International Asset Tracing

The Struggle for Transparency Abroad

By Mara V.J. Senn and Giselle K. Fuentes

Show me the money!" As business transactions and asset holdings get more international, secret bank accounts act as a haven to avoid taxes, engage in fraudulent transactions, and illicitly transfer funds. Finding the money, much less showing the money, is becoming more difficult. Anticorruption and kleptocracy initiatives are hitting the news, but a huge hole in this dragnet is the world of secret bank accounts. However, a number of initiatives are shedding light on these hidden, offshore accounts, which not only could decrease corruption and kleptocracy, but could also help trace terrorism funding and bring more transparency to many transactions around the world.

Some high-profile tax havens are being affected, such as the Cayman Islands, Jersey, Guernsey, and the Isle of Man. The governments of the United States, United Kingdom, and Cayman Islands have all proposed or passed legislation to make financial transactions more transparent. In addition, in April 2013, the Washington-based International Consortium of Investigative Journalists (ICIJ), in an effort to expose the secret world of offshore banking, reported the results of its 15-month joint investigation with international media companies into offshore secrecy. The investigation included a review of 2.5 million files revealing the names and financial information about hidden companies and private trusts in the British Virgin Islands, the Cook Islands, and other offshore hideaways in more than 170 countries. It is likely that this trend of increased transparency will continue.

Although overall transparency is a welcome development, especially in countries where assets are plundered by corrupt leaders, it could also adversely impact unwitting victims. Many offshore accounts are there for perfectly legitimate reasons, and certain new transparency initiatives may disrupt some of those accounts and related overseas transactions. For example, people may open offshore accounts to diversify their investments, to have easier access to money while living or working abroad, or to engage in international business transactions in jurisdictions where local accounts are necessary. New laws and regulations requiring financial entities to create systems to identify, track, and report account information to the government may prove to be a substantial burden, leading to increased fees and transaction costs for taxpayers legitimately using foreign accounts and assets for legal reasons. This would be in addition to having to file complicated tax forms and the fear of the serious consequences that may arise in failing to abide by the new laws and regulations. Some of these developments have already imposed burdens on foreign financial institutions.

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Appeal of Offshore Accounts

Offshore, untraceable accounts and corporations offer a number of advantages to those wishing to evade detection: They can help the account holder avoid paying higher taxes and can allow a bribe to be paid without being traceable. Ultimately, the main goal is to distance the assets from their actual owner, while allowing control over them. Offshore financial operatives can and do create very complicated and elaborate financial structures that span several countries in order to maintain the anonymity of their clients. Common locations for offshore accounts include Bermuda, British Virgin Islands, Cayman Islands, the Cook Islands in the South Pacific, the Channel Islands of Guernsey and Jersey, Ireland, Isle of Man, Panama, and Singapore.

Local agents, accountants, lawyers, banks, and other financial services providers—also called "gatekeepers"—who are familiar with the laws of offshore jurisdictions known to allow asset secrecy, can use the legal tools available in these jurisdictions to navigate and provide their clients with access to the local financial industries. These "clandestine" jurisdictions are appealing because they have promulgated financial secrecy laws in an effort to attract foreign investment. Moreover, they have no requirements for publicly registering any financial or account information. In addition to the financial secrecy they provide, these jurisdictions—commonly referred to as "tax havens"—impose little or no tax on income from sources outside their jurisdictions and allow individuals to hide assets from tax collectors in their countries of origin. In some cases, these tax haven jurisdictions do not recognize or enforce foreign judgments or subpoenas.

In practice, money is moved offshore through bank accounts in jurisdictions with very strong bank secrecy laws (such as, until recently, Switzerland), or through shell corporations established in jurisdictions that require no registration and no public disclosure of information. The shell corporations typically have no employees, operations, or physical assets and exist merely on paper. They use corporate directors or "nominees" who agree to their names being used on corporate documents to hide the identities of the real owners and their affiliation with the companies. Many of these nominees lend their names to thousands of companies. The ICIJ analysis alone identified 28 "sham directors" who served as the representatives on the corporate documents of more than 21,000 companies, with individual sham directors representing as many as 4,000 companies each. This system of using "stand-ins" to shield the real owners of companies that do not want their identities revealed makes it very difficult for investigators to track assets and identify the people who are in control of the offshore companies and accounts.

