

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



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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.

CAYMAN ISLANDS

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

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.

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Abbreviations

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| 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 |

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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 Uglad 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 Uglad House registered entities, and what business, if any, these entities carry on in Uglad 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 Islands*³. 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 Uglund House. Similar to corporate service providers in the U.S., Maples Corporate Services Limited provides registered office services, using Uglund 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 Uglund 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 Uglund 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. Uglund 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 Uglund 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.

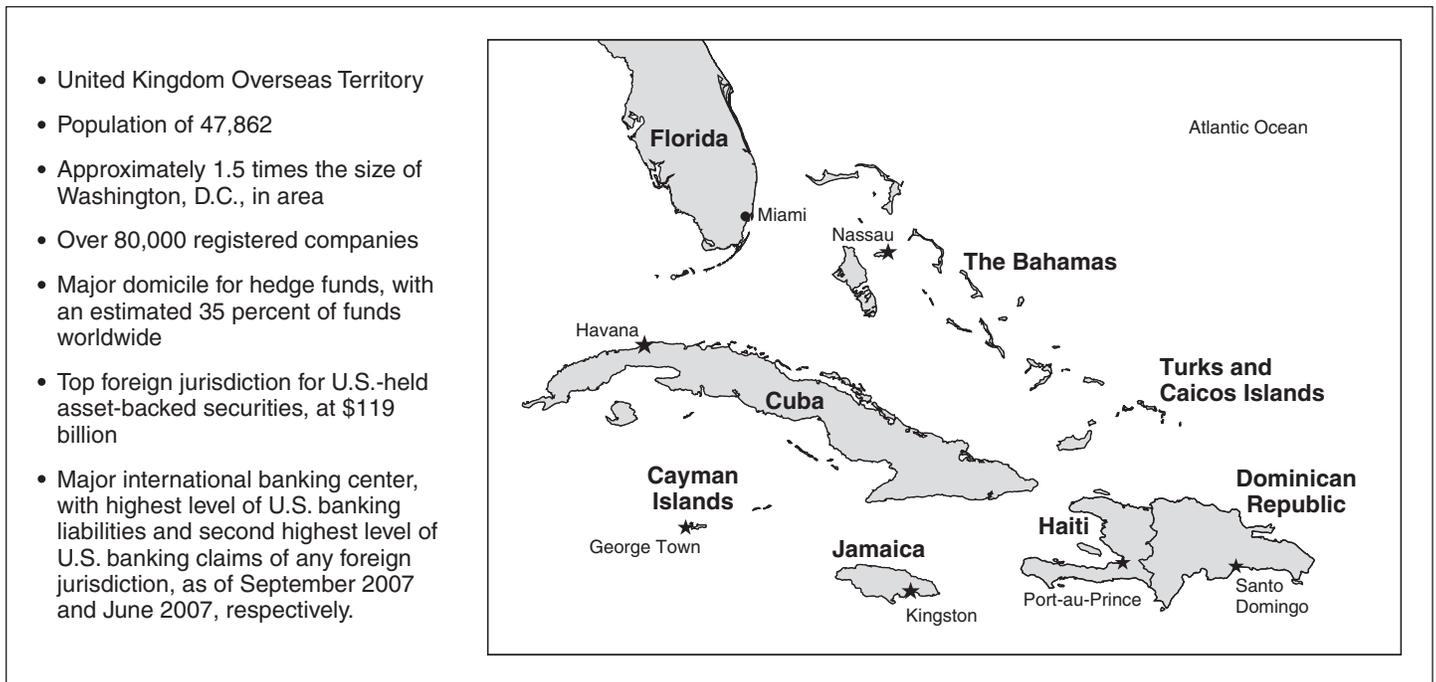
We provided a draft of this report to the Commissioner of Internal Revenue, the Secretary of the Treasury, and the Leader of Government Business of the Cayman Islands for review and comment. IRS and the Cayman Islands government provided technical comments, which we incorporated as appropriate.

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.

