TAX COMPLIANCE

Offshore Financial Activity Creates Enforcement Issues for IRS

Statement of Michael Brostek, Director
Strategic Issues Team

Page 6 of this testimony was amended on March 19, 2009, to correctly identify the bank director who admitted wrongdoing as an employee of Swiss bank UBS AG, not the Liechtenstein Global Trust Group.
Highlights

Offshore Financial Activity Creates Enforcement Issues for IRS

What GAO Did This Study

Much offshore financial activity by individual U.S. taxpayers is not illegal, but numerous schemes have been devised to hide the true ownership of funds held offshore and income moving between the United States and offshore jurisdictions.

In recent years, GAO has reported on several aspects of offshore financial activity and the tax compliance and tax administration challenges such activity raises for the Internal Revenue Service (IRS). To assist the Congress in understanding these issues and to support Congress’s consideration of possible legislative changes, GAO was asked to summarize its recent work describing individual offshore tax noncompliance, factors that enable offshore noncompliance, and the challenges that U.S. taxpayers’ financial activity in offshore jurisdictions pose for IRS. This statement was primarily drawn from previously issued GAO products.

What GAO Found

Individual U.S. taxpayers engage in financial activity involving offshore jurisdictions for a variety of reasons. When they do, they are obligated to report any income earned in the course of those activities. They are also required to report when they control more than $10,000 in assets outside of the country. However, much of this required reporting depends on taxpayers knowing their reporting obligations and voluntarily complying. Some taxpayers do not comply with their income and asset reporting obligations.

IRS examinations that include offshore tax issues can take much longer than other examinations. GAO’s past work has shown that from 2002 through 2005, IRS examinations involving offshore tax evasion took a median of 500 more calendar days to develop and examine than other examinations. The amount of time required to complete offshore examinations is lengthy for several reasons, such as technical complexity and the difficulty of obtaining information from foreign sources. However, the same statute of limitations preventing IRS from assessing taxes or penalties more than 3 years after a return is filed applies to both domestic and offshore financial activity. The additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open them at all, despite evidence of likely noncompliance.

What GAO Recommends

GAO makes no recommendations in this testimony. GAO reiterates previous recommendations regarding the Qualified Intermediary (QI) program and refers to a previous matter that Congress consider extending the statute of limitations for offshore cases. IRS generally agreed with the recommendations about the QI program and with the suggestion about the statute of limitations. Legislation to extend the statute of limitations has been introduced but not enacted.

GAO-09-478T or key components. For more information, contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov.
Mr. Chairman and Members of the Committee:

I appreciate this opportunity to discuss offshore financial activity and the problem of offshore tax evasion by individual taxpayers. International financial activity is common in our increasingly global economy, it is encouraged or facilitated by various federal policies, and the number of U.S. taxpayers with foreign financial accounts is growing. Financial activity across foreign jurisdictions poses challenges for both tax policy and administration. Like all forms of noncompliance, offshore schemes add to the tax gap—the difference between taxes owed and taxes voluntarily paid on time—and shifts more of the tax burden onto compliant taxpayers. Honest taxpayers may then find reason to reexamine their own willingness to stay compliant. Offshore tax evasion can be especially difficult to identify because of the layers of obfuscation that can come with doing business in overseas locations outside the jurisdiction of the United States. Doing business outside of the country is, of course, perfectly legal, but hiding income or assets in offshore locations in order to evade taxes is not. As is the case with all tax evasion, the Internal Revenue Service’s (IRS) success in helping taxpayers who want to comply with the tax laws as they pertain to offshore financial activity is of critical importance. Likewise, IRS's ability to identify and pursue those who choose not to comply is essential to combating abusive offshore transactions.

My statement today will largely draw from our prior work, often done for this committee, to describe individuals and the characteristics of their offshore tax noncompliance, factors that enable offshore noncompliance, and the challenges that U.S. taxpayers' financial activities in offshore jurisdictions pose for IRS.

Our reports on the Qualified Intermediary (QI) program, the Offshore Voluntary Compliance Initiative (OVCI), offshore examinations, and the Cayman Islands upon which this statement is based were prepared 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 the audit objectives for those reports.
It is perfectly legal for U.S. persons to hold money offshore. Taxpayers may hold foreign accounts and credit cards for a number of legitimate reasons. For example, taxpayers may have worked or traveled overseas extensively or inherited money from a foreign relative. As shown in figure 1, although holding money offshore is legal, taxpayers must generally report their control over accounts valued at more than $10,000. Taxpayers must also report income, whether earned in the United States, or offshore.

