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The Appleby Message: Not Digestible

Appleby is a major firm providing offshore legal, fiduciary and administration services. Appleby and its Group Managing Partner, Peter Bubenzer in Bermuda, issued in June 2010 an article entitled "OFCS [Offshore Financial Centers] in the Crosshairs --- But Not Alone in Their Struggle to Survive." Appleby offices are in many offshore financial centers: Bahrain, Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Hong Kong, Isle of Man, Jersey, London, Mauritius, Seychelles and Switzerland. That article by Appleby makes several statements about the role of OFCs, and those statements, not digestible, merit replies.

First, the Appleby article states that *"One of the issues raised in more recent onshore discussions has been the absence of tax in the major OFCs. Of course this is not true, as most have, for their small size, relatively sophisticated infrastructures, which are funded by taxes or fees,"* such as for example, in Bermuda custom duties and payroll taxes. However, the real issue is that OFCs permit foreign persons to use those financial centers free of tax: free of income taxes and all other taxes. The fact that purely local activities within the OFC might be subject to customs duties and payroll taxes, is really not relevant to the role of OFCs.

Second, the Appleby article states that *"The sovereign right of countries to determine their tax system seems to be overlooked in many discussions on OFCs' own tax structures."* True, countries have the sovereign right to determine their own tax systems. But those tax systems, whether of offshore financial centers or onshore financial centers, should not encourage nor facilitate residents of other jurisdictions to evade taxes in their country of residence and violate the tax system of their country of resident.

Third, Appleby refers to "tax competition" and argues that *"[tax competition] is still alive and well in the onshore world (examples are the differential tax rates among the various States of the United States of America or the different tax rate that people across the European Union)."* However, the states in the United States and the countries in the EU provide different tax rates for activities within their respective jurisdictions. The offshore financial centers provide tax free benefits primarily to non-residents and foreign corporations who/which have no real economic activity within the respective jurisdictions, and which in many cases are not permitted to do business locally. Offshore financial centers, all of which are "financial secrecy jurisdictions," do not merely provide tax competition. Because of the confidentiality those jurisdictions provide, they facilitate and encourage tax evasion/tax fraud.

Fourth, the Appleby article states that *"Many OFCs have now been added to the OECD "White List," each having entered into <u>a considerable number</u> of TIEAs [Tax Information Exchange Agreements] or DTTs [Double Tax Treaties]."* However, the OECD requires that a jurisdiction enter into only twelve (12) such agreements in order to be on the White List. Twelve such agreements is hardly "a considerable number." Further, some low tax/zero tax jurisdictions have entered into such agreements with (1) other low tax/zero tax jurisdictions, or (2) jurisdictions which have hardly any economic activity or personal wealth (such as the Faroe Islands and Greenland, and those insignificant agreements count for OECD purposes, toward the minimum of twelve.

Fifth, the Appleby article, in discussing automatic exchange of information, states *"At present, the only automatic TIEAs that I am aware of consist of arrangements between the USA and Canada, and those partial arrangements that exist under the Savings Directive implemented in the European Union."* This clearly is a misstatement. The Tax Justice Network prepared a memorandum in December 2009, entitled "Memorandum on Automatic Exchange of Information and the United Nations Tax Committee" which indicated that at least some information is exchanged automatically:

(a) Between Mexico and the United States

(b) Between Mexico and Canada

(c) Between Australia and New Zealand

(d) Between the Nordic countries (Denmark, Faroe Islands. Finland, Iceland, Norway, Sweden), according to their Convention on Mutual Assistance in the Tax Matters

(e) By Australia, Canada, Denmark, Finland, France, Japan, Korea, New Zealand, Norway, Sweden, United Kingdom, pursuant to income tax treaties (See the March 2000 OECD report,

"Improving Access to Bank Information for Tax Purposes," page 40.) The Tax Justice Network believes that in the ten years since that report was issued, at least several other countries are exchanging information automatically pursuant to applicable income tax treaties or in other agreements administrative assistance.

Further the United States enacted in March 2010 the Foreign Account Tax Compliance Act ("FATCA"). When FATCA enters into effect, it will in effect require all foreign financial institutions and other foreign entities which invest in the United States their own funds or their clients' funds, to provide automatically to the U.S. Government information about U.S. persons with financial accounts at those foreign financial institutions or other foreign entities.

Also, recently there have been significant declarations in favor of automatic exchange of tax information:

(a) February, 2009: Agustin Carstens, then Secretary of Finance of Mexico (previously Deputy Managing Director of the International Monetary Fund and now Governor of the Central Bank of Mexico) emphasized in a letter to U.S. Treasury Geithner that: "The [automatic] exchange of information on interest paid by banks will certainly provide us with a powerful tool to detect, prevent and combat tax evasion, money laundering, terrorist financing, drug trafficking and organized crime."