Initiatives to Increase Transparency

Several countries have recently taken action to address tax avoidance and asset-hiding involving offshore activity.

United States Foreign Account Tax Compliance Act (FATCA). The United States recently enacted FATCA in an effort to promote transparency and curtail tax evasion.

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Following the 2009 UBS tax evasion case, in which US citizens hid billions of US dollars in Swiss bank accounts resulting in a $750 million fine, the United States passed FATCA in 2010 to combat the issues presented by offshore accounts. US citizens and residents generally are taxed in the United States on their worldwide income. Although it is legal for US citizens to open offshore accounts and to receive income from foreign sources, the law requires them to report these offshore accounts to the US Internal Revenue Service (IRS) or possibly be charged with tax evasion, fined with heavy penalties, and face jail time. Reasoning that the UBS case indicated that just requiring voluntary disclosure by taxpayers was not fully effective, FATCA requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by US taxpayers. It also requires foreign entities to report substantial ownership interests held by US taxpayers. However, FATCA does not allow private parties looking for untraceable accounts access to the information.

FATCA focuses on three main requirements: due diligence, reporting, and withholding.

Due diligence. FFIs must enter into an agreement with the IRS indicating that they will:

- obtain information on each holder of each account maintained by the FFI as is necessary to determine which of those accounts are US accounts; and
- comply with such verification and due diligence procedures as the IRS may require with respect to the identification of US accounts.

Reporting. Certain individual US taxpayers holding financial assets outside the United States must report those assets to the IRS. Generally, to fall within the purview of FATCA, the individual US taxpayer would need to have foreign financial assets with an aggregate value exceeding $50,000; higher asset thresholds apply to US taxpayers who file joint tax returns or who reside abroad.

FFIs must enter into FFI agreements with the IRS and report directly to the IRS information about the financial accounts held by US taxpayers or by foreign entities in which US taxpayers hold a substantial interest (more than 10 percent), including the name, address, account number, and account balance or value, and the gross receipts and gross withdrawals or payments from the account. FFIs must:

- comply with the annual reporting requirements with respect to any US account maintained by the FFI;
- comply with IRS requests for additional information on any US account maintained by the FFI; and
- if a foreign law would prevent the reporting of any required information: (1) attempt to obtain a valid and effective waiver of the law from each account holder; or (2) if a waiver is not obtained within a reasonable period of time, close the account.

FATCA requires not only banks to report this information directly to the IRS, but also other financial institutions, such as investment entities, brokers, and certain insurance companies.

Withholding. If an FFI does not enter into an agreement with the IRS, all relevant US-sourced payments, such as dividends and interest paid by US corporations, will be subject to a 30 percent withholding tax. The same 30 percent withholding tax will also apply to gross sale proceeds from the sale of relevant US property. (I.R.C. §§ 1471–74.)

Compliance concerns. According to the US Treasury Department, the United States has signed FATCA agreements with Denmark, Germany, Ireland, Japan, Mexico, Norway, Spain, Switzerland, and the United Kingdom. (*FATCA Archive*, U.S. Dep't Treasury, http://tinyurl.com/q6vg7nj (last updated June 11, 2013).) The United States is in talks with more than 50 other foreign jurisdictions to implement FATCA.

One concern for financial institutions is that compliance with the obligations imposed by FATCA will conflict with the local laws of the foreign jurisdictions. For instance, in Europe it would be difficult for foreign financial institutions to comply with FATCA without violating data protection laws and other legal restrictions. To address this issue, the US Treasury Department worked with several other countries to develop an intergovernmental approach to address the concerns expressed by foreign institutions around the world. Based on these discussions, it was agreed that financial institutions would instead report the information to their respective tax authorities, who would then provide the information to the United States under the legal framework provided by existing double taxation and tax information exchange agreements. The United Kingdom, United States, France, Germany, Italy, and Spain have already issued a joint statement agreeing to exchange tax information to enhance international compliance and facilitate enforcement to the benefit of all parties to the agreement.