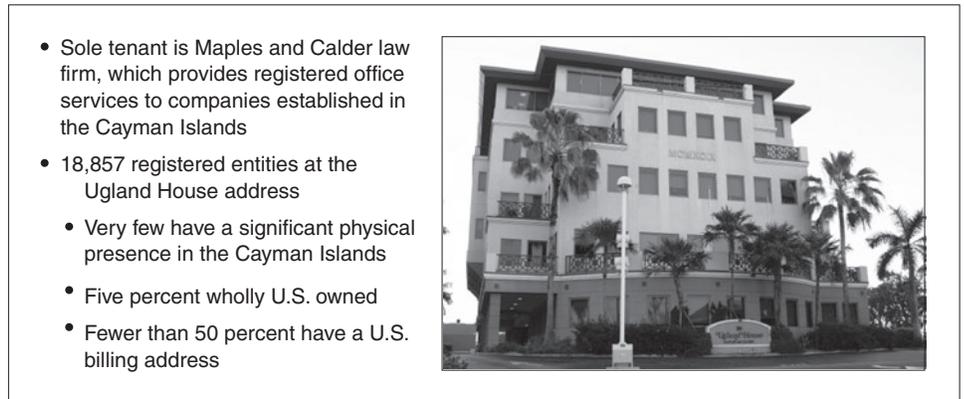
Maples provides registered office services to companies, using the Uglan House address.¹¹ A registered office¹² is required by Cayman Islands law for corporations registered in the Cayman Islands. States in the United States have similar statutory requirements. Registered office services include activities 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: Ugland 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-08-1028SP](#).

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.

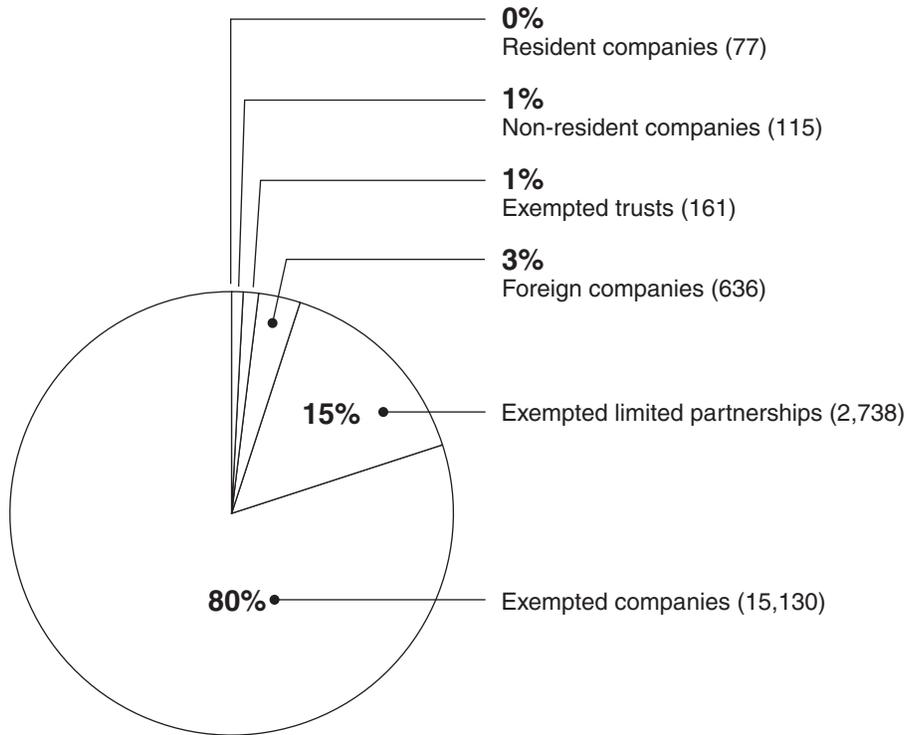
According to the Cayman Islands Registrar, as of March 6, 2008, 18,857 active entities used Uglad House as a registered office, and based on the nature of these entities very few have a significant physical presence in the Cayman Islands. As displayed in figure 3, approximately 96 percent of Uglad House 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: Uglan 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 Uglan 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 Uglan 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 Uglan 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 Ugland 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 Ugland 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 Ugland 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 Ugland 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 Ugland 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 Ugland 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 Ugland 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 Ugland 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.