(b) The U.N. Commission of Experts on Reforms of the International Monetary and Financial System, chaired by Joseph Stiglitz, a Noble Laureate in Economics ("Stiglitz Commission"), in its.report of March 19, 2009 (paragraph 41), emphasized the close.link between regulatory arbitrage and tax evasion, and supported.strengthening the U.N. Tax Committee. The Stiglitz Commission report (paragraph 79) also recommends automatic exchange of tax information:

> The effective implementation of national systems of taxation form a crucial part of domestic development finance. Measures must be taken to preserve national

> autonomy in the selection of sources and methods of government financing while ensuring that national differences do not create incentives to evade responsibility of contributors to the support of government policies. An efficient method of achieving this result would be the acceptance by all countries of an amendment of Article 26 of the [U.N. model income tax treaty] to make the information exchange automatic"

Sixth, the Appleby article states *"It should be noted that the major OFCs do not receive financial and or grants from onshore governments or global monetary institutions."* Presumably the author was not referring to major OFCs like London, Luxembourg, Zurich and such-like which rank among the top ten secrecy jurisdictions on TJN's 2009 Financial Secrecy Index. But for the record we would note that the Cayman Islands, which continues to resist British government requests that it adopts a more sustainable tax regime, including direct and land taxes, has its considerable external debt guaranteed by the U.K. taxpayer, see here: http://www.nytimes.com/2009/10/04/business/global/04cayman.html?_r=1&ref=busineess

Seventh, the Appleby article states that the *"global economic crisis did not have its origin in the offshore world."* However offshore financial centers contributed to the global financial crisis: special purpose entities and special purpose vehicles in tax free offshore financial centers were treated "off balance sheet" by major financial institutions, and much of the shadow banking activity that underlies the build-up of unknown systemic risks was driven by opportunities to use complex offshore structures for tax and regulatory arbitrage.

The Applement statement mentions favorably the Report by the U.S. Government Accountability Office (GAO), entitled "Cayman Islands: Business and Tax Advantages attract U.S. Persons and Enforcement Challenges Exist" (July 2008). That GAO Report emphasizes the structured finance activities carried out by Cayman Islands entities, including securitization of asset-backed securities, including mortgage backed securities, such entities frequently being treated "off balance sheet." (pages 3,8,9,14,15,19,20,21).

Further, the GAO Report refers to other abuses in offshore financial centers, such as Enron having 441 entities in the Cayman Islands in the year that Enron filed for bankruptcy. The GAO Report states (page 33) 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."

Eighth, the Appleby article does admit that the offshore/world has facilitated *"crude tax evasion, such as hiding assets by non-declaration or under-reporting to onshore tax authorities."*

Ninth, Appleby states "*OFCs view themselves as responsible financial centers providing a base for companies and individuals seeking, with proper advice and disclosure onshsore, to structure their affairs as tax efficiently as the applicable onshore and offshore laws allow. The majority of offshore work in the major OFCs consists of providing services to companies and individuals who are operating in full compliance with their own tax laws, and these OFCs would not want it any other way."*

When a company is organized in an offshore financial center (or other financial secrecy jurisdiction), the local government authorities generally do not know whether the owners of that company "are operating in full compliance" with the laws of the jurisdiction of residence of those owners. Normally the Appleby office in the offshore financial center (or other secrecy jurisdiction) would act only as registered agent of the locally organized company, and therefore that Appleby office would not really know of the activities and the assets of that company.

Also, Tax Justice Network researched in 2005 the amount of assets held by individuals in jurisdictions outside their country of residence and not declared by them in the country of residence (Tax Justice Network, "The Price of Offshore"). Tax justice Network's conservative estimate: US$11.5 trillion, which results in an annual loss of tax revenue for governments of about US$255 billion. Tax Justice Network believes that the US$11.5 trillion figure has increased substantially since then, resulting from additional undeclared income on such undeclared assets, and substantial additional capital flight.

Tenth, Appleby states that *"it has been suggested that the offshore world must move to the automatic exchange of tax information rather than the present treaty-based request system, with its checks and balances too protect the legitimate rights of taxpayers that exist in all civilized countries. In the context of the worldwide system of automatically exchange tax information, where there is a global standard applicable to all, it must be right to expect such rules to apply to OFCs. In the absence of an equal application of such requirement onshore and offshore, requiring it solely for the OFCs would clearly be unfair and discriminatory."* That statement merits two comments: First the "request system," that is, exchange of information/upon request which is the official OECD promoted policy, is not effective exchange of information.