Figure 1: U.S. Taxpayers Are Required To Report Offshore Financial Activity

The type and extent of individual taxpayers’ illegal offshore activity varies. In 2004, we reviewed OVCI\(^1\) to provide information to Congress on the

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\(^1\) Launched in January 2003, OVCI was an attempt to quickly bring taxpayers who were hiding funds offshore back into compliance while simultaneously gathering more information about those taxpayers as well as the promoters of these offshore arrangements. As an incentive to come forward, IRS said it would not impose the civil fraud penalty for filing a false tax return, the failure to file penalty, or any information return penalties for unreported or underreported income earned in one or more of the tax years ending after December 31, 1998. However, taxpayers were required to pay applicable back taxes, interest, and certain accuracy or delinquency penalties. Taxpayers were also required to disclose information about themselves and those who promoted or solicited their offshore arrangements.
characteristics of taxpayers who came forward regarding their noncompliant offshore activities, and to understand how those taxpayers became noncompliant. According to IRS data, OVCI applicants were a diverse group, for instance with wide variations in income and occupation. In each of the 3 years of OVCI we reviewed, at least 10 percent of the OVCI applicants had original adjusted gross incomes (AGI) of more than half a million dollars, while the median original AGI of applicants ranged from $39,000 in tax year 2001 to $52,000 in tax year 2000. Applicants listed over 200 occupations on their federal tax returns, including accountants, members of the clergy, builders, physicians, and teachers.\(^2\)

Some OVCI applicants’ noncompliance appeared to be intentional, while others’ appeared to be inadvertent. Those applicants who had hidden money offshore through fairly elaborate schemes involving, for instance, multiple offshore bank accounts, appeared to be deliberately noncompliant. Other applicants appeared to have fallen into noncompliance inadvertently, for example, by inheriting money held in a foreign bank account and not realizing that income earned on the account had to be reported to IRS on their tax returns.

OVCI applicants’ median adjustment to taxes due was relatively modest. For tax year 2001, the median additional taxes owed were $4,401, median penalties assessed were $657, and median interest owed was $301.

However, other examples of offshore evasion have involved very substantial sums, complex structures and clear nefarious intent. For example, in 2006, Congress found several cases involving taxpayers with relatively large sums involved in abusive offshore transactions, including a U.S. businessman who, with the guidance of a prominent offshore promoter, moved from $400,000 to $500,000 in untaxed business income offshore.\(^3\) In another case, in 2006 a wealthy American pled guilty to tax evasion accomplished by creating offshore corporations and trusts, and


then using a series of assignments, sales and transfers to place about $450 million in cash and stock offshore. According to the indictment, the businessman used these methods to evade more than $200 million in federal and District of Columbia income taxes.

Several Factors May Facilitate the Use of Offshore Jurisdictions to Avoid Paying Taxes

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. For instance, individuals can sometimes use corporate entities to disguise ownership or income. Abusive offshore schemes are often accomplished through the use of limited liability corporations (LLC), limited liability partnerships and international business corporations, as well as trusts, foreign financial accounts, debit or credit cards, and other similar instruments. According to IRS, offshore schemes can be complex, often involving multiple layers and multiple transactions used to hide the true nature and ownership of the assets or income that the taxpayer is attempting to hide from IRS.

In addition, creation of offshore entities and structures can be relatively easy and inexpensive. For example, establishing a Cayman Islands exempted company can be accomplished for less than $600 (not taking into account service providers’ fees), and the company is not required to maintain its register of shareholders in the Cayman Islands or hold an annual shareholders meeting. Other offshore jurisdictions provide similar services to those wishing to set up offshore entities.

Another factor that makes it easier for individuals to avoid paying taxes through the use of offshore jurisdictions is that taxpayers’ compliance is largely based on voluntary self-reporting. When reporting is entirely voluntary, compliance can suffer. IRS has found that when there is little or no reporting of taxpayers’ income by third parties to taxpayers and IRS, taxpayers include less than half of the income on their tax returns.

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4 This is not unique to offshore locations. As we previously reported in GAO, Company Formations: Minimal Ownership Information Is Collected and Available, GAO-06-376 (Washington, D.C.: Apr. 2006), most U.S. states do not require ownership information at the time a company is formed.

