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## CAYMAN ISLANDS

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

Statement of Michael Brostek,  
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Strategic Issues



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# Highlights

Highlights of [GAO-08-779T](#), a testimony to 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 there is 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. The full report on GAO's review is [GAO-08-778](#), being released at the same time as this testimony.

## What GAO Recommends

GAO makes no recommendations in this testimony or the accompanying 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 the accompanying report and GAO incorporated their comments as appropriate.

To view the full product, including the scope and methodology, click on [GAO-08-779T](#). For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

## CAYMAN ISLANDS

### Business Advantages and Tax Minimization 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 are often participants in investment and structured-finance activities, including those related to hedge funds and securitization.

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 regulatory environment 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 investment return by minimizing U.S. taxes. Nevertheless, as with other offshore jurisdictions, some U.S. persons may use Cayman Island entities to illegally evade income taxes or hide illegal activity.

Information about U.S. persons' Cayman activities comes from self-reporting, international agreements, and less formal sharing with the Cayman government. Because there is often no third-party reporting, self-reported information may be vulnerable to being inaccurate or incomplete. U.S. officials said the Cayman government has been responsive to taxpayer-specific information requests.

The Internal Revenue Service has several initiatives that target offshore tax evasion, including cases involving Cayman entities, but oversight and enforcement challenges related to offshore financial activity exist. U.S. officials said that cooperation with the Cayman Islands government has been good. Also, Maples partners said that ultimate responsibility for compliance with U.S. tax laws lies with U.S. taxpayers.

#### 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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Chairman Baucus, Senator Grassley, and Members of the Committee,

I appreciate this opportunity to discuss offshore financial activity in the Cayman Islands and the challenges posed for both tax policy and administration. 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 problems 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. The report we are issuing today<sup>1</sup> focuses on these activities. The objectives of our report 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<sup>2</sup>; (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, describe 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; interviewed U.S. and Cayman Islands officials as well as partners of Maples and Calder, the law firm that occupies Uglad House; and examined data from sources in the U.S. and Cayman Islands related to Uglad House and the Cayman Islands. For more information on our methodology, please see the report we are issuing today in conjunction with this testimony. We conducted our work from July 2007 to July 2008 in accordance with generally accepted government

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<sup>1</sup> See *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-08-778 (Washington, D.C.: July, 2008).

<sup>2</sup> 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.

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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.

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## 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. 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.<sup>3</sup> 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. The Cayman Islands reports that in 2008 it had 277 licensed banks, over 80,000 registered companies, more than 9,000 registered investment funds, and 760 captive insurance companies. According to the Department of the Treasury, U.S. investors held approximately \$376 billion in Cayman-issued securities at the end of 2006, making it the fifth most common location for U.S. investment in foreign securities. As of September 2007, U.S. banking liabilities to the Cayman Islands were the highest of any foreign jurisdiction, at nearly \$1.5 trillion. As of June 2007, U.S. banking claims on the Cayman Islands stood at \$940 billion, second only to the United Kingdom.

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## U.S. Persons Are Frequently Associated With Uglan House Registered Entities

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 Uglan House. Its business is to facilitate Cayman Islands-based international financial and commercial activity for a clientele of primarily international financial institutions, institutional investors, and corporations. Similar to corporate service providers in the United States, Maples Corporate Services Limited provides registered-office services, using Uglan House as a registered address, to entities it establishes. Registered-office services include activities such as

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<sup>3</sup> Direct taxes are taxes on income, and may take the form of taxes on personal and corporate income, social security contributions, and payroll taxes.

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maintenance of certain entity records and filing of statutory forms, resolutions, notices, returns, and fees. Cayman Islands law requires company-service providers like Maples and Calder to adhere to specific Anti-Money Laundering (AML) and Know-Your-Customer (KYC) requirements. For example, they 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.

Very few Uglad 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 Uglad House address. Approximately 96 percent of these entities were classified as exempted entities under Cayman Islands law, and were thus generally prohibited from carrying out domestic business within the Cayman Islands.

Maples and Calder senior partners told us that approximately 5 percent of the entities registered at Uglad House were wholly owned by U.S. persons, while 40 to 50 percent were related to the U.S. in that they had a billing address in the United States. A U.S. billing address does not necessarily imply ownership or control. According to the partners, U.S. persons associated with Uglad House registered entities are often participants in investment and structured-finance activities, including those related to hedge funds and securitization. Entities associated with these activities are not generally directly owned or controlled. For instance, investment-fund entities are often established as partnerships and are essentially owned by the fund's investors. 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, such as in deals involving securitization. The entities created by Maples and Calder that are directly owned or controlled include corporate subsidiaries, such as those used by multinational corporations to conduct international business.

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## Several Factors Influence U.S. Taxpayers' Decisions to Conduct Financial Activity in the Cayman Islands

U.S. persons who conduct financial activity in the Cayman Islands 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.