It will be interesting to see how the FATCA agreements will be used in practice in gathering information to be reported to the United States. For example, the FATCA agreement between the United States and Switzerland makes reference to the 1996 Avoidance of Double Taxation with Respect to Taxes on Income treaty and its amending protocol of 2009, and states the parties' desire to facilitate the implementation of FATCA. Per the terms of the FATCA agreement, the implementation of FATCA would be based on direct reporting by Swiss financial institutions to the IRS, supplemented by the exchange of information upon request pursuant to the tax treaty as amended. Under the tax treaty, however, the parties are only permitted to exchange information in cases of suspected tax fraud and are not allowed to disclose information in cases of suspected tax evasion. In the event that this information is not provided to the IRS, whether it be because the local laws or the tax treaty do not allow for it and a waiver was not obtained from the respective account holder, FATCA requires that the financial institution close the account or be subjected to a 30 percent withholding tax on the US

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assets. However, the unilateral closure of certain bank accounts may also conflict with local laws, thereby creating another dilemma for financial institutions trying to implement and comply with FATCA.

In addition, the costs associated with FATCA will have serious implications for financial institutions abroad. For example, there will be costs related to creating and implementing databases and systems that help identify, track, and report the information required by FATCA. If the costs become unmanageable or burdensome, financial institutions may opt to turn away prospective US account holders or close the existing accounts of US entities and individuals. This would not only affect criminals, who have offshore accounts to evade taxes and commit other financial crimes, but regular, law-abiding US citizens, who live and work abroad and maintain these accounts for legitimate reasons. Another possibility is that the costs associated with the administrative burden of implementing FATCA placed on the financial industry will ultimately be passed down to the public.

Finally, laws like FATCA may discourage US investors from operating abroad, as they may not want to be subjected to stricter scrutiny as a result of their dealings abroad. This may also encourage US citizens who are living and working abroad to surrender their US citizenship so as to not be subject to the requirements and heavy penalties due to noncompliance imposed by FATCA.

Although the IRS estimates that initiatives such as FATCA will help in the recovery of billions of tax revenue from offshore accounts, this law is only one facet of the IRS's efforts to put an end to offshore tax evasion. Another initiative implemented by the IRS is its offshore voluntary disclosure programs (OVDPs). The US Government Accountability Office (GAO) reported in March 2013 that this program, which began in 2003, has resulted in over 39,000 disclosures and the recoupment of more than $5.5 billion in back taxes, interest, and penalties. (U.S. Gov't Accountability Office, GAO-13-318, Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May Be Missing Continued Evasion (2013).) Under this program, the IRS offers incentives to US taxpayers using undisclosed foreign accounts to avoid or evade taxes the opportunity to voluntarily report their offshore assets. The incentives include the opportunity to become compliant with US tax laws, a reduced risk of criminal prosecution, and lower penalties than if the unreported information was discovered by the IRS. The IRS has had OVDPs for 2003, 2009, 2011, and 2012, with each subsequent program including a higher standard offshore penalty rate. According to the GAO, one of the factors that has influenced participation in the 2012 OVDP, which is still open to the public, is FATCA. (*Id.* at 10, tbl. 1.) With FATCA being implemented, it will be more difficult for US taxpayers who choose not to disclose to keep their offshore assets and accounts under the radar.

Last year, Facebook hid almost half-a-billion British pounds in a Cayman Islands tax haven to avoid paying taxes in Great Britain and its other main markets.

UK Initiatives

The United Kingdom has also taken action to combat tax evasion and promote transparency by entering into agreements with Jersey, Guernsey, and the Isle of Man that would grant the United Kingdom's tax collection agency, Her Majesty's Revenue and Customs (HMRC), the authority to demand financial disclosures relating to UK residents without having to first present detailed prima facie evidence of evasion. (*See* Simon Bowers, *Budget 2013: Tax Avoidance and Evasion Targeted by George Osborne*, Guardian (Mar. 20, 2013), http://tinyurl.com/cralxzf.) Financial disclosure talks have also been initiated between the United Kingdom and other British territories such as the Virgin Islands, Bermuda, the Cayman Islands, and Gibraltar. (*See* Mike Foster, *No Hiding Place as Tax Noose Tightens*, Fin. News (Mar. 27, 2013), http://tinyurl.com/nnexwme.)