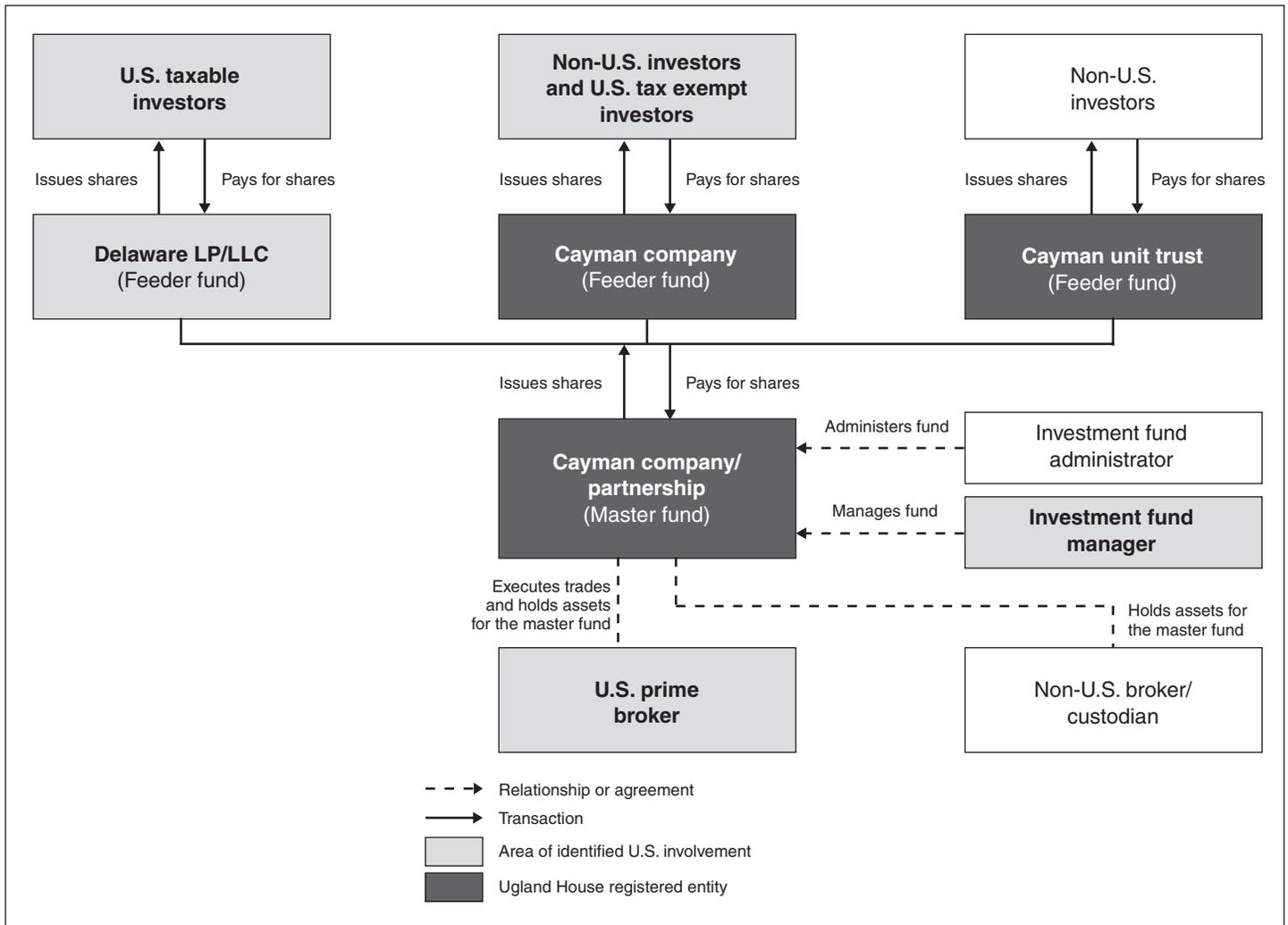
Ugland House Investment Entities Are Hedge and Private-Equity Funds, And U.S. Investors Are Largely Institutional, such as University Endowments and Pension Funds

