has not signed this agreement, and as a United Kingdom overseas territory, the Cayman Islands therefore is not party to the agreement. Ex-Im Bank officials said that many structured finance deals involving the lease of U.S. aircraft now utilize other jurisdictions governed by the treaty, such as Delaware.

Other Uglan-Registered Entities Include Corporate Subsidiaries, Holding Companies, and Trusts

In addition to investment funds and structured finance entities, Maples provides registered office services to general corporate entities such as corporate subsidiaries and holding companies. Maples also establishes trusts, and a portion of those choose to be registered.

Maples and Calder partners reported that a limited number of their general corporate entities are wholly owned subsidiaries of multinational corporations. Examples of this type of entity with a U.S. connection identified from Maples' new business instructions that we reviewed include:

- Formation of a company to be a subsidiary of a U.S. company to provide film production services for a film being shot in Romania.
- Formation of a company by a U.S.-based company for the purposes of providing information technology services in Asia.

According to Maples and Calder partners, Cayman Islands holding companies often have been used by businesses in emerging market countries to conduct initial public offerings of shares listed in the United States or Europe.

Captive insurance companies are also contained within this general corporate category of Maples' business, although the number of captive insurance entities registered at Uglan House is relatively low due to the Cayman Islands requirement for captive insurance companies to have a licensed insurance manager located within the Cayman Islands. For this reason, captive insurance companies in the Cayman Islands frequently use the insurance manager's location as their registered office address.

A portion of Maples general corporate business involves the establishment of holding companies. Examples of this type of entity with a U.S.

connection that we identified from new business instructions that we reviewed include:

- Formation of an intermediate holding company for a company listed on the New York Stock Exchange with operations in 30 countries.
- Formation of an investment holding company for the Hong Kong arm of a Wall Street bank.
- Formation of two investment holding companies for real estate investments in Eastern Europe to be owned by a private-equity fund managed by a U.S. private-equity fund manager.

Maples and Calder partners said that the formation of holding companies typically involves intermediate limited liability holding companies formed by multinational corporations to isolate risk related to their foreign assets. They said that the formation of personal holding companies was increasingly rare. They also indicated that the holding companies that they typically establish involve the company existing at the bottom of a family of corporate structures to hold specific assets, rather than at the top of the pyramid of the corporate family. As the example cases above describe, some holding companies established by Maples are associated with private-equity funds.

Lastly, Maples establishes trusts for clients, some of whom choose to be registered as exempted trusts under Cayman Islands law. Exempted trusts afford official confirmation in the form of a certificate that the trust will remain exempt from any potential future direct taxes that may be imposed by the Cayman Islands for a specified period of time of up to 50 years. Such certificates are regarded in the market as reflecting the stable status quo as well as providing an additional level of commercial certainty.²³ A senior Maples and Calder partner said that the clients for their trust business are invariably institutional trustees rather than the settlers of trusts, and mainly consist of banks (U.S. and non-U.S.) serving as trustees for non-U.S. taxpayers in private wealth trusts. He stated that a portion of Maples trust business involves private wealth management, and that wealthy individuals in Central and South America and the Middle East establish trusts in other nations such as the Cayman Islands to manage their wealth primarily because their home jurisdictions have no structure equivalent to a trust due to their not having a common law tradition. According to Maples and Calder partners, being able to offer Cayman

²³ For more detail see the E-supplement to this report, GAO-08-1028SP.

Islands trusts enables major U.S. banks to compete with other major foreign banks for private wealth management and lending business. Because the United States has trusts, U.S. persons rarely seek to establish trusts in the Cayman Islands, according to Maples and Calder partners. Maples and Calder partners also noted that U.S. states such as Delaware tend to service the domestic U.S. trust business. They said that, in addition to private wealth trusts, commercial trusts are sometimes established for Japanese clients as well.

Several Factors Influence U.S. Taxpayers' Decisions to Conduct Financial Activity in the Cayman Islands

U.S. persons who engage in Cayman-based financial activity commonly do so to gain business advantages, including tax advantages under U.S. law. Although such activity is typically legal, some persons have engaged in activity in the Cayman Islands, like other jurisdictions, in an attempt to avoid detection and prosecution of illegal activity by U.S. authorities.

While OFCs Generally Offer Tax Benefits, U.S. Persons May Choose to Conduct Financial Activity in the Cayman Islands for a Number of Additional Reasons

While the Cayman Islands is one of a number of OFCs that attract substantial financial activity from the United States due to tax and other benefits, the Cayman Islands offers a combination of additional factors that may draw U.S. activity. In particular, the Cayman Islands is generally regarded as having a stable and internationally compliant legal and regulatory system, a business-friendly regulatory environment, and a reputation as a prominent international financial center.

First, because the Cayman Islands' legal and regulatory system is generally regarded as stable and compliant with international standards, U.S. persons looking for a safe jurisdiction in which to place funds and assets may choose to carry out financial transactions there. In particular, Cayman Islands law is based on English common law, which is familiar in the United States due to similarities between British and U.S. legal systems. The Cayman Islands regulatory regime has also been deemed by the International Monetary Fund to be well-developed and in compliance with a wide range of international standards. Pursuant to a 2007 on-site evaluation, the Caribbean Financial Action Task Force (CFATF) also cited the Cayman Islands as having a strong compliance culture related to anti-money laundering and terrorist-financing activities. IRS officials cited the

Cayman Islands' reputation for regulatory sophistication as a potential factor in attracting legal financial activity from the United States.²⁴

U.S. persons may also be drawn to the Cayman Islands because of its business-friendly regulatory environment. Establishing a Cayman Islands entity can be relatively inexpensive. For instance, an exempted company can be created for less than \$600 U.S., not taking into account service-providers' fees, and it is not required to maintain its register of shareholders in the Cayman Islands or hold an annual shareholder meeting. Additionally, Cayman government officials noted that the jurisdiction has a public-private sector cooperative approach to regulation and attempts to be responsive to the needs of market participants. For instance, Cayman law requires CIMA to consult with the private sector prior to issuing or amending rules.²⁵ The jurisdiction's responsiveness to market needs led it to adopt the Segregated Portfolio Company (SPC), a type of entity that opened up the captive insurance industry to smaller companies unable to meet minimum reserve levels on their own, but capable of doing so in groups. The Cayman Islands may also attract U.S.-related captive insurance companies because it has lower capital requirements than some U.S. states.

Additionally, as reported by Maples and Calder attorneys and U.S. officials, some persons may be attracted to the Cayman Islands to take advantage of specific legal protections for creditors and investors. According to Maples and Calder attorneys, if a Cayman Islands fund or other entity becomes insolvent, Cayman law is generally focused on protecting the interests of creditors and investors. For example, according to Maples and Calder, Cayman law differs from U.S. bankruptcy law in that it provides no moratoria on secured-creditor action against a debtor company. Officials from OPIC report that, as an investor, it is important to OPIC that private-equity funds it invests in be organized in a jurisdiction with strong legal protections for creditors, such as the Cayman Islands. According to them, nearly half of the funds with which OPIC has been

²⁴ The Cayman Islands is also approved by the IRS as a jurisdiction with acceptable KYC rules for purposes of the IRS qualified intermediary program. See GAO, *Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes On Foreign Investors Are Withheld and Reported, But Can Be Improved*, GAO-08-99 (Washington, D.C.: December 2007) for more information on the qualified intermediary program.

²⁵ A Cayman Islands government official noted that this process is similar to the regulatory process in the United States wherein notice is given of proposed rulemaking and the public is invited to comment on the proposed rules.

involved were organized in the Cayman Islands. Similarly, officials from the Ex-Im Bank stated that Cayman Islands law gives them confidence that they will have less difficulty reclaiming assets if a party in an Ex-Im-backed transaction defaults.

The Cayman Islands may also be a jurisdiction of choice among U.S. persons due to factors related to its location and reputation for prominence as an international financial center. The Cayman Islands is proximate to the United States, operates in the same time zone as New York and the eastern United States and is English speaking, all factors that may contribute to U.S. persons' choices to conduct activity there. It has a robust financial services sector, which includes several major law firms and other locally based service providers, as well as prominent international accounting and audit firms, fund administrators, and banking institutions. The high volume of existing Cayman-based financial activity may also be responsible for drawing additional business. For instance, relationships between U.S. and Cayman law firms and other service providers may result in referrals of additional business.

Finally, U.S. persons may carry out activity in the Cayman Islands because of its reputation as a neutral jurisdiction for structuring deals with foreign partners. Ex-Im Bank officials explained that they frequently created Cayman Islands entities to facilitate the purchase of U.S. aircraft, and these deals often involve foreign entities who may prefer not to carry out business in the United States for tax, regulatory, or political reasons. Additionally, OPIC officials stated that foreign investors in private-equity funds that they are involved with value the Cayman Islands' reputation for legal neutrality towards investors from different jurisdictions.

Some U.S. Persons Can Defer or Minimize Tax by Carrying Out Financial Activity in the Cayman Islands

Some U.S. persons engaging in financial activity in the Cayman Islands are able to legally minimize their U.S. tax obligations. For instance, some U.S. persons can minimize their U.S. tax obligations by using Cayman Islands entities to defer U.S. taxes on foreign income. In general, the United States taxes U.S. persons, including corporations, on their worldwide income,²⁶ but only taxes foreign corporations on their U.S. income. The United States does not tax U.S. shareholders of corporations, whether foreign or domestic, until the corporation makes a distribution to the shareholder,

²⁶ U.S. persons may generally claim a credit for taxes imposed by foreign countries, thereby avoiding or reducing double taxation.

unless an exception applies, such as when the foreign corporation is a controlled foreign corporation and earns certain types of income. If a U.S. person earns foreign income, he is taxed on that income; however, if a U.S. person is a shareholder of a foreign corporation and that corporation earns foreign income, then, in general, the United States will not tax that income until it is distributed to the U.S. shareholder. In this way a U.S. taxpayer may be able to defer taxes on some foreign income.

For example, a U.S.-based multinational business with a Cayman Islands subsidiary earning foreign income may be able to defer U.S. taxes on that foreign income. The income deferred is not limited to income earned in the jurisdiction of incorporation but can be any non-U.S. income. If the foreign income had been earned by a U.S. component of the multinational, U.S. taxes would be owed when that income was earned. Instead, by employing a Cayman Islands subsidiary U.S. taxes are owed when the Cayman Islands subsidiary makes a distribution to the parent.

In some instances, U.S.-based parent corporations may be able to defer taxes on foreign-source income from foreign subsidiaries indefinitely by reinvesting that income overseas. Additionally, U.S. parent corporations may further reduce U.S. taxes on foreign income by waiting to bring the income into the United States until a period in which they have domestic losses. Since corporate income tax is based on profits the parent would only owe tax on repatriated income that exceeded its domestic losses.

The Internal Revenue Code has provisions limiting this deferral in certain circumstances. For example, if a foreign corporation qualifies as a controlled foreign corporation, then certain U.S. shareholders will not be able to defer tax on certain types of income, known as Subpart F income, earned by that foreign corporation.²⁷

In other cases, persons may conduct financial activity in jurisdictions without a corporate income tax like the Cayman Islands to avoid entity-level tax. In general, a foreign corporation's earnings are taxed where earned, in the entity's jurisdiction of incorporation, or both, depending on the tax laws of the jurisdiction. Since the Cayman Islands has no direct taxes, a corporation organized there will not owe taxes to the Cayman Islands government. For instance, foreign hedge funds sponsored by U.S.-

²⁷The law in this area is more fully explained in the E-supplement to this report, GAO-08-1028SP.

based managers are also generally organized as corporations in tax-neutral jurisdictions like the Cayman Islands to avoid double taxation for foreign investors. Officials we spoke with from the Ex-Im Bank also indicated that one motivation for structuring aircraft-financing leases in the Cayman Islands was the lack of entity-level tax on the entities established to hold the aircraft during the period of the lease.

One indication of the extent to which U.S. companies use Cayman Islands entities to defer taxes is their reaction to a recent tax law. In 2004, Congress approved a received dividend deduction for certain earnings of foreign subsidiaries of U.S. companies repatriated for a limited time.²⁸ Approximately 5.5 percent of the nearly \$362 billion repatriated between 2004 and 2006 was from Cayman Islands controlled foreign corporations. The Cayman Islands ranked eighth among all countries in the amount of repatriated income.

Another way U.S. persons may use Cayman Islands entities to reduce U.S. tax obligations is to receive investment income in a form that avoids the unrelated business income tax (UBIT). The investment income of U.S. tax-exempt entities, including pension funds, charitable trusts, foundations, and endowments, can be subject to UBIT if it is earned by a U.S. partnership in which the tax-exempt entity is a partner. Many U.S. investment vehicles, such as hedge funds, are organized as limited partnerships because, unlike U.S. corporations, these entities are not generally separately taxed, and as a result, income is only taxed at the level of individual investors. Tax-exempt entities that invest in hedge funds organized as foreign corporations can be paid in dividends, which are not subject to UBIT. If an investment fund is incorporated in a jurisdiction without a corporate income tax, such as the Cayman Islands, the fund's returns will not be subject to corporate income tax. According to the SEC, the growth in hedge funds has been largely driven by increased investment on the part of U.S. tax-exempt entities.