Cayman Islands Initiative

Some tax havens are also taking steps themselves to increase transparency. For example, the Cayman Islands are known as a tax haven by many companies that attempt to avoid paying higher tax rates in other countries. Consistent with this reputation, in December 2012, it was reported that Facebook hid almost half a billion British pounds in a Cayman Islands tax haven last year in an effort to avoid paying taxes in Britain and its other main markets. (*See Cayman Islands to Name Previously Hidden Companies*, Telegraph (Jan. 18, 2013), http://tinyurl.com/bcesykt.)) Moreover, the Caymans' reputation as a tax haven made headlines last year after it was revealed that US presidential candidate Mitt Romney held millions of dollars in Bain Capital funds there. However, after increasing pressure from investors and governments on the Cayman Islands to reform their asset-sheltering regulations, it appears that the islands are taking steps to address this problem. In January, the *Financial Times* reported that it reviewed proposals sent by the Cayman Islands Monetary Authority, to Cayman-based hedge fund businesses outlining plans to create a database that would make public the names of thousands of previously hidden companies and their directors for the first time in the country's history pending an ongoing consultation process. (*Id.*) The proposed reforms would be considered a break from decades of secrecy in the Cayman Islands that

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has serious implications for companies and hedge funds domiciled in this territory.

ICIJ Investigation

Finally, the transparency trend is being furthered by the efforts of the press. The ICIJ received leaked data about secret offshore accounts that is 160 times bigger than the State Department files leaked by Wikileaks. An analysis conducted by an international consortium of media organizations confirmed that "havens in the South Pacific and Caribbean in some cases have become sanctuaries for individuals seeking to conceal their activities from investigators and investors." (Scott Higham et al., *Offshore Tax Havens Became Traps for Investors*, Int'l Consortium Investigative Journalists (Apr. 7, 2013), http://tinyurl.com/qhewfk4.) The investigation was described as the "largest data leak in history," concluding that "alongside perfectly legal transactions, the secrecy and lax oversight offered by the offshore world allows fraud, tax dodging and political corruption to thrive." (Gerard Ryle et al., *Secret Files Expose Offshore's Global Impact*, Int'l Consortium Investigative Journalists (Apr. 3, 2013), http://tinyurl.com/d692qdz.)

The results of the investigation, which were reported in April 2013, included findings that shed some light on the purposes for which offshore accounts are used. For instance, the investigation analyzed documents that revealed the following:

- A prominent Canadian lawyer, husband to a liberal senator, moved $1.1 million to secretive financial havens while he was locked in battle with the Canada Revenue Agency over his taxes.
- A corporate mogul whose business empire has won building contracts worth billions of dollars amid Azerbaijani President Ilham Aliyev's massive construction spree is tied to the president's family through secretive offshore companies.
- Two major French banks, BNP Paribas and Crédit Agricole, oversaw the creation of a large number of totally opaque offshore companies in the British Virgin Islands, Samoa, and Singapore from the late 1990s until the end of the 2000s for clients in search of secrecy and lower tax rates.
- A half-billion-dollar Ponzi scheme in Venezuela shuffled investor money among a maze of offshore companies, hedge funds, and bank accounts stretching from the Cayman Islands to Switzerland and Panama, and smoothed the way by funneling bribes to officials in Venezuela.

(*See* Kimberley Porteous & Emily Menkes, *Highlights of Offshore Leaks So Far*, Int'l Consortium Investigative Journalists (June 14, 2013), http://tinyurl.com/cczchyf.)

As a result of this information and mounting international pressure, several countries, including Austria, Britain, France, Germany, Italy, Luxembourg, and Spain, are moving toward ending banking secrecy.

Conclusion

With the implementation of laws around the world that call for more transparency within the financial system, there are bound to be serious ramifications for those using hidden accounts to engage in improper activities. If more countries begin to require stricter reporting and record-keeping procedures to be put in place, this may expose the identities and monetary transactions of thousands of corporations and individuals around the world who have, for either legal or criminal reasons, decided that they wanted to remain anonymous. It may also lead to more effective investigations into tax evasion, corruption, money laundering, and other white collar crimes as investigators are allowed better access to suspicious money trails.

However, there is a fear that laws requiring more transparency abroad will have unintended consequences that may adversely affect persons who are not attempting to commit crimes. Companies and individuals that maintain accounts abroad should be aware of these recent actions and should take these laws into account when planning their financial structures. ■

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