5 IRS found that for non-farm sole proprietor income subject to little or no third-party reporting, taxpayers misreported more than half of such income in 2001, according to IRS’s most recent tax gap estimates.
One way that taxpayers are required to self-report foreign holdings is through the Report of Foreign Bank and Financial Accounts (FBAR) form.\(^6\) Citizens, residents, or persons doing business in the United States with authority over a financial account or accounts in another country exceeding $10,000 in value at any time during the year are to report the account to the Department of the Treasury (Treasury). U.S. persons transferring assets to or receiving distributions from a foreign trust are required to report the activity to IRS on Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. From 2000 through 2007, the number of FBARs received by Treasury has increased by nearly 85 percent, according to IRS. In 2008, IRS also said that, despite the significant increase in filings, concern remains about the degree of reporting compliance for those who are required to file FBARs. Also in 2008, the U.S. Senate Joint Committee on Taxation (JCT) reported that three categories of U.S. persons are potentially not filing FBARs and Form 3520s as required by law: taxpayers who are unaware or confused about filing requirements, taxpayers who are concealing criminal activity and taxpayers who are structuring transactions to avoid triggering the filing requirements.

Our 2004 review of applicants who came forward to declare offshore income under OVCI also suggested a high level of FBAR nonreporting, even by those individuals who reported all of their income to IRS.\(^7\) For instance, for each year covered by OVCI, more than half of the applicants had generally reported all of their income and paid taxes due—even on their offshore income—but had failed to disclose the existence of their foreign bank accounts as required by Treasury.

Finally, financial advisors often facilitate abusive transactions by enabling taxpayers’ offshore schemes. We have reported that most possible offshore tax evasion cases are discovered through IRS’s investigations of promoters of offshore schemes.\(^8\) During our 2004 review of OVCI, we examined Web sites promoting offshore investments and found that most provided off-the-shelf offshore companies or package deals, including the ability to incorporate offshore within the next day by buying an off-the-

\(^6\) The FBAR form, TD F 90-22.1, is a Department of the Treasury form that is filed separately from the taxpayer's tax return.

\(^7\) GAO-04-972T

shelf company at a cost of $1,500. These promoters provided taxpayers a way to quickly and easily move money offshore and repatriate it without reporting that money to IRS.

Congress also has found promoters behind several offshore evasion schemes such as the Equity Development Group (EDG), an offshore promoter based in Dallas, that recruited clients through the Internet and helped them create offshore structures. With few resources and no employees, EDG enabled clients to move assets offshore, maintain control of them, obscure their ownership, and conceal their existence from family, courts, creditors and IRS and other government agencies. In another case, a Seattle-based securities firm, Quellos Group, LLC, designed, promoted, and implemented securities transactions to shelter over $2 billion in capital gains from U.S. taxes, relying in part on offshore secrecy to shield its workings from U.S. law enforcement. This scheme was estimated to cost the U.S. Treasury about $300 million in lost revenue.

Large financial firms also have been found to have advised U.S. clients on the use of offshore structures to hide assets and evade U.S. taxes. For example, in 2008 the IRS announced that Liechtenstein Global Trust Group (LGT), a leading Liechtenstein financial institution, had assisted U.S. citizens in evading taxes. In another case, in June 2008, Bradley Birkenfeld, a former employee of Swiss bank UBS AG, pleaded guilty in federal district court to conspiring with an American billionaire real estate developer, Swiss bankers and his co-defendant, Mario Staggl, to help the developer evade paying $7.2 million in taxes by assisting in concealing $200 million of assets in Switzerland and Liechtenstein. Birkenfeld admitted that from 2001 through 2006 he routinely traveled to and had contacts within the United States to help wealthy Americans conceal their ownership of assets held offshore and evade paying taxes on the income generated from those assets. In February 2009 the Department of Justice announced that UBS entered into a deferred prosecution agreement for conspiring to defraud the U.S. government by helping U.S. citizens to conceal assets through UBS accounts held in the names of nominees and/or sham entities. In announcing the deferred prosecution agreement, the Department of Justice alleged that Swiss bankers routinely traveled to the United States to market Swiss bank secrecy to U.S. clients interested in attempting to evade U.S. income taxes. Court documents assert that, in 2004 alone, Swiss bankers allegedly traveled to the United States.

IRS agreed to pay $780 million in fines, penalties, interest and restitution for its actions.