Some U.S. persons may also aggressively interpret U.S. tax law. The U.S. Internal Revenue Code is highly complex, and new strategies to reduce U.S. taxes continue to emerge as business environments change and in response to new rules and guidance. As we have reported before, some have postulated that major corporations' tax returns are actually just the

²⁸ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1515-20 (Oct. 22, 2004).

opening bid in an extended negotiation with IRS to determine a corporation's tax liability.²⁹

In some cases, new tax-avoidance practices may emerge that involve complex legal issues. For instance, IRS is examining a strategy used by offshore hedge funds to avoid unfavorable tax consequences of owning U.S. stocks directly. Because many hedge funds are organized in tax-free jurisdictions like the Cayman Islands that do not have income-tax treaties with the United States, investors in these funds are generally subject to full 30 percent withholding rates on certain earnings from U.S. investments such as dividends. However, some hedge funds may have avoided these withholding taxes on dividends by selling their U.S. stocks to a U.S.-based derivatives dealer prior to a dividend payout in exchange for a payment equivalent to the value of the dividend, and then repurchasing the stocks after the payout.

Specific tax positions may require complex legal and economic analysis to determine their legality. In particular, transfer pricing by multinational enterprises can pose challenges for IRS and U.S. regulators. IRS officials said that U.S. persons use entities established in many low-tax jurisdictions for transfer-pricing purposes. They also reported that they have dealt with transfer-pricing issues involving Cayman Islands entities, but that the problem is not worse there than in other jurisdictions.

While the Internal Revenue Code and Treasury regulations state that transfer prices between related parties must be consistent with transfer prices that would be charged between unrelated parties, some taxpayers may manipulate these prices to obtain favorable tax outcomes in the related context. Additionally, because multinational operations and transactions can be quite complex and pricing methods may be inexact, evaluating the appropriateness of particular transfer prices can be difficult. A recent Treasury report delineates a number of areas in which taxpayers take advantage of ambiguities in rules and legal guidance, aggressively setting transfer prices to move profits offshore and thereby avoid U.S. taxes.³⁰ In particular, the report found that two types of activities among related parties—cost-sharing arrangements and services

²⁹ GAO, *Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting*, GAO-06-851T (Washington, D.C.: June 13, 2006).

³⁰ See U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties* (November 2007).

transactions—were key sources of transfer-pricing abuse.³¹ Further, while Treasury urges caution in interpreting specific aspects of its findings, a recent working paper by Treasury's Office of Tax Analysis finds that data are consistent with, although not proof of, the existence of potential income shifting from inappropriate transfer pricing.

**Despite Cayman
Regulatory Safeguards,
Some U.S. Persons
Conduct Financial Activity
in the Cayman Islands to
Hide Illegal Activity from
U.S. Authorities**

As with other foreign jurisdictions and OFCs, some persons have conducted financial activity in the Cayman Islands in an attempt to avoid discovery and prosecution of illegal activity by the United States. As discussed later in this report, in 45 instances over the past 5 years IRS field agents have requested information from the IRS official responsible for the Caribbean about potential criminal activity on the part of U.S. persons in the Cayman Islands. Additionally, as we further explore later in this report, our review of 21 criminal and civil cases including those referred to us by DOJ, SEC, and IRS shows that U.S. persons have been involved in civil lawsuits and come under criminal investigation for suspected offenses including tax evasion, money laundering, and securities fraud. The full extent of illegal offshore financial activity is unknown, but risk factors include limited transparency related to foreign transactions,³² and difficulties faced by the U.S. in successfully prosecuting foreign criminal activity. Still, as we state later in this report, IRS officials said that criminal activity was comparatively lower in the Cayman Islands than in some other offshore jurisdictions.

Although not unique to the Cayman Islands, limited transparency regarding U.S. persons' financial activities in foreign jurisdictions contributes to the risk that some persons may use offshore entities to hide illegal activity from U.S. regulators and enforcement officials. Voluntary compliance with U.S. tax obligations is substantially lower when income is not subject to withholding or third-party-reporting requirements. Because U.S.-related financial activity carried out in foreign jurisdictions is not

³¹ Cost sharing arrangements between related parties, which involve participants that agree to share the costs of developing intangibles that will later be used by each participant, carry risks of transfer-pricing abuse, especially with respect to the valuation of contributed intangibles and the consequent compensatory buy-in payments for those contributions. Similarly, pricing of certain types of services provided between related parties, especially services performed using valuable intangibles, may be particularly vulnerable to transfer-pricing abuses.

³² Cayman Islands government officials said that this is a common problem when one country seeks information on activities within another country.

subject to these requirements in many cases, persons who intend to evade U.S. taxes are better able to avoid detection. As an example, foreign corporations established in the Cayman Islands and elsewhere with no trade or business in the United States are not generally required to report dividend payments to shareholders, even if those payments go to U.S. taxpayers. Therefore, a U.S. shareholder could fail to report the dividend payment with little chance of detection by IRS. Persons intent on illegally evading U.S. taxes may be more likely to carry out financial activity in jurisdictions with no direct taxes, such as the Cayman Islands, because income associated with that activity will not be taxed within those jurisdictions.

Some U.S. persons have also taken steps to complicate efforts to identify U.S. involvement in illegal activity by structuring their activities in offshore jurisdictions. As with other OFCs, some U.S. persons may create complex networks of domestic and offshore entities in order to obscure their role in illegal schemes. For instance, the defendants in *United States v. Taylor* and *United States v. Petersen* pled guilty in U.S. District Court to crimes related to an illegal tax evasion scheme involving offshore entities, including Cayman Islands entities.³³ As part of the scheme, the defendants participated in establishing a “web” of both domestic and offshore entities which were used to conceal the beneficial owners of assets, and to conduct fictitious business activity that created false tax losses, and thus false tax deductions, for clients.

Additionally, because offshore entities such as SPVs can be used to achieve a wide array of purposes, they can be abused even when the entities, the parties involved, and the stated business purposes pass scrutiny at the time of establishment. For instance Enron, a global energy company had 441 entities in the Cayman Islands in the year that it filed for bankruptcy. Maples and Calder partners said they created entities for Enron at the instruction of major U.S. law firms. The partners noted that Enron’s legitimate business activity often involved holding assets in offshore subsidiaries, including many in the Cayman Islands. However, Enron did use structured-finance transactions to create misleading accounting and tax outcomes and deceive investors. Maples and Calder partners said they conducted due diligence on investment-fund managers

³³ Statement by Defendant in Advance of Plea Guilty, *United States v. Taylor*, No. 2:08-cr-00064-TC (D. Utah, Jan. 24, 2008); Statement by Defendant in Advance of Plea Guilty, *United States v. Petersen*, No. 2:05-cr-00805-TC-DN (D. Utah, Jan. 18, 2008).

and persons establishing structured-finance entities in accordance with AML/KYC standards, and that they had filed a SAR with regard to suspected illegal activity by Enron. Maples and Calder partners also said that the accounting fraud perpetrated by Enron was not intrinsically offshore in nature; rather, it was committed from within the United States, and that no suggestion of violation of either Cayman Islands law or U.S. law was ever raised with respect to Maples and Calder.

The difficulty that U.S. regulators and law-enforcement officials face in investigating and litigating cases may also influence U.S. persons' choice to conduct illegal activity in offshore jurisdictions. As we have reported, obtaining information on U.S. persons' financial activities abroad can be time-intensive for IRS, due to issues including difficulty accessing beneficial-ownership information.³⁴ Additionally, offshore related cases may be time-consuming to litigate. For example, Treasury reports that IRS spends substantial resources to litigate cases involving transfer-pricing abuse by taxpayers. IRS confirms that transfer-pricing cases involve entities established in the Cayman Islands and elsewhere. Transfer-pricing cases can be very time-intensive to litigate because of the highly specialized issues involved, and the results may provide limited guidance for subsequent litigation of transfer-pricing issues due to the unique sets of facts and circumstances involved in each case.

The U.S. Government Has Access to Several Information Sources Regarding U.S. Taxpayers' Business Activities in the Cayman Islands, but Most Information Is Self-Reported

Individual U.S. taxpayers and corporations generally are required to self-report their taxable income to IRS. Similarly, publicly owned corporations traded on U.S. markets are required to file annual or quarterly statements with SEC. When an individual or corporation conducts business in the Cayman Islands, there is often no third-party reporting of transactions, so the accuracy of the disclosures to U.S. regulators is dependent on the accuracy and completeness of the self-disclosure. When the U.S. government needs to obtain information from the Cayman Islands, there are formal information-sharing agreements in place to facilitate the exchange of information, in the form of a TIEA or MLAT. In addition, both the U.S. and Cayman Islands governments share information through their respective financial intelligence units. There are also channels for various agencies of each government to share intelligence.

³⁴ GAO, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (Washington, D.C.: March 2007).

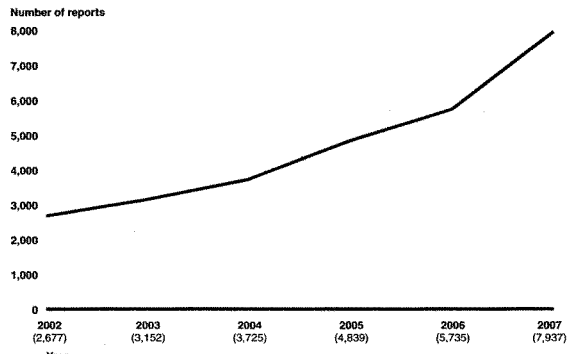
Although U.S. Taxpayers Report Some Cayman Islands Activities to U.S. Regulators, Overall Information Reporting Is Limited

IRS and SEC collect self-reported information from individuals and corporations with activity in the Cayman Islands. IRS collects information on the number of controlled foreign corporations,³⁵ as well as the number of foreign trusts and certain bank accounts owned by U.S. taxpayers overseas, while SEC collects information on publicly owned companies with operations in foreign countries. For example, for tax year 2004, approximately 1,402 foreign corporations in the Cayman Islands were controlled by a U.S. corporate taxpayer, according to IRS data. Those controlled foreign corporations in the Cayman Islands accounted for more than \$23 million in average total income, placing them ninth among all jurisdictions in average total income among U.S.-controlled foreign corporations reporting to IRS. Net income earned from controlled foreign corporations in the Cayman Islands ranks thirteenth among all jurisdictions in terms of all foreign corporations controlled by a large corporate U.S. taxpayer. In 2002, the most recent year for which IRS had data, 193 returns were filed by taxpayers indicating that they controlled a trust in the Cayman Islands. This number accounted for over 7 percent of all controlled foreign trusts in 2002. In terms of total income, U.S. tax returns indicating that the taxpayer controlled a foreign trust in 2002 reported about \$472 million in income and foreign trusts in the Cayman Islands accounted for nearly 28 percent of that total, or about \$132 million.

Any U.S. person with signature authority over or a financial interest in an overseas account whose value exceeds \$10,000 at any time during a year is required to file a report called a Report of Foreign Bank and Financial Accounts (FBAR) disclosing this information to the Department of the Treasury. Failure to file this information can lead to civil penalties, criminal penalties, or both. For those taxpayers with signature authority over bank accounts in the Cayman Islands, the number of FBAR filings for bank accounts in the Cayman Islands has increased steadily since 2002, rising from 2,677 in 2002 to 7,937 in 2007 (see fig. 7).

³⁵ A foreign corporation is a "controlled foreign corporation" when at least half of the foreign corporation is owned by U.S. shareholders who own at least 10 percent of the stock. For more specific information about the definition and consequences of a controlled foreign corporation see the E-supplement to this report, GAO-08-1028SP.

Figure 7: U.S. Persons Reporting Cayman Islands Foreign Bank Accounts, 2002-2007



Source: FinCEN.

In November 2007, 732 companies traded on U.S. stock exchanges reported to SEC that they were incorporated in the Cayman Islands. Of these, 309 reported their Cayman Islands address on their filing. As part of their annual SEC filings, companies must also disclose the existence of any significant subsidiaries, either offshore or domestic. As of November 2007, 378 U.S. public companies reported having at least one significant subsidiary in the Cayman Islands.

Because only limited third-party reporting is required by financial entities in the Cayman Islands, accuracy and completeness of the information are dependent on the taxpayer. For many taxpayers with domestic transactions and accounts, IRS is able to match expenses and income information provided by a third party to the taxpayer's return. This approach has been proven to increase U.S. taxpayer compliance. However, Cayman Islands financial institutions are often not required to file reports with IRS concerning U.S. taxpayers. This increases the likelihood of inaccurate reporting by U.S. taxpayers on their annual tax returns and SEC required filings. The likely low level of compliance with these requirements is an example of the general problem with the completeness and accuracy of self-reported information.

**U.S. Regulators Can
Formally Request
Information Regarding
U.S. Persons' Cayman
Activities**

In addition to the information that both IRS and SEC receive from filers of annual or quarterly reports, the U.S. government also has formal information-sharing mechanisms by which it can receive information from foreign governments and financial institutions. In November 2001, as a result of negotiations between U.S. and Cayman Islands officials, the United States signed a TIEA with the government of the United Kingdom and the government of the Cayman Islands with regard to the Cayman Islands. The TIEA provides a process for IRS to request information related to specific identified taxpayers, their specific transactions, companies, and named associates in respect of both criminal and civil matters, including at the investigative stages. The IRS sends TIEA requests to the Cayman Islands based on internal requests from the Criminal Investigations division, in cases where a taxpayer is under active criminal investigation, or from a revenue agent conducting an examination of a taxpayer. In addition to the TIEA, which is the newest international cooperation channel between the U.S. and the Cayman Islands, the U.S. government and the Cayman Islands also entered into a MLAT in 1986, which entered into force under U.S. law in 1990. The MLAT enables activities such as searches and seizures, immobilization of assets, forfeiture and restitution, transfer of accused persons, and general criminal information exchange, including in relation to specified tax matters. Extradition from the Cayman Islands to the United States is enabled under the United Kingdom's United States of America Extradition Order of 1976 (as amended in 1986).