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

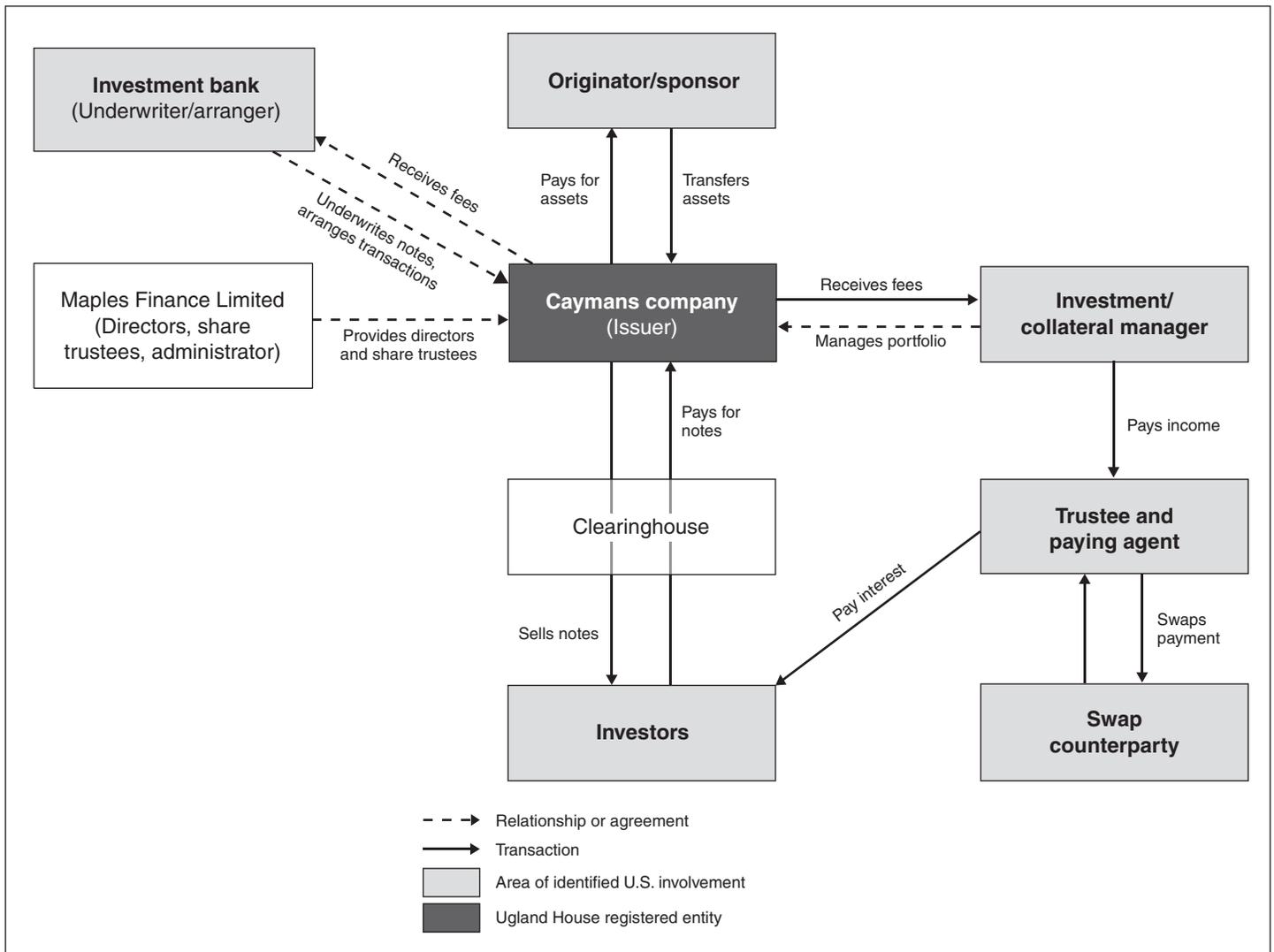
²¹ OPIC is a U.S. government agency that helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, complements the private sector in managing risks associated with foreign direct investment, and supports U.S. foreign policy.