IRS has several initiatives that target offshore tax evasion, but tax evasion and crimes involving offshore entities are difficult to detect and to prosecute. We have reported that offshore activity presents challenges related to oversight and enforcement, such as issues involved in self-reporting, the complexity of offshore financial transactions and relationships among entities, the lengthy processes involved with completing offshore examinations, the lack of jurisdictional authority to pursue information, the specificity required by information-sharing agreements, and issues with third-party financial institution reporting.  

As noted earlier, individual U.S. taxpayers and corporations generally are required to self-report their foreign taxable income to IRS. Self-reporting is inherently unreliable, for several reasons. Because financial activity carried out in foreign jurisdictions often is not subject to third-party reporting requirements, in many cases persons who intend to evade U.S. taxes are better able to avoid detection. For example, foreign corporations with no trade or business in the United States are not generally required to report to IRS any dividend payments they make 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 IRS detection. In addition, when self-reporting does occur, the completeness and accuracy of reported information is not easily verified.

In addition, the complexity of offshore financial transactions can complicate IRS investigation and examination efforts. Specifically, offshore schemes can involve multiple entities and accounts established in different jurisdictions in an attempt to conceal income and the identity of the beneficial owners. For instance, we have previously reported on offshore schemes involving “tiered” structures of foreign corporations and domestic and foreign trusts in jurisdictions that allowed individuals to

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11 The beneficial owner is the true owner of the income, corporation, partnership, trust, or transaction who receives or has the right to receive the proceeds or advantages of ownership.
hide taxable income or make false deductions, such as in the case of *United States v. Taylor*. The defendants in *United States v. Taylor* and *United States v. Petersen* pleaded guilty in U.S. District Court to crimes related to an illegal tax evasion scheme involving offshore entities. As part of the scheme, the defendants participated in establishing a “web” of domestic and offshore entities that was used to conceal the beneficial owners of assets, and to conduct fictitious business activity that created false business losses, and thus false tax deductions, for clients.

Given the characteristics of offshore evasion, IRS examinations that include offshore tax issues for an individual can take much longer than other examinations. Specifically, our past work has shown that from 2002 through 2005, IRS examinations involving offshore tax evasion took a median of 500 more calendar days to develop and examine than other examinations. The amount of time required to complete offshore examinations is lengthy for several reasons, such as technical complexity and the difficulty of obtaining information from foreign sources. For instance, many abusive offshore transactions are identified through IRS examination of promoters, and IRS officials have said that it can take years to get a client list from a promoter and, even with a client list, there is still much work that IRS needs to do before the participants of the offshore schemes can be audited. Because of the 3-year statute of limitations on assessments, the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open them at all, despite evidence of likely noncompliance.

We said that to provide IRS with additional flexibility in combating offshore tax evasion schemes, Congress should make an exception to the 3-year civil statute of limitations assessment period for taxpayers involved in offshore financial activity. IRS agreed that this would be useful. In testimony before Congress, the Commissioner of Internal Revenue has

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12 GAO-08-778.


14 GAO-07-237.

15 In most cases, the law gives IRS 3 years from the date a taxpayer files a tax return to complete an examination and make an assessment of any additional tax. This is known as the 3-year statute of limitations on assessments.
said that in cases involving offshore bank and investment accounts in bank secrecy jurisdictions, it would be helpful for Congress to extend the time for assessing a tax liability with respect to offshore issues from 3 to 6 years. Legislation was introduced in 2007, but not enacted, to increase the statute of limitations from 3 to 6 years for examinations of returns that involve offshore activity in financial secrecy jurisdictions.

At a more fundamental level, jurisdictional limitations also make it difficult for IRS to identify potential noncompliance associated with offshore activity. Money is mobile and once it has moved offshore, the U.S. government generally does not have the authority to require foreign governments or foreign financial institutions to help IRS collect tax on income generated from that money. In prior work we have reported that a Deputy Commissioner of IRS’s Large and Midsized Business Division said that a primary challenge related to U.S. persons’ uses of offshore jurisdictions is simply that when a foreign corporation is encountered or involved, IRS has difficulty pursuing beneficial ownership any further because of a lack of jurisdiction. IRS officials told us that IRS does not have jurisdiction over foreign entities whose incomes are not 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.