The TIEA is now the dedicated channel for tax information, while the MLAT remains the channel for the exchange of information with regards to nontax criminal violations. According to a Cayman Islands government official, neither the TIEA nor the MLAT allow for "fishing expeditions." Rather, as is standard with arrangements providing for exchange of information on request, requests must involve a particular target. For example, IRS cannot send a request for information on all corporations established in the Cayman Islands over the past year. The request must be specific enough to identify the taxpayer and the tax purpose for which the information is sought, as well as state the reasonable grounds for believing the information is in the territory of the other party.

Since the TIEA began to go into effect in 2004, IRS has made a small number of requests for information to the Cayman Islands. An IRS official told us that those requests have been for either bank records of taxpayers

or for ownership records of corporations.³⁶ The IRS official also told us that the Cayman Islands government has provided the requested information in a timely manner for all TIEA requests. Since the MLAT went into effect and through the end of 2007, the Department of Justice told us that the U.S. government has made over 200 requests for information regarding criminal cases to the Cayman Islands. A Cayman Islands government official told us that assistance was provided by the Cayman Islands in response to these requests in all but rare instances, and that when a request was refused it was because it did not comply with the specific articles of the treaty.

Some Financial Intelligence Information on U.S. Persons' Cayman Activities Is Available to U.S. Regulators

The U.S. government's financial intelligence unit, FinCEN, works to gather information about suspected financial crimes both offshore and in the United States. As part of the Department of the Treasury, FinCEN is authorized, under the Bank Secrecy Act, to require certain records or reports from financial institutions. Thousands of financial institutions are subject to Bank Secrecy Act reporting and recordkeeping requirements. As part of its research and analysis, FinCEN can make requests of its counterpart in the Cayman Islands, CAYFIN. CAYFIN can and does make requests to FinCEN as well. When FinCEN receives SARs that involve connections to activity in a foreign jurisdiction—such as the Cayman Islands—the agency can investigate by requesting additional information from that jurisdiction's financial intelligence unit. Cayman Islands law requires SARs from any person who comes across suspicious activity in the course of their trade, employment, business, or profession without limitation to financial institutions. SARs generate leads that law enforcement agencies use to initiate investigations of money laundering and other financial crimes. Similarly, when FinCEN receives reports from institutions within the United States that involve foreign persons it can disclose the information to that country's financial intelligence unit. Certain U.S. law enforcement and regulatory agencies also have the ability to review SARs generated in the United States. If these agencies proceed with further investigation and require additional specific information from the foreign jurisdiction involved, the SAR-generated information can be used to support an MLAT or TIEA request.

³⁶The TIEA has been in effect for criminal cases since 2004 and for civil cases since 2006.

FinCEN and CAYFIN routinely share suspicious activity information. In fiscal year 2007, FinCEN made 6 suspicious activity information requests to CAYFIN. From July 2006 to June 2007, CAYFIN made 25 suspicious activity information requests to FinCEN to follow up on potential new leads as well as existing Cayman Islands-generated SARs. From July 2006 to June 2007, CAYFIN shared suspicious activity information with FinCEN in 30 instances, and CAYFIN described 27 of these instances as spontaneous in that CAYFIN disclosed suspicious financial activity with a nexus to the U.S. without receiving a specific request for information from FinCEN. The remaining three information disclosures were responses to requests from FinCEN and were related to active U.S. law enforcement investigations. According to CAYFIN, financial institutions primarily filed suspicious activity reports on U.S. persons for suspicion of fraud-related offenses. Other offenses leading to the filing of suspicious activity reports included drug trafficking, money laundering, and securities fraud, which mostly consisted of insider trading. In addition, according to Cayman Islands officials, statistics regarding SARs filed with CAYFIN show the United States as the most frequent country of subject (30 percent of SARs).

**Some Other Information
Sharing also Occurs
between U.S. and Cayman
Islands Regulators**

In addition to the formal information sharing codified into law between the U.S. government and Cayman Islands government and financial institutions represented by TIEA and MLAT requests and SARs, Cayman Islands officials reported sharing with and receiving information from federal agencies, state regulators, and financial institutions:

- According to CIMA, 40 requests for assistance were dealt with between 2003 and early 2008, including requests from SEC, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and various state insurance and banking regulators.
- CAYFIN reported informally sharing information with IRS criminal investigators on several occasions in cases involving predicate offenses such as drug trafficking or securities fraud.
- CIMA officials reported having traveled to the United States to do due diligence on U.S.-based fund managers/administrators.
- CIMA reported that other nations' regulators have traveled to the Cayman Islands to conduct onsite inspections of entities for the purposes of consolidated supervision and Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) reviews. While SEC has not conducted such inspections/reviews to date, CIMA indicated that it has provided substantial assistance to SEC over the

years and recently facilitated SEC's conduct of interviews in the Cayman Islands relevant to a current SEC investigation.

- The Cayman Islands Registrar of Companies maintains a limited amount of publicly available information—company name, type, status, registration date, and address of the registered office—about all Cayman Islands-registered entities.
- CIMA officials stated that they regularly coordinate with U.S. regulators at the state and federal level, and have several existing agreements that structure the terms of coordination with these agencies. For example, U.S. insurance regulators from Washington State recently negotiated a Memorandum of Understanding (MOU) to share information and coordinate with CIMA regarding cross-border insurance matters.

U.S. and Cayman Officials Have Taken Steps to Address Illegal Activity, but Enforcement Challenges Exist

Tax evasion and other illegal activity involving offshore jurisdictions take a variety of forms. Because the activity is offshore, the U.S. government faces additional enforcement challenges.

U.S. Agencies Have Uncovered Illegal Activities with Cayman Islands Connections

While not unique to the Cayman Islands, "hiding income offshore" is fifth on the IRS's list of 12 most egregious tax schemes and scams for 2008. The IRS list cites several illegal practices, including hiding income in offshore bank and brokerage accounts and foreign trusts, and accessing this income using offshore debit cards, credit cards, and wire transfers. IRS, SEC, and DOJ officials we spoke with described how offshore schemes have been used to facilitate tax evasion, money laundering, and securities violations. To address these issues, IRS's SBSE, LMSB, and CI Divisions have several initiatives that target abusive offshore transactions, and officials told us that some of the cases that they have identified have involved Cayman Islands connections. Still, a lack of jurisdiction-specific data prevents IRS from knowing the full extent of Cayman Islands activity, and the Cayman Islands was reported to be similar to other offshore jurisdictions with regard to the types of activity that occur there.

For example, IRS's SBSE Division investigates leads referred from other IRS areas, and also actively develops information sources that may assist in identifying new areas of illegal activity. Several initiatives have emerged

from these two areas, including programs focused on offshore credit cards, electronic-payment systems, offshore brokerages, and promoters of offshore shelters. A program that we have previously reported on is IRS's offshore Credit Card Summons project.³⁷ This program is a compliance initiative that seeks to identify noncompliant taxpayers with offshore bank accounts, investments, and/or other financial arrangements by "following the money" associated with their credit-card transactions. This program has been in effect since 2000, when a federal judge authorized IRS to issue John Doe Summonses to U.S. credit card companies with banks in offshore jurisdictions. IRS officials we spoke with explained that, since its inception in 2000, this program has resulted in completed examinations of over 5,800 returns, almost half of IRS's FBAR violation caseload, and over \$150 million in tax, \$26 million in interest and \$30 million in penalties. Returns continue to be examined under the program. In addition, officials reported that the program has placed pressure on one credit card company to revoke the ability of an offshore bank in the Bahamas to issue cards, and the Bahamas government to revoke the bank's license.

IRS officials said that some abusive transactions identified through these initiatives involved Cayman Islands entities or accounts, although the exact extent of this involvement was unclear. IRS officials indicated that jurisdiction-specific statistics were not maintained, and thus comprehensive numbers on Cayman involvement in abusive transactions were unavailable. One official also stated that although illegal transactions had been detected, most of the offshore business activity in the Cayman Islands was probably legitimate.

The LMSB executive with whom we spoke noted that there is no jurisdiction-specific initiative involving the Cayman Islands. He also said that the type of activity that occurs in the Cayman Islands is similar to that in other offshore jurisdictions. Officials from LMSB described several enforcement initiatives that involve the use of offshore entities by U.S.-related companies and investment funds, and reported that Cayman Islands entities have been involved in activities under investigation by LMSB in a number of cases. For instance, LMSB officials described ongoing investigations related to swap transactions to avoid tax on dividend income, as discussed previously in this report. IRS officials said that the rise of the hedge fund industry has required them to devote resources to evaluating the changed business environment and exploring

³⁷ GAO-07-237.

legal issues associated with strategies by industry participants to reduce U.S. tax burdens. According to IRS, it now has a special team exploring the tax implications of specific hedge-fund activities, including this arrangement, known as a total-return swap.

LMSB has activity-specific initiatives for several areas that involve offshore activity, including designated groups with expertise in employment-tax enforcement and transfer-pricing schemes, issues discussed previously in this report. LMSB officials stated that transactions associated with these areas can be highly complex and may involve aggressive but legal interpretations of the U.S. Internal Revenue Code. For instance, LMSB officials said that it is legal for a U.S. company to establish an offshore subsidiary to employ U.S. citizens who work abroad, thereby avoiding Social Security taxes on those workers in some circumstances. However, if IRS finds that a domestic corporation is actually the true employer of the overseas workers, it can challenge the legitimacy of the arrangement, leaving the U.S. corporation liable for Social Security taxes.³⁸ LMSB officials involved in transfer-pricing enforcement described IRS's activities in this area, and said that IRS has seen transfer-pricing issues related to the Cayman Islands. They pointed out, though, that Cayman Islands issues were similar to those in any other low-tax jurisdiction. They also described several IRS efforts to counter transfer-pricing abuses, including developing new regulations publishing industry directives and providing guidance to field examiners in cases involving transfer-pricing issues.

While some offshore activity amounts to aggressive, but legal, interpretation of the Internal Revenue Code, the U.S. government has identified multiple cases involving civil and suspected criminal activity related to the Cayman Islands. Specifically, the IRS Criminal Investigations Attaché who oversees requests related to the Caribbean reported that over the past 5 years field agents had requested information regarding suspected criminal activity by U.S. persons in 45 instances pertaining to taxpayers or subjects in the Cayman Islands. However, the official also stated that the Cayman Islands had fewer criminal violations than some other offshore jurisdictions. Department of Justice officials told us that

³⁸ Section 302 of the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 110-245 (July 17, 2008) added subsection 3121(z) to the Internal Revenue Code. Subsection 3121(z) states that, in general, if a foreign company is a federal contractor and is a member of a domestically controlled group of entities, then that contractor is treated as an American employer for the purposes of the Social Security taxes for its U.S. employees.

DOJ has prosecuted cases involving the use of Cayman accounts and entities. We analyzed 21 criminal and civil cases to identify common characteristics of legal violations related to the Cayman Islands. Among these cases, the large majority involved individuals, small businesses, and promoters, rather than large multinational corporations. While they were most frequently related to tax evasion, other cases involved securities fraud or various other types of fraud. In most instances, Cayman Islands bank accounts had been used, and several cases involved Cayman Islands companies or credit-card accounts.

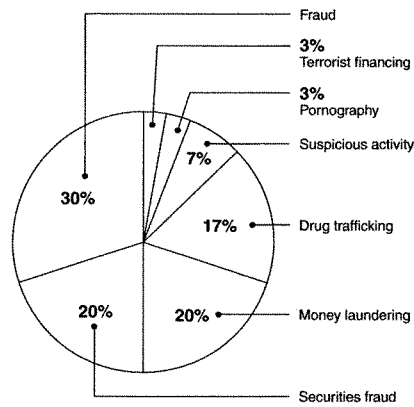
The documentation we reviewed for two of the cases, one referred to us by DOJ and one found in our database searches, mentioned a Maples and Calder connection. DOJ referred to us an ongoing tax case concerning a taxpayer's participation in a number of sale-in, lease-out transactions,³⁹ some of which involved Uglad House entities. IRS disallowed the tax benefits of the transaction and the affected party paid the resulting tax assessment and was suing to recover the amount at the time we did our research. A DOJ official said that it did not appear that Maples and Calder initiated or promoted the transactions. In the case found in our search, a hedge fund was established as an entity with Uglad House as its registered office. The U.S. hedge fund founder and manager has admitted fraudulent conduct in the United States in the course of a civil enforcement action brought by the Commodity Futures Trading Commission. The documentation we reviewed contained no allegation that Maples and Calder acted improperly. In neither of these cases did the activity in question occur in the Cayman Islands. A Maples and Calder partner said that the involvement of his law firm in these cases would almost certainly have been limited to establishing the entities in question.

SARs also provide useful information about the types of potentially illegal activity U.S. persons conduct in the Cayman Islands. As seen in figure 8, most SARs disclosed by CAYFIN to FinCEN in 2006 and 2007 were related to securities fraud, money laundering, drug trafficking, and other types of fraud. These SARs were all disclosed to the United States at the initiative of CAYFIN. CAYFIN tracks statistics on SARs related to tax issues; however for the years in question, none were reported related to the United States. Officials from Treasury and SEC reported that the Cayman

³⁹ In this sale-in, lease-out transaction, assets were sold to one party and then leased back to the original owner or user. The purchasing party then claimed certain tax benefits as a result of ownership.

Islands has been cooperative in sharing information and SEC reported that several of the SARs shared have led to U.S. investigations.

Figure 8: U.S.-Related SARs Disclosed to FinCEN by CAYFIN in 2006-2007 by Type of Offense



Source: CAYFIN.