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

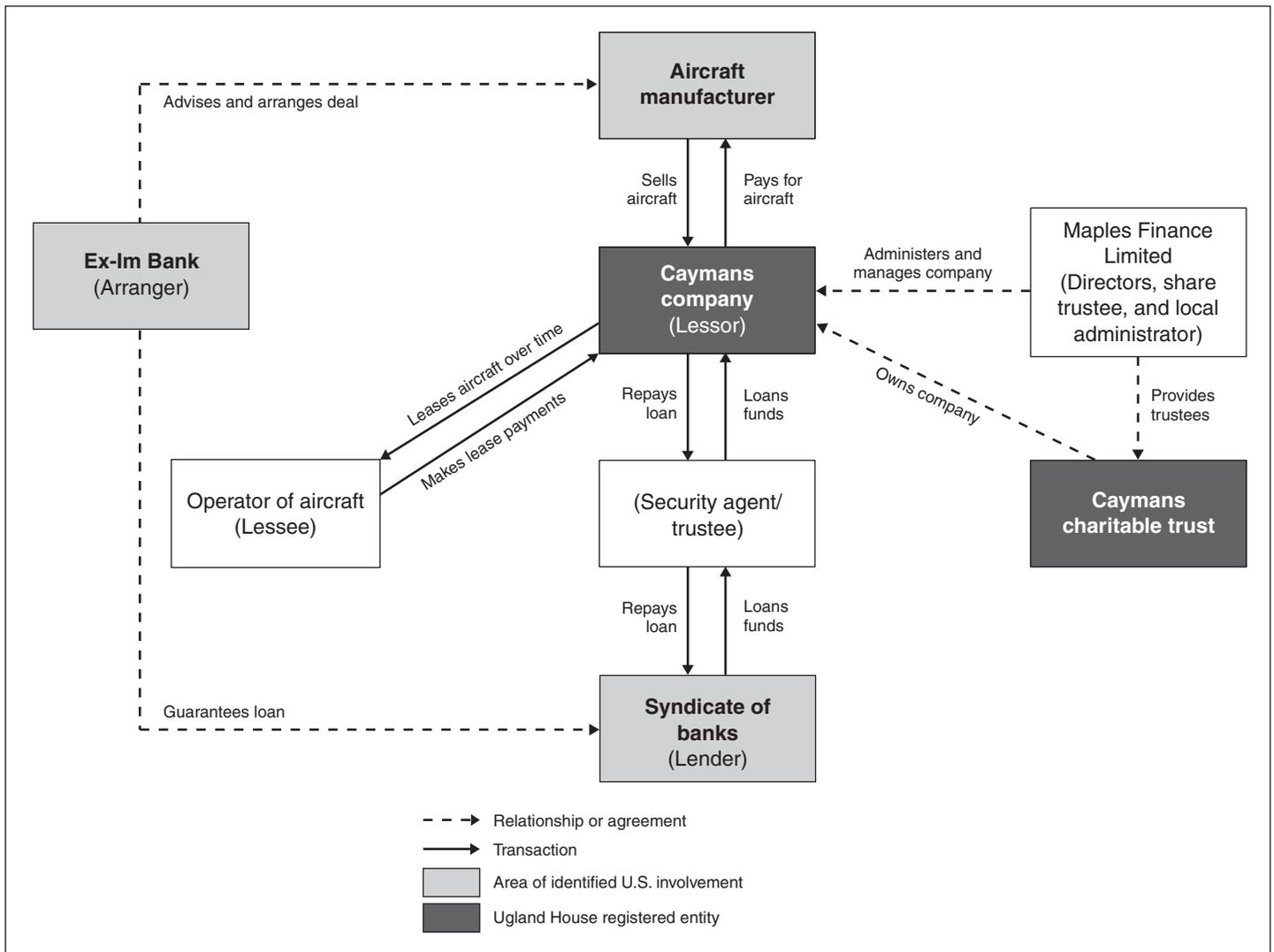


Source: GAO presentation of Maples and Calder information.

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 U.S. 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.-

²⁷ The 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).

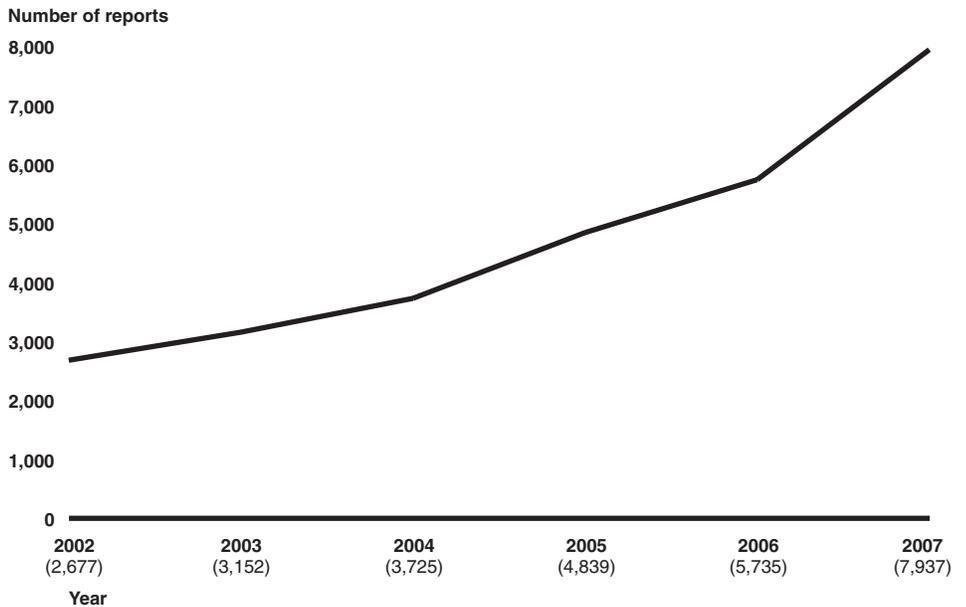
Although U.S. Taxpayers Report Some Cayman Islands Activities to U.S. Regulators, Overall Information Reporting Is Limited

