BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

The Cayman Islands and Offshore Tax Issues

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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 -Section1441-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 the 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 moist 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.