Offshore Activities Pose Several Enforcement Challenges

IRS and DOJ officials stated that particular aspects of offshore activity present challenges related to oversight and enforcement.⁴⁰ Specifically, these challenges include lack of jurisdictional authority to pursue information, difficulty in identifying beneficial owners due to the complexity of offshore financial transactions and relationships among entities, the lengthy processes involved with completing offshore examinations, and the inability to seize assets located in foreign jurisdictions. Due to these oversight and enforcement challenges, U.S.

⁴⁰ Although we asked U.S. officials about the challenges they may face in investigations of offshore activity, some of the challenges they cited may also apply when investigating any non-U.S. activity.

persons who intend on conducting illegal activity may be attracted to offshore jurisdictions such as the Cayman Islands.

First, jurisdictional limitations make it difficult for IRS to identify potential noncompliance associated with offshore activity. An LMSB Deputy Commissioner said that a primary challenge of U.S. persons' use of offshore jurisdictions is simply that, when a foreign corporation is encountered or involved, IRS has difficulty pursuing beneficial ownership any further due to a lack of jurisdiction. Specifically, IRS officials told us that IRS does not have jurisdiction over foreign entities without income effectively connected with a trade or business in the United States. Thus, if a noncompliant U.S. person established a foreign entity to carry out non-U.S. business, it would be difficult for IRS to identify that person as the beneficial owner.

Additionally, the complexity of offshore financial transactions can complicate IRS investigation and examination efforts. In particular, offshore schemes can involve multiple entities and accounts established in different jurisdictions in an attempt to conceal income and the identity of beneficial owners. For instance, IRS officials described schemes involving "tiered" structures of foreign corporations and domestic and foreign trusts in jurisdictions including the Cayman Islands that allowed individuals to hide taxable income or make false deductions, such as in the cases of *United States v. Taylor* and *United States v. Peterson*, as discussed previously. Further, LMSB officials told us they had encountered other instances in which Cayman Islands entities were used in combination with entities in other offshore and/or onshore jurisdictions. One such instance involved an Isle of Man trust used in combination with Cayman bank accounts in order to obscure the beneficial ownership of funds. In another case, a U.S. taxpayer used a Cayman Islands corporation, Cayman Islands bank, U.S. brokerage account, U.S. broker bank, and U.S. bank to transfer funds offshore, control the brokerage account through the Cayman Islands corporation, and ultimately repatriate the funds to his U.S. bank account. One IRS official explained that it can be more useful to "follow the money" rather than follow paper trails when trying to determine ownership and control in such situations.

Another challenge facing offshore investigations and prosecutions that we have previously reported on is the amount of time required to complete offshore examinations due to the processes involved in obtaining

necessary information.⁴¹ A senior official from DOJ's Office of International Affairs indicated that the Cayman Islands is the busiest United Kingdom overseas territory with regard to requests for information, but also the most cooperative. She also said that the Cayman Islands is one of DOJ's "best partners" among offshore jurisdictions. Despite the Cayman Islands government's cooperativeness, DOJ officials told us that U.S. Attorneys are advised that if any offshore jurisdiction may be involved in a particular case, effort must be made as soon as possible to clarify needed information and initiate requests to obtain that information, in order to have sufficient time to successfully receive and include the information. They said that this is the case even with more cooperative jurisdictions, such as the Cayman Islands, due to the processes involved in making a request. According to Cayman Islands officials, they respond to MLAT requests within an average of six to eight weeks, and their response time for TIEA requests may be shorter. Past GAO work has shown that between 2002 and 2005 IRS examinations involving offshore tax evasion took a median of 500 more calendar days to develop and examine than other examinations. IRS officials from LMSB indicated that the specificity of information needed to make requests was also an inherent limitation involved in investigations of offshore activity.

Once noncompliance is determined, one LMSB official said that U.S. authorities cannot seize assets in foreign jurisdictions. Assets can be shared between the U.S. and foreign governments when an agreement exists, though. A DOJ official reported that the Cayman Islands has an agreement to share proceeds of criminal-asset forfeitures with the U.S. government, and has been a very cooperative partner. The Cayman Islands and U.S. governments have shared over \$10 million from cases in which the two governments have cooperated, and several million dollars have also been returned to U.S. victims of fraud in other cases and in asset-sharing with the United States since the inception of the MLAT.

The Cayman Islands Government Has Developed Safeguards to Prevent and Detect Illegal Activity

The Cayman Islands government has taken other steps to address illegal activity by U.S. persons, in addition to supporting and cooperating with U.S. government efforts. For instance, the Cayman Islands has implemented a regulatory regime that IMF has found to be generally in compliance with a wide range of international standards and has been cited by the CFATF as having a strong compliance culture related to

⁴¹ GAO-07-823T.

combating money laundering and terrorist finance. In addition, CIMA has supervision over various financial institutions in the Cayman Islands, including banks; insurance companies; investment funds; trust companies; and an array of service providers including insurance managers, fund administrators, and corporate-service providers. CIMA officials said that they do not regulate entities differently on the basis of their residence offshore or onshore.

CIMA licenses financial institutions and service providers in the Cayman Islands, and CIMA officials said that they consider several factors in determining whether or not to issue a license, such as fit and proper management, ownership and control, compliance with industry requirements, compliance with industry standards, and consolidated-supervision arrangements. In the case of the licensing of branches or subsidiaries of non-Cayman Islands banks, CIMA officials stated that they look to the foreign bank regulator in the bank's home jurisdiction to ensure that (1) the foreign regulator permits the Cayman Islands branch or subsidiary; (2) that the Cayman Islands operation will be subject to consolidated supervision by the foreign regulator in cooperation with CIMA as host regulator, in compliance with international standards; and (3) that the bank proposing to open a Cayman Islands operation is in good standing with its home-country regulator. CIMA officials said that the same procedures would be applied to any branches or subsidiaries of foreign trust companies that are subject to regulation in their home jurisdictions.

CIMA officials said that they take a risk-based approach to supervision of regulated financial activities, consistent with international standards such as the Basel and the International Organization of Securities Commissions (IOSCO) principles.⁴² They develop a risk profile for the supervised entity, which then leads to on- and off-site reviews of fund activity. In relation to on-site reviews of fund administrators, CIMA looks at whether the

⁴²The Basel Committee's core principles for effective banking supervision are conceived as a voluntary framework of minimum standards for sound supervisory practices in the banking sector. Committee members include central-bank and regulatory officials from the United States and other industrialized countries. One of the objectives of the Basel Committee is to close gaps in international supervision coverage so that no internationally active banks escape supervision and supervision is adequate. IOSCO is the principal international organization of securities commissions, and is composed of securities regulators from over 105 countries. IOSCO develops principles and standards for improving cross-border securities regulation, reviews major securities regulatory issues, and coordinates practical responses to these concerns.

different types of investors are correctly allocated to the intended investment funds; usually done with a 10 percent sample. CIMA officials said that some on-site inspections are done outside the Cayman Islands, such as in New York, Jamaica, and the Bahamas. Off-site reviews of funds include reviewing offering documents, audited financial statements, supervisory returns, and information provided by or available from regulators and other data sources for red flags, such as regulatory breaches, violations of SEC or United Kingdom rules, criminal charges, or any material related to the fund's appointed service providers. While SEC has not conducted such inspections/reviews to date, CIMA indicated that it has provided substantial assistance to SEC over the years and recently facilitated SEC's conduct of interviews in the Cayman Islands relevant to a current SEC investigation.

In addition, CIMA officials said that captive insurance companies organized in the Cayman Islands must meet certain requirements, such as submitting a sound business plan, revealing beneficial ownership under KYC rules, and identifying third-party administrators and actuaries. Applicants first find an insurance manager in the Cayman Islands or establish and staff a principal office in the Cayman Islands. Once the entity is licensed, the manager provides audited annual financial statements (an interim report if the next annual audit is longer than 12 months away) and other supervisory returns. CIMA officials said that they meet with each company and the insurance manager every 18 to 24 months.

Finally, CIMA requires audits of its regulated entities to be submitted within a prescribed time frame, and although the Cayman Islands has no direct taxation, CIMA officials said that if an auditor saw a clear criminal violation of another nation's tax laws, CIMA would expect that to be in the auditor's report and would take it into account in any invocation of its regulatory powers. Further, if at the licensing stage there are any concerns or lack of clarity about the proposed business activity, from a tax (or any other) perspective, then CIMA officials told us that CIMA would require the applicant to submit a professional legal opinion on the tax aspects of the activity.

In addition to administering regulatory safeguards, Cayman government officials from the Financial Secretary's Office told us that they act to implement regulatory standards and close loopholes when identified. For example, they described a previous action by the Cayman government to prohibit the establishment of shell banks.

Cayman Islands government officials and Maples and Calder representatives stated that their role in helping the United States ensure compliance with U.S. tax laws is necessarily limited. While government officials stated that seeking to legally reduce or avoid U.S. taxes would not be a legitimate reason to prohibit the establishment of a company or trust in the Cayman Islands, if it was clear that the entity was being set up as part of a scheme to evade taxes or violate other U.S. laws, that activity would be recognized as illegitimate and would not be allowed. As a matter of policy, and practically, the Financial Secretary and Deputy Secretary stated that the Cayman Islands government cannot administer other nations' tax laws and are not aware of any jurisdiction that undertakes such an obligation as a general matter. They told us that until a request is made by the United States for tax-related assistance, the Cayman Islands government is "neutral" and does not act for or against U.S. tax interests. They said that at the point that a request is made, the Cayman Islands can be relied upon to provide appropriate assistance. They also said that the Cayman Islands would not be opposed to further agreements with the United States regarding tax information sharing if the international norms and standards supported such efforts, but that there would need to be a clear justification for such agreements. Senior partners from Maples and Calder that we spoke with stated that complying with U.S. tax obligations is the responsibility of the U.S. persons controlling the offshore entity, and that they require all U.S. clients to obtain onshore counsel regarding tax matters before they will act on their behalf. They added that they are not qualified to advise on U.S. tax laws nor is it their role to enforce them, just as is the case for U.S. lawyers when it comes to the tax laws of other countries.

Concluding Observations

Ugland House provides an instructive case example of the tremendous challenges facing the U.S. tax system in an increasingly global economy. Although the Maples and Calder law firm provides services that even U.S. government-affiliated entities have found useful for international transactions and the Cayman Islands government has taken affirmative steps to meet international standards, the ability of U.S. persons to establish entities with relatively little expense in the Cayman Islands and similar jurisdictions facilitates both legal tax minimization and illegal tax evasion. Despite the Cayman Islands' adherence to international standards and the international commerce benefits gained through U.S. activities in the Cayman Islands, Cayman entities nevertheless can be used to obscure legal ownership of assets and associated income and to exploit grey areas of U.S. tax law to minimize U.S. tax obligations. Further, while the Cayman Islands government has cooperated in sharing information through

established channels, as long as the U.S. government is chiefly reliant on information gained from specific inquiries and self-reporting, the Cayman Islands and other similar jurisdictions will remain attractive locations for persons intent on engaging in illegal activity.

Balancing the need to ensure compliance with our tax and other laws while not harming U.S. business interests and also respecting the sovereignty of the Cayman Islands and similar jurisdictions undoubtedly will be a continuing challenge for our nation.

Agency and Cayman Islands Government Comments

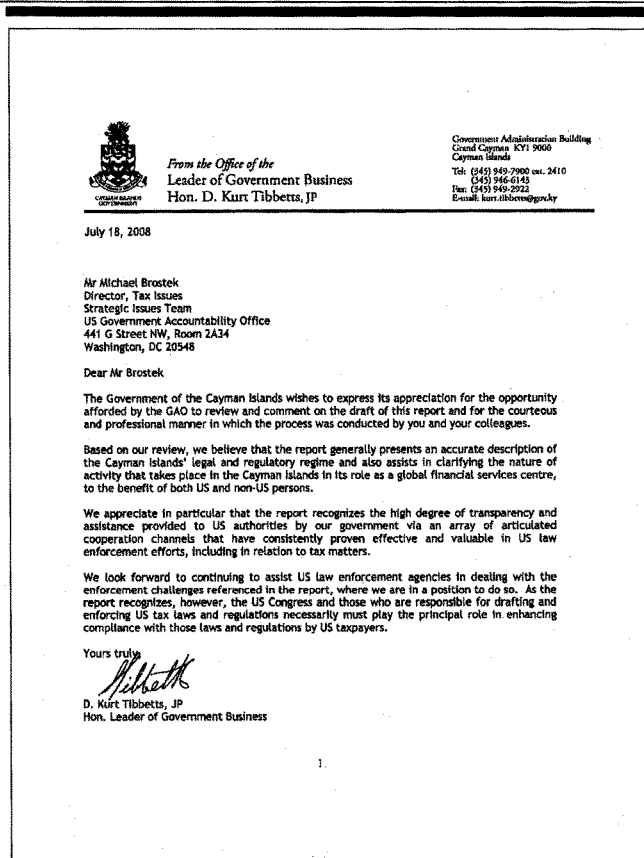
We provided a draft of this report to the Commissioner of Internal Revenue, the Secretary of the Treasury, and the Leader of Government Business of the Cayman Islands for review and comment. IRS and the Cayman Islands government provided technical comments, which we incorporated as appropriate. In a letter to GAO, the Cayman Islands Leader of Government Business expressed appreciation for the opportunity to review and comment on the draft report. He said that the report generally presents an accurate description of the Cayman Islands' legal and regulatory regime and assists in clarifying the nature of activity that takes place in the Cayman Islands. The letter from the Cayman Islands Leader of Government Business can be found in appendix I.