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.

³⁶ The 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.

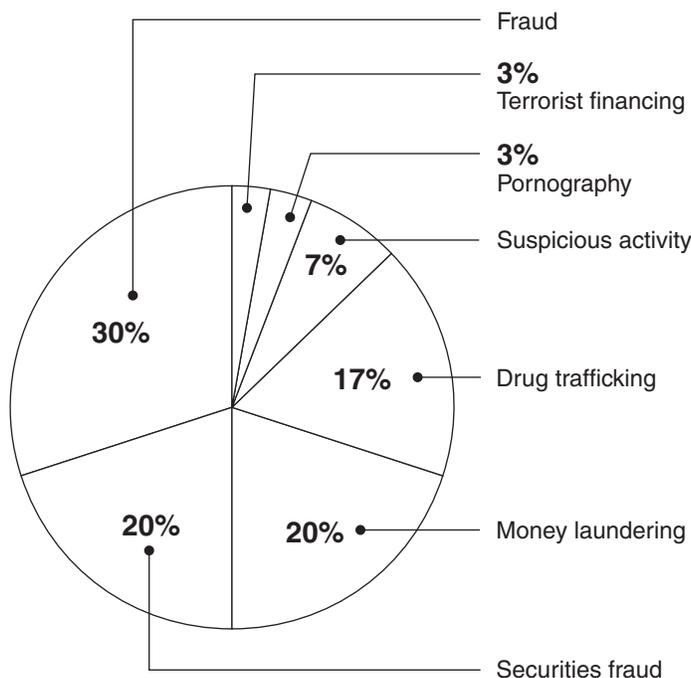
The documentation we reviewed for two of the cases, one referred to us by DOJ and one found in our database searches, mentioned a Maples and Calder connection. DOJ referred to us an ongoing tax case concerning a taxpayer's participation in a number of sale-in, lease-out transactions,³⁹ some of which 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

⁴² The 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



From the Office of the
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July 18, 2008

Mr Michael Brostek
Director, Tax Issues
Strategic Issues Team
US Government Accountability Office
441 G Street NW, Room 2A34
Washington, DC 20548

Dear Mr Brostek

The Government of the Cayman Islands wishes to express its appreciation for the opportunity afforded by the GAO to review and comment on the draft of this report and for the courteous and professional manner in which the process was conducted by you and your colleagues.

Based on our review, we believe that the report generally presents an accurate description of the Cayman Islands' legal and regulatory regime and also assists in clarifying the nature of activity that takes place in the Cayman Islands in its role as a global financial services centre, to the benefit of both US and non-US persons.

We appreciate in particular that the report recognizes the high degree of transparency and assistance provided to US authorities by our government via an array of articulated cooperation channels that have consistently proven effective and valuable in US law enforcement efforts, including in relation to tax matters.

We look forward to continuing to assist US law enforcement agencies in dealing with the enforcement challenges referenced in the report, where we are in a position to do so. As the report recognizes, however, the US Congress and those who are responsible for drafting and enforcing US tax laws and regulations necessarily must play the principal role in enhancing compliance with those laws and regulations by US taxpayers.

Yours truly,

A handwritten signature in black ink, appearing to read "K. Tibbetts".

D. Kurt Tibbetts, JP
Hon. Leader of Government Business

Appendix II: GAO Contacts and Staff Acknowledgements

GAO Contacts

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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.

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