Under the "request system," in order for a government ("Requesting Government") to make a valid request for information of another government ("Requested Government"), the Requesting Government in effect must already know substantially all of the information being requested. That is why the number of effected requests has been minimal. An attorney for several offshore financial centers, including some jurisdictions where the Appleby Group has offices, noted that "Bermuda [where Appleby was originally, and still is, headquartered] has had such arrangements [exchange of information upon request] with the US for twenty years, and over that time [Bermuda] has effected less than fifty exchanges [of information]. (Richard Hay, "Beyond a Level Playing Field: Free (R) Trade in Financial Services.") Offshore financial centers and onshore financial centers support exchange of information upon request because such method is not effective exchange of information.

Eleventh, Appleby states that *"A number of these [offshore financial centers] jurisdictions, for example the Cayman Islands, have been subject to an examination (by the General Accounting Office of the USA [GAO]) as to their co-operation in the effective use of their agreements and were declared to be fully co-operative."*

The report of the U.S. Government Accounting Office, GAO, cited in the Appleby statement and discussed below, indicates (pages 5 and 37) that the United States has used only "a small number of times" the Tax Information Exchange Agreement (ITEA) between the United States and Cayman since it went into effect in 2004, to exchange information related to civil and criminal tax investigations. That GAO Report also states (cover page and page 37)

> 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………….
>
> ……….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 establishes 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 the reasonable grounds for believing the information is in the territory of the other party.

However, the Appleby discussion of the GAO report, "Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement challenges/Exist" (July 2008) is not accurate. Although the GAO Report does indicate that when the United States Government needs relevant information, the cooperation by the Cayman authorities has generally been good. However, the main point of the GAO Report is that because (a) the Cayman Islands is a zero tax jurisdiction for non-residents and corporations (even Cayman corporations) and (b) the Cayman Islands has confidentiality laws, the U.S. Government (i) has problems becoming aware of illegal activity and (ii) has enforcement problems. Some of the relevant sections of the GAO Report are attached in Annex A.

Twelfth, Appleby states *"…..as noted in Transparency Internationals published lists, the world's worst offender according to its assessment of global transparency was the state of Delaware in the USA."* Two Comments: Tax Justice Network ("TJN"), not Transparency International, prepared the Financial Secrecy Index ("FSI") published in

December 2009, referred to in the Appleby statement. Also as noted in the FSI, many jurisdictions suffer from the lack of financial transparency. The jurisdictions where the Appleby Group has offices are high on the FSI including offices in three of the top five financial secrecy jurisdictions (Switzerland (3), Cayman Islands (4), and London (5)), and offices in two more jurisdictions in the top ten financial secrecy jurisdictions (Bermuda (7) and Hong Kong (10)).

Jurisdictions where the Appleby group has an office	**Ranking in the Financial Secrecy Index as the top Financial Secrecy Jurisdictions**
Bahrain	14
Bermuda	7
British Virgin Islands	16
Cayman Islands	4
Guernsey	13
Hong Kong	10
Isle of Man	24
Jersey	11
London	5
Mauritius	32
Seychelles	39
Switzerland	3

Indeed, of the twelve Appleby offices, nine are in jurisdictions which are in the top twenty financial secrecy jurisdictions according to TJN's Financial Secrecy Index.

In summary, the Appleby statement is not "digestible."

Annnex A

Relevant Provisions of the Report of the United States Government Accountability Office (GAO), "Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist" (July 2008), emphasize the enforcement problems confronted by the U.S. Government regarding activities in offshore financial centers and other offshore jurisdictions.

The GAO Report stresses the "enforcement challenges," the problems of obtaining information about financial activities in the Cayman Islands (and in effect activities in other offshore financial centers):

(a) "….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. (page 4)

(b) 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 activities, 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. (page 5)

(c) IRS officials told us that concealing ownership of entities 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. (page 5)

(d) According to [the U.S.] 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. (page 6)

(e) 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. (page 31)

(f) Although not unique to the Cayman Islands, limited transparency regarding U.S. persons' financial activities in foreign jurisdictions contributed 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 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 illegal 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. (pages 32-33).

(g) 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 <u>United States v. Taylor</u> and the <u>United States v. Petersen</u> pled guilty in U.S. District Court to crimes related to an illegal tax evasion scheme involving offshore entities, including Cayman Islands entities. 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. (page 33).

(h) Cayman Islands financial institutions are often not required to file reports with IRS [U.S. Internal Revenue Service] 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. (page 36).

(i) Tax invasion and other illegal activity involving offshore jurisdictions take a variety of forms. Because activity is offshore, the U.S. government faces additional enforcement challenges. (page 40).

(j) IRS and DOJ [U.S. Department of Justice]officials stated that particular aspects to offshore activity resent 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, 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. 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 [IRS official] said that a primary challenge of U.S. persons' use of offshore jurisdictions is simply that, when a foreign 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 the United States v. Petersen, as discussed previously. Further, [IRS] officials told us they had encounters 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 order 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 controlled 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. (pages 44-46).