We will send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. This report is available at no charge on GAO's web site at <http://www.gao.gov>. If you or your staff have any questions, please contact me at (202)512-9110. I can also be reached by e-mail at brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Comments from the Cayman Islands Government



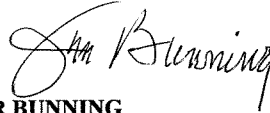
Appendix II: GAO Contacts and Staff Acknowledgements

GAO Contacts

Michael Brostek, (202) 512-9110 or brostekm@gao.gov

Acknowledgements

In addition to the contact person named above, David Lewis, Assistant Director, Perry Datwyler, S. Mike Davis, Robyn Howard, Brian James, Danielle Novak, Melanie Papasian, Ellen Phelps Ranen, Ellen Rominger, Jeffrey Schmerling, Shellee Soliday, A.J. Stephens, Jessica Thomsen, and Jonda VanPelt made key contributions to this report.



STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"The Cayman Islands and Offshore Tax Issues"
July 24, 2008

Thank you, Mr. Chairman.

I welcome the opportunity to hear from this distinguished panel about possible offshore tax evasion in the Cayman Islands.

As some European nations have discovered, it is not so easy to maintain high taxes on individuals in a democratic, pluralistic, and relatively free society. In a land where the highest tax rates on individuals typically rise above 50%, it has become common for wealthy individuals to hide their money in secret offshore accounts. The German tax scandal that has reached the highest levels of German society is only a preview of what will happen here, if we sharply raise tax rates at the top of the income scale.

Raising taxes on the wealthy may satisfy the primal urge to punish the success of your neighbor, but it is counterproductive to the goal of raising revenue: individuals will go to great lengths to avoid punitive and confiscatory taxes. Unless we all are willing to sacrifice some of our freedom, stopping them becomes more difficult the higher the tax rates go.

A better solution - - one that will keep capital here instead of in secretive financial centers at the four corners of the globe - - is to maintain our current tax structure and repeal certain punitive rates, such as the 55% estate tax. We should also update our laws to allow greater coordination between the various parts of the federal government that receive reports on potential financial crimes, and continue to seek information sharing agreements with tax haven jurisdictions.

There are 100 taxpayers in the Liechtenstein audit and just under 20,000 undeclared UBS accounts. This is troubling, but from all the evidence presented to us, offshore tax evasion is still a fringe phenomenon. Our problems could become far less manageable if we adopt European-style taxes to punish success.

Thank you, Mr. Chairman. I look forward to the testimony of the witnesses before us today.

SUBMITTED BY SENATOR GRASSLEY

The Chronicle of Philanthropy
February 7, 2008 Thursday

A Question of Calculation

By Peter Panepento and Grant Williams

Many charities that generate income through businesslike activities such as magazine publishing and retail sales are taking advantage of vague rules and specific exemptions built into statutes to avoid paying federal tax on this income, according to a Chronicle review of previously unavailable tax forms and other tax returns.

The Chronicle study of the business practices of 91 of the nation's largest charities finds that more than half of the groups list zero or negative taxable income for activities that are unrelated to their core missions.

The finding, which mirrors a just-released analysis by the Internal Revenue Service, comes at a time when the IRS and some lawmakers are questioning whether Congress needs to revisit the laws governing the collection of the so-called "unrelated business income tax," a tax that was created to put charities and businesses on a more level playing field.

Newly Public Forms

For its study, The Chronicle reviewed the most recent 990-T tax forms of dozens of prominent charities—a cross-section of nonprofit organizations like Harvard University, the American Red Cross, the Salvation Army, the National Geographic Society, the Christian Broadcasting Network, and the Metropolitan Museum of Art. The 990-T forms are available to the public for the first time, thanks to a change in federal law.

Of the 91 large nonprofit organizations analyzed, 46—or 51 percent—listed zero or negative taxable income after taking deductions and making other calculations.

In all, the 91 groups in the Chronicle's review generated \$419.1-million in income through such activities as publishing magazines and operating museum shops, bookstores, parking facilities, and restaurants.

Once these organizations calculated their taxes, that \$419.1-million figure was reduced to a collective loss of \$3-million.

The finding does not mean the nonprofit organizations have run afoul of tax laws. In fact, legal experts say charities are merely following federal rules that have been on the books for years that allow them to take deductions for myriad operating expenses and shield much of their income from tax through exemptions.

But the finding may verify concerns voiced by a top IRS official to Congress that current rules on unrelated business-income tax—known as UBIT—may allow "excess flexibility" for charities in some cases when they calculate the amount of their unrelated business taxable income.

The IRS's own studies of unrelated business income reporting finds that each year, roughly two-thirds of the public charities that generate unrelated business income pay nothing in tax, a trend that dates back to the beginning of its reporting on unrelated-business income in the 1992 tax year.

Unfair Competition

Under federal law, nonprofit organizations must pay tax on income generated from business activities that are not “substantially related” to their charitable mission.

The government levies the tax to prevent nonprofit groups from enjoying an unfair competitive edge over private companies.

But The Chronicle’s findings have some lawmakers worried that existing rules are giving charities an unfair tax advantage over businesses.

There are also questions over whether some charities are being too aggressive in how they account for these activities to avoid taxes.

Sen. Charles E. Grassley, of Iowa, the senior Republican on the Senate Finance Committee, says the information “raises a significant number of questions that need to be looked at more closely by charity boards, Congress, and the Treasury Department.”

Of the 91 organizations that provided their most recent Forms 990-T to The Chronicle for review, 45 calculated that they owed unrelated-business income tax.

Collectively, those payments totaled nearly \$21.4-million. Payments from just five of the 45 groups accounted for \$16.2-million, or 76 percent, of the total tax paid: the Metropolitan Museum of Art, Stanford University, United Jewish Appeal/Federation of Jewish Philanthropies of New York, Emory University, and New York Community Trust.

The remaining 46 organizations reviewed by The Chronicle paid no tax. Seventeen of these groups, after taking deductions and making other calculations, listed \$0 as their taxable income. Another 29 of these organizations reported a loss for their taxable income, meaning that their unrelated-business activities cost more money than they generated.

For some organizations, the declared losses totaled millions of dollars.

The Christian Broadcasting Network, in Virginia Beach, Va., generated more than \$4.7-million in unrelated-business income, largely through broadcasting and advertising. After taking its deductions and making other calculations, the organization reported a loss on its unrelated-business-income activities of more than \$15.3-million. Another group, National Public Radio, in Washington, reported a loss of nearly \$9.5-million after reporting income of more than \$4.4-million for activities like sponsorships and the sale of excess satellite capacity.

Senator Grassley says that The Chronicle’s review raises “key questions” for government regulators. “One is whether a charity should be engaged in a loss-making enterprise that may take funds away from their charitable mission,” Mr. Grassley said. “Another is whether charities are inappropriately lowering their tax bills by assigning costs from the charitable activities to the business activities, allowing them to avoid tax and compete unfairly with for-profit businesses.”

Some organizations know in advance that they will lose money each year but do so intentionally through activities that help the public or potential donors, like visitors to a restaurant run by a nonprofit organization for the charity’s patrons. Also, many groups have set up for-profit subsidiaries on which they do pay taxes.

IRS Raises Concerns

Last summer, Steven T. Miller, commissioner of the IRS’s tax-exempt and government-entities division, told a Congressional hearing that his agency was concerned that roughly half of nonprofit organizations that file the unrelated-business tax return report “zero income or a loss in the conduct of their unrelated-business activities.”

Among charities (excluding other types of tax-exempt groups), that figure is even higher. Figures released by the IRS last month show that only 37.7 percent of the nearly 12,400 charities that reported unrelated-business income paid tax on those earnings during the 2004 tax year.

Those organizations reported a collective gross income of more than \$5.5-billion, yet paid only \$192.5-million in tax—meaning that for every dollar in unrelated-business income, these groups paid about 3.5 cents in federal taxes.

During the 2003 tax year, that figure was even lower. Charities paid about \$102.6-million in federal taxes on more than \$4.8-billion in unrelated business income—or 2.1 cents for every dollar earned.

While the figures suggest to some observers that charities are able to write off millions in otherwise taxable income, some experts say the system is working as it was intended.

“The UBIT rules serve more as a boundary than as an actual source of revenue to the government,” says Marc Owens, a lawyer specializing in nonprofit issues in Washington and the former chief of the IRS’s tax-exempt division. “It’s a barometer that charities use to make sure they are keeping true to their mission.”

He adds, “If there was no boundary on the commercialization of the assets, it would be awfully easy to operate commercial businesses willy-nilly. The UBIT rule serves as a check on that.”

How Rules Work

Just how do the rules governing nonprofit business activities work in practice?

One common way that nonprofit groups reduce their income-tax liabilities is to take deductions for operating expenses, then apply those deductions to their tax bills—the same method that commercial businesses use.

But because of the way the rules are written, charities often have significant leeway in how they calculate those deductions.

Suzanne Ross McDowell, a lawyer in Washington and a former Treasury Department official, says that “when you determine what losses or expenses you are going to allocate to unrelated-business income, the regulations leave a lot of room to determine what you think is a reasonable allocation, and these are questions on which reasonable people could come to different conclusions.”

“There is not a lot of guidance out there, so organizations may come to the reasonable conclusions that help their bottom line,” she says.

Nonprofit groups, for example, are allowed to write off some of the salaries and wages of employees who work on business activities. But there are no hard-and-fast rules for determining how much they can deduct for these expenses.

On its most recent Form 990-T, the American Red Cross deducted \$334,777 in salaries and wages related to “charitable gaming” events.

The Red Cross told The Chronicle that only one chapter engaged in such events—which were mainly pull-tab games—and has since stopped its participation because “management has determined that it is in the long-term interest of the Red Cross to rely on fund-raising activity that is directly related to service delivery.” The Red Cross declined to identify the chapter involved.

Another group, the Trinity Christian Center of Santa Ana, in California, told the IRS on its most recent Form 990-T that its primary unrelated-business activity is operating gift shops and restaurants. The organization, which operates the Trinity Broadcasting Network, said it owed no

income tax after calculating a loss of \$378,377. Its deductions included \$306,989 for salaries and wages.

Colby M. May, a lawyer for the Trinity Christian Center, said in an e-mail message that the gift shops and restaurants “are not set up price-wise to generate an actual profit after taking into account the overhead and direct costs.”

Mr. May said the facilities “are there for the convenience of visitors, to assist them in having the most enjoyable experience that can be provided when they visit. The actual costs necessary to offer such conveniences, however, cannot be recouped without pricing the activities out of reach of the average visitor. Hence, these activities virtually always operate at a loss when applying all direct and overhead expenses.”

Numerous Exemptions

While the federal law states that some forms of charities’ commercial income are taxable—like advertising revenue from magazines and journals that nonprofit groups regularly publish, as well as income from insurance policies that they offer—the law also includes more than two dozen separate exemptions that allow organizations to shelter such income.

Some of these exemptions are in wide use, including those for capital gains from the sale of stock or property; dividends and interest from investments; and certain royalty and rental income.

As organizations have gotten more sophisticated, said Ms. McDowell, increasingly “exempt organizations may be seeking advice from tax advisers and structuring business activities to take advantage of the royalty exclusion, which is absolutely fine. It’s good tax planning.”

The Chronicle review also found that healthy deductions were common for organizations that rely heavily on advertising revenue and income from renting their facilities for private parties and other uses.

In 2006 the National Geographic Society, in Washington, earned \$89-million in taxable advertising revenue from its magazines. After deducting the costs of magazine paper, printing, postage, editorial salaries, distribution, and selling expenses, and taking into account other items and expenses, the organization calculated its taxable income at \$3.2-million.

When the society then took a \$3.2-million deduction for a “net operating loss”—a sum that charities (as well as taxable entities) are allowed to carry over from previous years and frequently do—the organization’s taxable income dropped to zero.

The society wound up calculating that it owed \$64,357 in alternative minimum tax, which applies to some organizations that would otherwise owe little or no tax.

Crista Ministries, in Seattle, reported unrelated-business income of \$8.6-million for its 2007 fiscal year, which ended in June, mostly in the form of advertising revenue from three commercial radio stations it operates in the Puget Sound area.

The organization reported taxable income of more than \$2.2-million after taking deductions that included \$55,476 for compensation of officers, directors, and trustees, and \$2.3-million for salaries and wages.

For example, Crista figured that its president, Bob Lonac, spent about 10 percent of his time—or \$25,128—involved with broadcast operations unrelated to the group’s mission and deducted this portion of his salary, according to John Jordan, the organization’s vice president and controller. In the end, Crista calculated that it owed \$767,758 in unrelated-business income tax.

Longstanding Debate

Debates over the scope of charities' business dealings and whether they should be taxed stretch back to the early decades of the 20th century.

Under pressure from business executives, Congress decided in 1950 to tax charities' unrelated-business activities in hopes of preventing nonprofit groups from enjoying an unfair competitive edge over private companies.

But the law was riddled with loopholes, and in the ensuing years Congress and the courts have added more.

Intense Congressional interest in the issue surfaced in the 1980s, when the Internal Revenue Service, the House Ways and Means Committee, advocates of small commercial businesses, and other people questioned the appropriateness of nonprofit organizations' generating millions of dollars of tax-free income from activities outside the scope of their charitable missions.

Those questions continue today, as the line between related and unrelated business-income remains blurred, says the IRS's Mr. Miller.

"This problem is becoming more critical as tax-exempt entities provide goods or services that are similar to or in some cases virtually indistinguishable from those offered by the tax-paying commercial sector," Mr. Miller said in testimony to the House Ways and Means Committee in July. "This movement raises a number of concerns, including the erosion of the nation's tax base, unfair competition with the commercial sector, and potential damage to the public's support of the charitable sector."

Noelle Barton and Sonya Behnke contributed to this report.