In addition, while the U.S. government has useful information-sharing agreements in place to facilitate the exchange of information on possible noncompliance by U.S. persons with offshore jurisdictions, agreements involving the exchange of information on request generally require IRS to know a substantial amount about the noncompliance before other nations will provide information. For example, the U.S. government uses Tax Information Exchange Agreements (TIEA) as the dedicated channel for exchange of tax information, while Mutual Legal Assistance Treaties (MLAT) remain the channel for exchanging information for offenses involving nontax criminal violations. Nevertheless, the Commissioner of Internal Revenue recently said that in some instances the process to obtain names of account holders is inefficient, and IRS must rely on other legal and investigative techniques. As we have reported previously with regard to the use of these channels with the Cayman Islands government, neither TIEAs nor MLATs allow for “fishing expeditions,” or general inquiries about a large group of accounts or entities. Rather, as is standard with arrangements providing for exchange of information on request, each request must involve a particular target. For example, IRS cannot send a request for information on all corporations established in the Cayman Islands.
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 that the information is in
the territory of the other party.

One program IRS established to help ensure compliance when offshore
transactions occur is the QI program. Under the QI program, foreign
financial institutions voluntarily report to IRS income earned and taxes
withheld on U.S. source income, providing some assurance that taxes on
U.S. source income sent offshore are properly withheld and income is
properly reported. However, significant gaps exist in the information
available to IRS about the owners of offshore accounts. Perhaps most
important, a low percentage of U.S. source income sent offshore flows
through QIs. For tax year 2003, about 12.5 percent of $293 billion in U.S.
income flowed through QIs. The rest, or about $256 billion, flowed through
U.S. withholding agents. While QIs are required to verify account owners’
identities, U.S. withholding agents can accept owners’ self-certification of
their identities at face value.

Reliance on self-certification leads to a greater potential for improper
withholding because of misinformation or fraud. IRS does not measure the
extent to which U.S. withholding agents rely on self-certifications. In our
2007 report we recommended that IRS perform this measurement and use
these data in its compliance efforts.16 For instance, IRS could increase
oversight for U.S. withholding agents who primarily rely on self-
certifications in determining whether withholding should occur. IRS has
taken some steps to measure such reliance, but IRS’s approach thus far
has not been systemic and also does not address improving the efficiency
of its compliance efforts.

The previously discussed case of Swiss bank UBS provides a stark
example of the QI program’s vulnerabilities. In February 2009, UBS
entered into a deferred prosecution agreement with Justice and agreed to
pay $780 million in fines, penalties, interest and restitution for defrauding
the U.S. government by helping United States taxpayers hide assets
through UBS accounts held in the names of nominees and/or sham
entities. UBS entered into a QI program agreement with IRS in 2001, and

16 GAO, Tax Compliance: Qualified Intermediary Program Provides Some Assurance
That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved,
was required to report U.S. citizens’ income to the IRS during the time that it conspired to defraud the U.S. government.

We also recommended that IRS require the QI program’s external auditors report on any indications of fraud or illegal acts that could significantly affect the results of their reviews of the QIs’ compliance with their agreements. However, it should be noted that we can not say that having this reporting requirement in place would have forestalled UBS’s efforts to defraud the United States or detected them earlier. IRS has proposed some amendments to the QI program that would somewhat enhance QI auditors’ responsibilities in this area.

In our 2007 report on the QI program, we also recommended that IRS determine why U.S. withholding agents and QIs report billions of dollars in funds flowing to unknown jurisdictions and unidentified recipients, and recover any withholding taxes that should have been paid. IRS has taken steps toward implementing this recommendation. We also recommended that IRS modify QI contracts to require electronic filing of forms and invest the funds necessary to perfect the data. IRS is including an application for filing information returns electronically in all QI applications and renewals but has not measured whether including the forms in the applications has had an impact on the number electronic filers.

In our 2004 review of OVCI, we noted that the diverse types of individuals involved in offshore noncompliance may require multiple compliance strategies on the part of IRS. The limited transparency involved in U.S. persons’ activities in offshore jurisdictions also presents several challenges to IRS and Treasury. As Commissioner of Internal Revenue Shulman recently commented, “There is general agreement in the tax administration community that there is no ‘silver bullet’ or one strategy that will alone solve the problems of offshore tax avoidance.”

Multiple Coordinated Strategies Are Necessary to Address the Challenges Posed by Offshore Tax Evasion

17 GAO-08-99.
18 GAO-08-99
19 GAO-04-972T
Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other members of the committee may have at this time.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Michael Brostek, Director, Strategic Issues, on (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include David Lewis, Assistant Director; S. Mike Davis; Jonda VanPelt; Elwood White; and A.J. Stephens.
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