HOW TO READ A NONPROFIT GROUP'S BUSINESS INCOME TAX RETURN

1. A description of business activities that are not directly related to the organization's charitable mission.
2. Total income generated from such business activities.
3. Deduction for expenses incurred from business activities
4. The net income generated by such business activities. This figure usually is reduced significantly by deductions claimed on another section of this form.
5. Lists itemized deductions that reduce the amount of business income subject to taxation.
6. Charities are allowed to write off the salaries and wages of employees who spend some or all of their time on unrelated business-income activity. If an employee spends 10 percent of his or her time on such activity, for example, 10 percent of that person's salary can be included on this line.
7. The total amount of current-year deductions reported by the charity.
8. Amount after subtracting the deductions from the net income reported on line 13C.
9. Deduction that allows charities to apply previous unclaimed losses to the current year's taxable income.
10. Actual amount of unrelated business income that is taxable after all of the deductions are calculated.
11. Some charities that claim zero taxable income are still required to pay the federal alternative minimum tax.
12. The total amount of unrelated business- income tax owed by the charity.
13. Pages 3 and 4 include schedules that detail specific unrelated business-income activities.

**WRITTEN TESTIMONY OF
FRANK NG
COMMISSIONER OF LARGE AND MID-SIZED BUSINESSES
INTERNAL REVENUE SERVICE
BEFORE THE
SENATE FINANCE COMMITTEE
HEARING ON
TAX HAVEN FINANCIAL INSTITUTIONS: THEIR FORMATION
AND ADMINISTRATION OF OFFSHORE ENTITIES AND
ACCOUNTS FOR USE BY U.S. CLIENTS**

JULY 24, 2008

Good morning Chairman Baucus, Ranking Member Grassley and members of the Committee. Thank you for the opportunity to appear before you today to discuss an issue of critical importance to tax administration in this country – the practice of sheltering U.S. earned income in foreign jurisdictions as a means of avoiding U.S. taxation.

My name is Frank Ng and I am the head of the IRS Large and Mid-Sized Businesses Division (LMSB), which includes responsibility to oversee the IRS' international tax administration strategy.

We have strengthened our organizational focus to address international tax administration challenges through the development of the first service-wide approach to international tax administration – one that integrates the international perspective into our IRS business division strategies and processes.

We recognize that there is no longer a bright line that can be drawn between international and domestic tax issues. With increasing globalization, virtually every large business return – as well as the returns of many small companies and even individuals – has international features due to the ease of cross-border transactions.

Our service-wide international strategy has three strategic goals. The first of these is to improve taxpayer service. We know that international tax law is extremely complex. We must provide all taxpayers with international transactions clear and accurate information and guidance to help them file accurate tax returns. This will help avoid unintentional errors and reduce unnecessary contacts afterwards.

Our second goal is to enhance enforcement of the tax laws. To do this well we must better identify, address, and pursue high compliance risk and emerging international tax issues. We need to:

- Strengthen reporting requirements;
- Enhance IRS access to international data;
- Ensure adherence to professional standards by tax professionals; and
- Increase industry and global issue focus by aligning resources to cases and issues with the highest compliance risk.

To address this second goal, we have implemented an initiative that allows us to better focus on high risk tax issues and ensures that we utilize a strategic approach to manage them. Our Issue Focused Examinations and Tiered Issue Strategies are designed to do just that. Today, five of the ten Tier I high priority examination issues for LMSB are in the international tax area.

We identify potential compliance issues through examinations, Schedule M-3 reviews, and other data sources. These issues are then assessed for risk and prioritized to determine the audit approaches that will be employed. Not surprising, many of our top tier issues have significant international components.

Our third goal in achieving a service-wide approach to international issues is to modernize IRS through its people, processes, and technology. As trade and capital flow more easily across borders, the global marketplace is developing at an ever-increasing rate. The fast pace of change in the global economy requires an equally fast pace of change within our organization's infrastructure.

We must strategically manage and develop the technical skilled resources, associated compliance processes, and technology systems to meet international service and enforcement missions effectively and efficiently. We have started a technical training program called the Leveraging International Expertise that provides a base-level knowledge on international tax issues for all of our large case examiners and enhances the utilization of our most highly-skilled international examiners to more complicated cases requiring their expertise. Additionally, we are developing a new transfer pricing process and structure that will provide for new compliance approaches and processes to deal more effectively and efficiently on transfer pricing matters.

This morning, I would also like to offer a little background about some of these international issues and explain why they are a challenge. I then want to focus my testimony on the IRS' investigative activities where U.S. citizens are unlawfully hiding assets and associated income overseas.

We have significantly stepped up our efforts in this area, both in civil and criminal investigations. We are using a number of innovative techniques to root out noncompliance, as I will explain further. And, while I am limited in the detail that I can share about ongoing investigations, I am pleased with the early successes that we are having at systematically pursuing unlawful offshore schemes.

I will also discuss briefly the Uglend House and the GAO report that looked at the Cayman Islands as a tax secrecy jurisdiction, and I will conclude with what we think needs to be done moving forward.

Background

U.S. tax administration is complicated by the rapid pace at which our overall economy is globalizing. A growing percentage of large and mid-size business tax filings are from multinational businesses that include a variety of subsidiaries and partnerships operating within an enterprise structure where the ultimate parent is as likely to be foreign as domestic. In addition, a growing number of U.S. businesses acquire capital, raw materials, inventory, and other products and services from foreign businesses.

These events are natural outcomes of an increasingly global economy, and businesses have every right to optimize their global structures. Nonetheless, the complexities of globalization and cross-border activity continue to challenge U.S. tax administration. With multiple domestic and global tiered entities, it is often difficult to determine the full scope and resulting tax impact of a single transaction or series of transactions. Moreover, different jurisdictions impose a variety of different legal requirements and tax and accounting rules on multinational enterprises, leading to complex business structures. These circumstances create opportunities for aggressive tax planning.

It is not just large corporations that are taking advantage of globalization to engage in aggressive tax planning. Wealthy individuals are seeking ways to shelter income by moving it offshore or by participating in tax shelters organized by unscrupulous promoters who move in the shadows of the global economy.

Discovering and addressing these activities are complicated by the relative lack of transparency in the transactions that individuals and entities can conduct offshore. Not only are transactions themselves often intentionally designed, or carried out in a manner, to obscure the existence of assets or income, but the individuals engaging in the transaction, and their roles, are often intentionally difficult to identify.

A number of parties, including this Committee, may be interested in the quantification and magnitude of evasion through the use of offshore entities and accounts. Unfortunately, data do not currently exist that will allow us to make a reliable estimate. The National Research Program study of individual taxpayers for Tax Year 2001, which is our best measure of the nation's tax gap, was not designed to estimate the extent of offshore tax evasion. However, we believe offshore non-compliance is a serious compliance issue for the IRS and based on our current enforcement activities, the potential tax recovery is in the billions of dollars.

Ongoing IRS International Compliance Activities

Today at the IRS, we have approximately 1,500 employees focused primarily on international tax compliance activities, which include international examiners, tax treaty

analysts, economists, attorneys, and criminal investigators. As I indicated, developing a sustainable group of skilled technical employees to handle the myriad of complex international issues is a key priority for the IRS.

The IRS has targeted specific tax issues and areas of emphasis for international tax compliance attention, and these issues and areas are subject to mandatory review by our compliance personnel. As I indicated, we have designated the following Tier I international issues with high compliance risk potential:

- Transfer of intangibles/cost sharing
- Abusive foreign tax credit transactions
- Abusive hybrid instrument transactions
- Transfer pricing
- Foreign earnings repatriation

Each of these Tier I international issues is managed by an IRS Executive and issue management team that is responsible for the end-to-end strategic management of the issue. The guidance provided by the issue management team aids field examiners in the audit of specific cases with these issues. Currently, there are billions of income adjustments in dispute with taxpayers at the audit level related to cost sharing/transfer of intangibles transactions and potentially and billions more of income adjustments on transfer pricing transactions related to transfer pricing transaction associated with certain corporations.

The IRS will shortly initiate National Performance Review audits of overseas U.S. individual taxpayers – U.S. citizens and residents located outside the U.S. – to provide data to determine the compliance level of this taxpayer segment. In addition, the IRS has announced a compliance initiative to focus on foreign athletes and entertainers to ensure compliance with the U.S. tax laws. The IRS also has ongoing compliance initiatives with the Offshore Credit Card Project which is in addition to other offshore projects.

Stored Value Cards

The issue of stored valued cards represents, in many ways, the intersection of advances in technology with the increases in globalization. Stored value cards provide a mechanism for taxpayers with assets or income sheltered outside the United States to bring that money into the United States.

There are many legitimate uses for stored valued cards. They are often given as gifts to individuals allowing the person to purchase what he or she wants at any store that accepts traditional credit cards. These cards are known as “open system” stored value cards. Other cards are given and allow the user to shop only at a particular retail concern. These cards are referred to as “closed system” stored value cards. Retail industry estimates are that in 2007 alone approximately \$244 billion was spent on both types of stored value cards.

In addition to raising tax enforcement concerns, stored value cards may be used by terrorists to fund cells operating anywhere in the world by loading the cards from jurisdictions hostile to the U.S. Similarly, money launderers can use them to transfer large sums of tainted money within the U.S. and abroad.

The IRS Criminal Investigations (CI) division has been monitoring the use of stored valued cards for some time. They have conducted training programs for CI agents on signs that the cards may be subject to illicit use. As we develop additional information in this area, we will share it with the Committee.

Ongoing IRS Investigations

In the area of ongoing investigations, let me start by laying out some of the facts about one case that I am able to discuss, because the case that I am about to describe is a matter of public record. It involves a major Swiss bank.

In 2001, the bank signed a disclosure agreement with the U.S. to become a qualified intermediary (QI). This, among other things, required the bank to report on the income of U.S. taxpayers that were clients of the bank. However, a former employee of the bank, as part of his guilty plea to assisting a wealthy real estate developer in evading \$7.2 million in Federal income taxes by concealing \$200 million of assets in Switzerland and Liechtenstein, stated that a number of the bank's clients objected to such reporting.

The IRS has since requested, via a so-called John Doe summons, that a Swiss bank turn over account information on any U.S. clients who may have used Swiss bank accounts to avoid U.S. income taxes. The summons directs the bank to produce records identifying U.S. taxpayers who had accounts with the bank in Switzerland between 2002 and 2007 and who sought to have their accounts remain hidden from the IRS.

On July 1st a federal judge in Miami approved a Justice Department request to enable the IRS to serve the summons. We are working closely with the Justice Department to ensure that we get the information requested in the summons.

Accordingly, the IRS is exploring our options on how to bring a potentially large number of U.S. taxpayer cases to resolution.

Another recent example relates to U.S. citizens with accounts in Liechtenstein. As we announced in February, the IRS has initiated enforcement action involving more than 100 taxpayers with accounts in this jurisdiction. Because these are ongoing investigations that are not a matter of public record, I cannot go into great detail on these matters. At the highest level, we are again looking at circumstances where U.S. citizens have systematically avoided reporting income from foreign trusts.

Patterns of Evasive Activities

In the cases that we have seen around the world, I want to highlight a few patterns of behavior that we have uncovered in our investigations. Some of the activities I will describe are not, on their own, illegal. Taken together, though, they help to paint a picture of the complexity these investigations present.

First, we have seen financial institutions avoiding wire transfers from U.S. banks. In some cases, funds are diverted through a series of wire transfers using tax secrecy jurisdiction banks to disguise the identity of the true owners.

In some cases, discreet communications are stressed to the client. Phone calls are discouraged in favor of private visits. E-mail is not permitted, and code words are used to communicate. Clients have been advised not to carry documents related to accounts into the U.S.

Another method observed in examinations involves individuals physically carrying large amounts of cash from U.S. sources to tax secrecy jurisdiction banks. In some cases, taxpayers were advised to physically transport millions of dollars to an overseas bank.

We have also observed a number of techniques using offshore accounts to effect a form of estate planning. For example, there are cases where decedents who have an undisclosed foreign trust will leave an account to one or more heirs, but outside of the reported, taxed estate. The heirs may leave their inherited balance in the foreign trust unreported in the U.S. tax system.

These cases often involve sovereign jurisdictions where we have little legal authority and taxpayers that are often difficult to identify. As I will discuss later in my remarks, the United States has agreements to obtain and share tax information with many jurisdictions, but there are limits on our ability to use those agreements. And success in obtaining information can be short-lived. If we are successful in our enforcement strategies in one jurisdiction, the promoters and the schemers often simply move to another.

To put these issues in context, let me offer a little background about these issues and explain why they are so difficult for us. I then want to explain how we are dealing with these challenges, as well as lessons learned. Finally, I will discuss what we think needs to be done moving forward.

IRS Approach to Combating Offshore Tax Evasion*Information Reporting*

The IRS attempts to use an array of tools in attacking offshore noncompliance. The first of these is tax return information reporting. Most U.S. tax returns require that the filer provide information about foreign financial accounts, ownership in foreign entities, and financial statement data. For individuals, ownership of a foreign account is entered in

Part III of Schedule B of the 1040, for partnerships in Schedule B on Form 1065, and for organizations exempt from income tax in Part VI on Form 990.

The Form 1120 and Form 3520 have financial statement and foreign ownership informational requirements. Individuals and corporations who have created controlled foreign corporations (CFC) are required to file information returns annually on Form 5471 for each CFC. The monetary penalty for failure to file a timely and substantially complete Form 5471 is \$10,000, up to a maximum of \$60,000 for continued failure. Failure to file can also result in a reduction of foreign tax credits.

Any U.S. person (including citizens, residents, domestic partnerships, corporations, estates or trusts) with offshore accounts in excess of \$10,000 during the course of the calendar year must file a foreign bank and financial account (FBAR) report. This includes anyone who has a financial interest in or signature or other authority over any foreign financial account, including bank, brokerage, or other types of financial accounts, in a foreign country. FBAR forms are due on June 30 of each year.

There are severe civil and criminal penalties for noncompliance with the FBAR filing requirements. Civil penalties for a non-willful violation can range up to \$10,000 per violation. Civil penalties for a willful violation can range up to the greater of \$100,000 or 50 percent of the amount in the account at the time of the violation. Criminal penalties for violating the FBAR requirements while also violating certain other laws can range up to a \$500,000 fine or 10 years imprisonment or both. Civil and criminal penalties may be imposed together.

We also get information reporting about transactions with, and the ownership of, foreign trusts. U.S. persons are generally required to report transfers to foreign trusts and distributions from foreign trusts on Form 3520. In addition, a U.S. person who is treated as the owner of a foreign trust under the grantor trust rules is required to ensure that the foreign trust files a Form 3520-A to provide a full accounting of the trust activities for the tax year. There are significant civil penalties (up to 100 percent of the gross reportable amount) for failure to comply with the reporting requirements.

It is important to note that there are legitimate reasons for a U.S. taxpayer to have an offshore account. As with all information reporting to the IRS, we use this information as part of a broader risk analysis before reaching any conclusions about whether a taxpayer is engaged in tax evasion or otherwise avoiding tax liability.

The obvious downside to these types of information reporting is that they are dependent on the willingness of the taxpayer to comply. That is why we have looked for means of third-party reporting that often gives us a better view of what is taking place and thus encourages better compliance by the taxpayer.

Qualified Intermediary Program

In 2001 new regulations that completely overhauled the system for withholding and reporting on foreign persons took effect. An essential component of the new system is the QI program.

Under the program, foreign financial institutions voluntarily agree by contract directly with the IRS to operate under a simplified version of the withholding and reporting rules that U.S. financial institutions must follow. This means that the foreign financial institution agrees to collect identifying documentation from its customers, withhold U.S. tax based on that documentation, deposit the withheld tax with the IRS, file withholding tax returns on a Form 1042, file information returns on Form 1042-S and 1099, and submit to periodic audits performed by external auditors supervised by IRS examiners.

Prior to the 2001 regulations, dividends paid to a foreign address was treated as paid to a foreign person, and if the address were in a treaty country, the dividends were treated as paid to a resident of that country. For certain portfolio interest, entitled to a zero rate under the Code, foreign intermediaries were required to forward documentation identifying foreign beneficial owners to U.S. financial institutions. There was widespread noncompliance with this rule, in part due to the impracticality of requiring vast amounts of paper containing customer identification to be transferred and shared among competing financial institutions. Prior to 2001, foreign financial institutions abroad did not generally collect U.S. tax documentation, did not withhold U.S. tax, did not file information returns with IRS, and did not submit to IRS oversight.

Under the 2001 regulations, foreign financial institutions are required to forward beneficial owner documentation to U.S. financial institutions only if the foreign financial institutions are not qualified intermediaries. If they are qualified intermediaries, they are required to make all withholding decisions based on documentation collected from beneficial owners, withhold and deposit tax with IRS, file withholding tax returns and information returns with IRS, and submit to IRS oversight.

To date, 7,007 QI agreements have been signed. There are currently 5,660 active QI agreements. The difference between signed agreements and active agreements is due to mergers, acquisitions and terminations. For example the QI team has issued 600 default letters and has terminated 100 QI agreements. Currently, the QI program exists in 60 countries.

In layman's terms, the QI program gives the IRS an important line of sight to the activities of foreign banks and other financial institutions. It also provides detailed information reporting that the IRS did not previously receive.

However, the success of the program is dependent on the foreign bank being in compliance with its QI requirements. Nonetheless, when a foreign bank explicitly takes on those obligations under a QI agreement with IRS, the IRS is in a much better position to hold the bank responsible for living up to those obligations.

I believe the QI program is critical to sound tax administration in a global economy. By bringing foreign financial institutions more directly into the U.S. tax system, we can better ensure that U.S. persons are properly paying tax on foreign account activity, and that foreign persons are subject to the proper withholding rates. The QI program is relatively new, and as with any new and complex program, there will be flaws that must be addressed. In my view, we need to shore up the QI program and continuously enhance it.

Accordingly, the IRS is taking a number of steps to enhance the QI program. These steps include the following:

- Because accounting firms perform audits of QIs according to detailed procedures prescribed by IRS regulations, we have contacted the major accounting firms that engage in this business. We advised these firms of our concerns about questionable QI activity that we have observed. We engaged in a discussion about the role of the accounting community in conducting the audits of QIs, and what can be done to enhance the detection and reporting of violations of the QI agreement. The discussion was positive, and the IRS is confident the firms understand our concerns.
- Pursuant to a 2007 Government Accountability Office report, we are examining the possibility of regulations that would require audit firms to specifically report indications of fraud or illegal acts.
- We are working to increase the level and quality of information reporting by QIs. Potential changes to the QI regulations will require QIs to look through certain foreign entities – such as trusts – to determine whether any U.S. taxpayers are beneficial owners.
- We are examining database processes that would allow QIs to compare their data against commercial databases to verify taxpayer claims of residency for treaty benefit purposes.
- We are evaluating the benefit of collecting foreign TINs or require all beneficial owners to get U.S. TINs.
- Finally, we are considering whether to amend QI agreements to include spontaneous reporting on internal controls failures.

Tax Treaties, Information Exchange Agreements, and International Cooperation

Another tool in our arsenal is the use of international agreements such as tax treaties and tax information exchange agreements (TIEAs), under which other countries agree to obtain information on behalf of the United States for use in U.S. tax matters. However, a request for information under a tax treaty or TIEA must generally specify certain

information, such as the identity of the account holder. Without that information in the request, the other country would normally consider the request invalid.

We currently have agreements for information exchange with 73 jurisdictions and have expanded the program in recent years to include offshore jurisdictions such as the Cayman Islands and the Bahamas. We continue to expand the number of countries with which we have agreements as well as to renegotiate some agreements, such as the U.S. - Belgium tax treaty, to improve information exchange. However, we are still significantly limited by bank secrecy laws or lack of beneficial ownership information in some jurisdictions.

Using the bilateral agreements that we have with individual countries, in 2004 we worked with the Tax Commissioners of Australia, Canada, and the United Kingdom to form the Joint International Tax Shelter Information Centre (JITSIC). JITSIC was created to combat abusive international tax shelter activity on a real-time basis. The JITSIC office was based in Washington, DC, but in September, 2007, JITSIC expanded to a second office in London, England. Along with the expansion to London, JITSIC welcomed Japan as a new member.

JITSIC's primary focus has been on the bilateral exchange of specific abusive transactions and their promoters and investors. The results, to date, have been promising. The U.S. has received information regarding some transactions of which it had not been previously aware. In light of the complexity of the transactions, and considering the inherent difficulty normally associated with obtaining taxpayer-specific shelter information from foreign countries, it is unlikely that these transactions would have been uncovered and understood, but for JITSIC.

The U.S. has also received information regarding transactions of which it has been aware but may not have fully understood. Frequently, the information exchanged has provided additional facts and a better understanding of the transaction from the perspectives of two tax regimes. Without JITSIC, this type of exchange and accompanying dialogue would not take place.

We continue to work closely with our tax treaty partners on bilateral and multilateral compliance activities using the relevant Exchange of Information article in our tax treaties. We have also been an active participant of the Organization for Economic Cooperation and Development (OECD), in which we have worked to improve and strengthen worldwide standards for information exchange and sharing of best practices to address cross border noncompliance.

Informants

Informants have been valuable sources of information for IRS civil and criminal investigations into offshore tax evasion.

With the new “whistleblower” standards that reward informants, we anticipate that we will receive additional information on other potential tax violations. I know this is an area on which this Committee has taken great interest and we appreciate the concern.

Criminal Investigations

The IRS is increasing resources devoted to enforcing the failure to report foreign bank accounts and is currently pursuing dozens of criminal investigations of U.S. taxpayers for offshore tax evasion. Many of these investigations are a result of the IRS’ stepped up enforcement actions (announced in February 2008) involving more than 100 U.S. taxpayers to ensure proper income reporting and tax payment in connection with accounts in Liechtenstein. In addition, the IRS receives information from many other sources that can result in enforcement actions to ensure taxpayer compliance with the tax laws.

The primary focus on these investigations is on U.S. taxpayers who fail to file the FBAR form. U.S. persons are required to file a Form TD F 90-22.1, each year if they have a financial interest in or signature authority or other authority over any financial accounts, including bank, securities or other types of financial accounts, in a foreign country, if the aggregate value of these financial accounts exceeds \$10,000 at any time during the calendar year.

John Doe Summons

The final tool I will mention to fight offshore evasion is the use of information received from the use of John Doe summonses. The IRS generally uses the John Doe summons authority to identify individuals, groups or classes of U.S. taxpayers whose member identities are unknown, who are involved in specific areas of tax noncompliance and who cannot be identified through other means. For example, we would use this type of summons when we know that taxpayers use offshore bank accounts to avoid paying taxes, but we do not know their identities. A John Doe summons served on a domestic processor of offshore bank records would give us their names, addresses and other identifying information.

The IRS requested and received court approval to serve 153 John Doe summonses in connection with its Offshore Credit Card Project.

And, as I have already explained, we continue to use the John Doe Summons in furtherance of our offshore investigations.

The Uglan House

As noted in the report that the GAO prepared for this hearing, Uglan House is the name of an office building in Cayman Islands housing Maples and Calder (Maples), the largest Cayman Islands law firm. Maples is a corporate service provider meaning that sets up and registers companies in the Cayman Islands. Maples has another company – Maples Finance, Ltd. (Finance) whose staff consists of accountants and business people who

serve as officers and directors of the formed companies. Finance is located in a building behind Uglan House.

According to the GAO report, Maples serves as registered office for the 18,857 entities it created as of March 2008. About half of these entities are associated with U.S. firms and 5 percent are wholly owned U.S. companies. In 2005, the IRS received 5576 Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations indicating incorporation in the Cayman Islands. These entities reported gross receipts of \$161.9 billion.

As part of the IRS compliance efforts, significant effort have been applied to conduct transfer pricing audits that result in shifting of profits to low or no tax jurisdictions. Transfer-pricing audits often are very complex and highly factual resulting in controversy between the IRS and taxpayers on the valuation of intangibles and the determination of the arms length transfer price.

We worked cooperatively with the GAO in its analysis and shared information we had both about Uglan House and the Cayman Islands. And while the GAO made no recommendations as part of this report, the report notes some of the difficulties we face in dealing with the companies located in the Cayman Islands. Specifically, the attraction provided by Cayman Islands to many companies seeking to do business there is based on a number of legitimate business reasons. In fact, the GAO found that the Cayman Island's legal and regulatory system is regarded as stable and compliant with international standards. In addition the Caribbean Financial Action Task Force found in 2007 that the Cayman Islands had a strong compliance culture related to anti-money laundering and terrorist financing activities.

We have a TIEA with the Cayman Islands, which came into force for tax years beginning in 2004 for criminal purposes and 2006 for civil purposes. Under that agreement, we have made several requests to the Cayman Islands tax authorities for bank records and corporate ownership information. The Cayman authorities have replied in a timely manner and with complete information and continue to exhibit a very cooperative attitude with execution of the TIEA.

The difficulty we generally face in obtaining information in jurisdictions such as the Cayman Islands is our inability to identify with specificity the individual and activities to establish the basis for an information request under the TIEA or tax treaty. As business structures and transactions become complex, it is more difficult to detect potential tax abuse or evasion.

How Congress Can Help

The first thing that Congress can do to assist us in these areas is to fund fully the Administration's request for the IRS' annual budget. We need the necessary resources to continue to address many of the issues that I have discussed. Grappling with complex international tax issues requires a top-notch workforce and technological tools. The

President's FY 2009 Budget provides key resources to the IRS, and we urge your support. It also includes general legislative proposals designed to enhance third-party reporting. The most significant of these would require merchant card issuers to report annually on reimbursements to business entities.

The President's budget has legislative proposals that would be particularly helpful in this international area. The most significant of these would increase the foreign trust reporting penalty. The penalty provision would be amended to impose an initial penalty of the greater of \$10,000 or 35 percent of the gross reportable amount (if the gross reportable amount is known). The additional \$10,000 penalty for continued failure to report would remain unchanged. Thus, even if the gross reportable amount is not known, the IRS may impose a \$10,000 penalty on a person who fails to report timely or correctly as required and may impose a \$10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues.

Another area where Congress can help is to allow more time in which to conclude these investigations. Currently the statute of limitations is 3 years. However, because of the complexity of many of these cases, we often need additional time. We look forward to working with the staff and Members of this Committee and the House Ways and Means Committee to find an acceptable approach.

Finally, it is important that Congress continue to support our efforts to strengthen our network of tax treaties. They provide a basis for exchanging information.

Both Congress and the IRS are limited when dealing with individuals and businesses that are hiding their assets in foreign jurisdictions that use financial secrecy as a tool to attract commerce to their country. Thus, we must search for ways to reduce the incentive for taxpayers to seek out such offshore financial arrangements.

Deterrence is our most powerful weapon. In this regard, I am proud of the hard work the IRS and Justice Department investigators have put into these cases. As a result of their continuing work, I am confident that those who engage in these types of deliberate offshore tax evasion are very concerned right now. I believe that we owe it to the vast majority of honest taxpayers to pursue these cases aggressively, and I am committed to doing so.

Conclusions

Mr. Chairman, you and this Committee have been at the forefront in pursuing important areas of Federal tax non-compliance.

The subject of the hearing this morning is no exception. Offshore tax shelters are depriving the American treasury of billions of dollars each year.

I have attempted to bring you up to date on many of the steps we are taking in the offshore arena, and I hope this has been beneficial. I look forward to your continuing work in these areas and your assistance in halting abusive offshore tax shelters.

I appreciate the opportunity to be here this morning, and I will be happy to respond to any questions.

COMMUNICATION

MAPLES

Direct tel +1 345 814 5546
Email charles.jennings@maplesandcalder.com

Hon. Max Baucus
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Hon. Charles Grassley
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

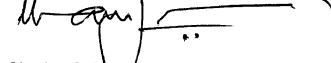
22 July 2008

Dear Chairman Baucus and Ranking Member Grassley

Maples and Calder, the sole occupant of Ugland House in George Town, Grand Cayman, welcomes the opportunity to submit the enclosed written statement for the record of the Finance Committee's 24 July hearing on "The Cayman Islands and Offshore Tax Issues".

I trust you will find this statement to be of assistance in your consideration of this matter.

Yours sincerely



Charles S Jennings
Joint Managing Partner

Encl.

Maples and Calder
PO Box 309 Ugland House Grand Cayman KY1-1104 Cayman Islands
Tel +1 345 949 8066 Fax +1 345 949 8080 www.maplesandcalder.com

MAPLES

**WRITTEN STATEMENT OF
MAPLES AND CALDER,
Ugland House, Grand Cayman, Cayman Islands**

**HEARING ON
"THE CAYMAN ISLANDS AND OFFSHORE TAX ISSUES"**

**BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE**

JULY 24, 2008

Submitted for the Record

Maples and Calder

PO Box 309 Ugland House Grand Cayman KY1-1104 Cayman Islands
Tel +1 345 949 8066 Fax +1 345 949 8080 www.maplesandcalder.com

We are Maples and Calder, the sole occupant of Ugland House in George Town, Grand Cayman, and we are pleased to have the opportunity to submit this statement for the record of the Senate Finance Committee hearing held July 24, 2008 on "The Cayman Islands and Offshore Tax Issues". Our statement provides background on our law firm and related corporate and fiduciary services businesses, explains how entities formed in the Cayman Islands enable investors from around the world, including the United States, to combine to engage in multinational business ventures, and addresses a number of misconceptions that have arisen about how and why investors do business in the Cayman Islands.

WHO WE ARE

Maples and Calder is an international law firm with over 200 lawyers and 750 staff worldwide in offices including the Cayman Islands, London, Hong Kong, Dublin and Dubai. We have no U.S. offices. We are well-known to governments and leading commercial law firms and financial institutions in every significant financial market worldwide.

Maples and Calder owns Maples Corporate Services Limited, a licensed trust company which provides registered office (i.e. registered agent) services to our law firm clients. We also own Maples Finance Limited, a licensed trust company and mutual fund administrator, which provides fiduciary and fund administration services.

Maples and Calder has cooperated fully with the U.S. Government Accountability Office ("GAO") in the preparation of its report and has devoted significant time and effort to provide the GAO with the most up-to-date and comprehensive information on our business and areas of expertise, the nature of our client base and the reasons clients choose to incorporate in the Cayman Islands.

WHAT WE DO

Our business focuses on facilitating international financial and commercial activity for an almost exclusively institutional client base of international financial institutions, investors and corporations. Our business and client base are global. Our clients come from some 99 different countries across the world, of which the United States is one. Our U.S. institutional clients are merely a reflection of the significant number of U.S. participants in international financial and commercial business. We require all clients, including U.S. clients, to obtain advice from counsel regarding onshore tax matters before we will act on their behalf in the Cayman Islands.

The challenge for multinational companies, investment banks and fund managers is to create a business or investment fund structure that is able to accommodate investors from all over the world within the complex parameters of existing tax and securities laws in the multiple home countries of the investors, the management team and the business or investment activities. Cayman Islands entities provide a tax-neutral platform to accomplish these multinational business objectives so that investors from multiple jurisdictions can join together without subjecting themselves to layers of foreign tax additional to the investors' home country tax.

**MISCONCEPTIONS AND FACTS ABOUT HOW AND WHY
INVESTORS DO BUSINESS IN THE CAYMAN ISLANDS**

1) MISCONCEPTION: More than 18,000 companies are headquartered in a five-storey building known as the Uglund House in the Cayman Islands. It is impossible for so many companies to be conducting business out of such a small building in a single location, so something wrong must be happening there.

FACTS:

- **Misconception over role of a company's registered office** - There is a misconception that a company's registered office address and operating business address are the same. The reality is that companies using Uglund House as their registered office do not actually operate their businesses from that location.
- **Registered office is not the site of business operations** - The registered office of a company in general is not the same as the location of its business operations. Jurisdictions in the United States and around the world have a similar basic corporate law requirement that a company must have a registered office in the jurisdiction in which it is incorporated. The registered office actually serves a very narrow function to act as a statutory agent where, for example, a company can be served with documents arising from litigation.
- **The Cayman Islands registered office function is the same as Delaware** - The Cayman Islands registered office function is almost identical to that of Delaware and Delaware-based registered agents (such as CT Corporation) in the United States. According to the Division of Corporations of the State of Delaware: "The State of Delaware is a leading domicile for U.S. and international corporations. More than half a million business entities have made Delaware their legal home, including 280,000 corporations and 400,000 alternative entities. More than 50% of all publicly-traded companies in the United States including 60% of the Fortune 500 have chosen Delaware as their legal home."
- **More than 200,000 entities alone have an address at 1209 Orange Street, Wilmington, Delaware – more than 10 times the number of registered entities at Uglund House in the Cayman Islands.**

2) MISCONCEPTION: Tax evasion is the primary driver for forming companies and conducting business transactions in the Cayman Islands. Investors in Cayman Islands entities are free from any form of tax.

FACTS:

- **Tax neutrality, not tax evasion or avoidance** - Investors and their advisors choose the Cayman Islands for tax neutrality, not tax evasion or avoidance. Cayman Islands entities provide a tax-neutral platform so that investors from multiple jurisdictions are not subject to layers of foreign taxation additional to the investors' home country tax. This tax neutrality provides a level playing field for all investors.
- **U.S. Government agencies recognise and facilitate the use of Cayman Islands entities for international business transactions** - The global financial system needs legal entities to be formed in a stable jurisdiction on a tax-neutral basis (whether in the Cayman Islands or elsewhere) to facilitate international business transactions. In fact, U.S. Government agencies such as the Overseas Private Investment Corporation (OPIC) and the Export-Import Bank are familiar with and support transactions using Cayman Islands entities registered at Ugland House for international transactions. Similarly, senior officials at the U.S. Treasury Department earlier this year orchestrated meetings among certain U.S. banks to discuss formation of a "super fund" to deal with market liquidity issues caused by the recent U.S. credit crunch. That "super fund" was to have been incorporated in the Cayman Islands with its registered office at Ugland House.
- **Cayman Islands provides a commercial vehicle to bring together investors from around the world to participate in a multinational business transaction** - The challenge for multinational companies, investment banks and fund managers is how to create a business or investment fund structure which is able to accommodate investors from all over the world within the complex parameters of existing tax and securities laws that apply to the investors, the management team and the business or investment activities, in their multiple home jurisdictions. The Cayman Islands offer a tax-neutral platform for these multinational business transactions.
- **Tax neutrality means no additional layers of foreign tax on top of the investor's home country tax** - The fact that there are no taxes in the Cayman Islands on these multinational business transactions often leads to a public misconception that investors in offshore companies are free from all forms of taxation. This is not the case at all. Investors based in onshore jurisdictions are likely to be taxed in their home countries on dividend, interest, and other income received from the offshore company and on any capital gains realized on the sale or redemption of shares in the offshore company. Many onshore jurisdictions also have introduced tax rules that impose tax on income and gains realized in the offshore vehicle as if they had been distributed to the investor. Additionally, the offshore company may itself be subject to withholding taxes imposed on income or gains on its investments by tax authorities in the onshore jurisdictions in which the offshore company's businesses or investments are located, and these withholding taxes are frequently not creditable against taxes paid by the investor in the offshore vehicle on the same income or gains.
- **Stable business and legal environment** – What makes this tax-neutral platform in the Cayman Islands so attractive for bringing together investors from around the world to participate in a multinational business transaction is that such platform is backed up by a fully-developed business law, an English-based legal system, and a regulatory and

professional infrastructure capable of implementing large and complex international business transactions. These investors consider, for example:

1. Speed and simplicity of establishing Cayman Islands entities;
2. Relatively low cost of doing so, particularly in the context of typical transaction sizes;
3. Flexible and practical business statutes, for example corporate transactions essentially limited by solvency rather than traditional notions of "capital";
4. Cayman Islands insolvency law, which is simple and effective, and hence of great comfort to lenders and investors (and again reducing costs);
5. Robust and healthy compliance culture;
6. English-based legal system, established judiciary, and absence of political or sovereign concerns;
7. Professional infrastructure and reputation. The Cayman Islands are well-known for their established and experienced financial services sector and their substantial capacity;
8. Recognition of corporate personality. The ability of multinationals to use separate group subsidiaries to maintain separate businesses and assets, often with their own ring fenced financing, can be a major contributor in the successful management of business and jurisdictional risks in cross-border transactions; and
9. Compliance with international anti-money laundering, anti-terrorist financing, and other financial regulatory standards.

3) MISCONCEPTION: *The Cayman Islands is an offshore tax haven shrouded in secrecy that invites tax abuse and discloses virtually no information on its financial transactions to the international community.*

FACTS:

- **Robust compliance culture, not secrecy, is the force behind the Cayman Islands' growth as an international finance centre** - Secrecy is not the driving motivator for reputable business coming to the Cayman Islands. The presence – not the absence – of a robust and healthy compliance culture of laws, regulations and international cooperation has contributed to the Cayman Islands' growth as an institutionally-focused, specialised financial centre.
- **Strong adherence to international anti-money laundering and anti-terrorist financing standards** - The Cayman Islands are currently among the highest rated offshore jurisdiction for complying with international standards concerning anti-money laundering and combating terrorist financing.
- **IMF review attests to effectiveness of the Cayman Islands financial regulatory system** - In 2003, the International Monetary Fund conducted an on-site assessment of the regulatory and anti-money laundering regime in the Cayman Islands and, in its 2005 report, concluded that the Cayman Islands had "an increasingly effective system of regulation" and that "the overall compliance culture within Cayman is very strong, including the compliance culture relating to anti-money laundering obligations".
- **The Cayman Islands has a well-established strong record of cooperation with the U.S. and international regulators** - The Cayman Islands Government has taken many proactive steps to enhance its cooperation with both U.S. and international regulators to adopt "best practice" international standards and to strengthen its regulatory structure against money laundering, terrorism, crime and tax fraud. The government has cooperated with the Organisation for Economic Cooperation and Development ("OECD"), the Financial Action Task Force ("FATF"), the International Monetary Fund ("IMF"), the International Organisation of Securities Commissions ("IOSCO") and the governments of many onshore jurisdictions (including the U.S. and the UK).
 - In 2001, the Cayman Islands signed a Tax Information Exchange Agreement with the U.S. The U.S. Treasury Secretary at the time, Paul O'Neill, commented "We commend the Cayman Islands for emphatically demonstrating that those who seek to engage in tax evasion or other financial crimes are not welcome within its jurisdiction". The following year, Treasury officials were reporting to the Senate that the agreement would be "an invaluable source of information to the IRS". This Tax Information Exchange Agreement conforms to the model developed, with U.S. participation, by the OECD Global Forum on Taxation, and is a form of an agreement which both the G-8 and G-20 countries have endorsed as reflecting "high standards of transparency and exchange of information for tax purposes".
 - The Cayman Islands Government has also enacted (a) the Proceeds of Criminal Conduct Law and the Terrorism Law, (b) the Securities Investment Business Law to regulate investment managers and advisors, (c) legislation to implement the Tax Information Exchange Agreement with the U.S., (d) legislation to implement the EU Savings Directive and (e) amendments to the Mutual Funds Law to increase the

minimum investment to US\$100,000 into investment funds registered under section 4(3) of the Mutual Funds Law.

-- In certain areas such as retroactive client identification obligations, the regulation of trust companies, company formation and registered agents, the abolition of bearer shares and the regulation of, and imposition of anti-money laundering obligations on, hedge funds, the Cayman Islands are more advanced than many onshore jurisdictions, including the United States and the United Kingdom.

- The Cayman Islands were one of the first jurisdictions to give an advanced commitment to the OECD in connection with its "harmful tax" initiative and as a result were not included on the OECD's list of harmful tax havens.
- The Cayman Islands are compliant with almost all the FATF anti-money laundering recommendations and currently rank third for overall compliance among 24 other jurisdictions, higher than countries such as the United Kingdom, Spain, and Italy.

CONCLUSION

In short, the Cayman Islands entities serve as commercial vehicles allowing investors from around the world to combine together to participate in multinational business transactions. Investors and their advisors choose the Cayman Islands for tax neutrality, not tax evasion or avoidance. Cayman Islands entities provide a tax-neutral platform for multinational business transactions, so that investors from multiple jurisdictions are not subject to additional layers of foreign tax on top of the investors' home country tax. The role of the Cayman Islands registered office function with respect to these Cayman Islands entities is almost identical to the role of Delaware and the Delaware-based registered agents in the United States.

Finally, it is the presence – not the absence – of a robust compliance culture of laws, regulations, and international regulatory cooperation that underlies the Cayman Islands' growth as an institutionally-focused financial centre.