The Cayman Islands may attract U.S.-related financial activity because of characteristics including its reputation for stability and compliance with international standards, its business-friendly regulatory environment, and its prominence as an international financial center. For instance, 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. Additionally, establishing a Cayman Islands entity can be relatively inexpensive—an exempted company can be created for less than \$600, not taking into account service-provider fees. Further, U.S. persons may also be attracted to the Cayman Islands because it is proximate to the United States, operates in the same time zone as New York, and is English speaking.

Another frequent reason for doing business in the Cayman Islands is to obtain tax advantages, such as through reduction or deferral of U.S. taxes. For instance, U.S. tax-exempt entities, such as university endowments and pension funds, may invest in hedge funds organized in the Cayman Islands in order to avoid the unrelated business income tax (UBIT). The investment income of U.S. tax-exempts may be subject to UBIT if earned by an investment vehicle organized as a U.S. partnership, a formation common among U.S.-based hedge funds. However, tax-exempts that invest in hedge funds organized as foreign corporations in jurisdictions like the Cayman Islands can be paid in dividends, which are not subject to UBIT.

Additionally, some U.S. persons may use Cayman Islands entities to defer U.S. taxes. For example, a U.S.-based multinational business may create a Cayman Islands subsidiary to hold foreign earnings, which are not generally taxed in the United States unless or until repatriated. Because the Cayman Islands, like some other OFCs, has no direct taxes, Cayman subsidiaries do not incur additional taxes owed to the Cayman Islands government. One indication of the extent to which U.S. companies use Cayman entities to defer taxes is their reaction to a recent tax law. In 2004,

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Congress approved a received dividend reduction for certain earnings of foreign subsidiaries of U.S. companies repatriated for a limited time.<sup>4</sup> Approximately 5.5 percent of the nearly \$362 billion repatriated between 2004 and 2006 came from Cayman Island controlled foreign corporations.

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. The full extent of illegal offshore financial activity is unknown, but risk factors include limited transparency related to foreign transactions,<sup>5</sup> and difficulties faced by U.S. regulators and the courts in successfully prosecuting foreign criminal activity. Voluntary compliance with U.S. tax obligations is substantially lower when income is not subject to withholding or third-party-reporting requirements. Because U.S.-related financial activity carried out in foreign jurisdictions is not subject to these requirements in many cases, persons who intend to evade U.S. taxes are better able to avoid detection. 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.

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## 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 are generally required to self-report their taxable income to the Internal Revenue Service (IRS). Similarly, publicly owned corporations traded on U.S. markets are required to file annual or quarterly statements with the Securities and Exchange Commission (SEC). When an individual or corporation conducts business in the Cayman Islands, there is often no third-party reporting of transactions, so disclosures to IRS and U.S. regulators are dependent on the accuracy and completeness of the self-disclosure. Cayman Islands financial institutions are often not required to file reports with IRS concerning U.S. taxpayers. This makes it more likely that there would be inaccurate reporting by U.S. taxpayers on their annual tax returns and SEC required filings.

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<sup>4</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1515-20 (Oct. 22, 2004).

<sup>5</sup> Cayman Island government officials said that this is a common problem when one country seeks information on activities within another country.

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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 of 2001, the United States signed a Tax Information Exchange Agreement (TIEA) with the government of the United Kingdom with regard to the Cayman Islands. The TIEA provides a process for IRS to request specific information related to taxpayers. IRS sends TIEA requests to the Cayman Islands based on requests from inside the agency. In addition to the TIEA, the U.S. government and the Cayman Islands also entered into a Mutual Legal Assistance Treaty (MLAT) in 1986. The MLAT enables activities such as extraditions, searches and seizures, transfer of accused persons, and general criminal information exchange, including in relation to specified tax matters.

Since the TIEA began to go into effect, 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.<sup>6</sup> 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.

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,<sup>7</sup> works to gather information about suspected financial crimes both offshore and domestic. As part of its research and analysis, FinCEN can make requests of its counterpart in the Cayman Islands, the Cayman Islands Financial Reporting Authority (CAYFIN). CAYFIN can and does make requests to FinCEN as well. FinCEN and CAYFIN routinely share suspicious activity information.

In fiscal year 2007 CAYFIN made 25 suspicious activity information requests to FinCEN to follow up on potential new as well as existing Cayman Islands-generated suspicious activity reports (SARs), while

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<sup>6</sup> The TIEA has been in effect for criminal cases since 2004 and for civil cases since 2006.

<sup>7</sup> FinCEN, an intelligence and analysis organization, is part of the U.S. Department of the Treasury's Office of Terrorism and Financial Intelligence.

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FinCEN made 6 requests to CAYFIN. 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 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.

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## U.S. and Cayman Officials Have Taken Steps to Address Illegal Activity, but Enforcement Challenges Exist

To address the challenges posed by offshore illegal activity, IRS has targeted abusive transactions in areas related to transfer pricing, hedge funds, offshore credit cards, and promoters of offshore shelters. IRS officials said that some abusive transactions identified through these initiatives involved Cayman Islands entities, although the exact extent of this involvement was unclear because it does not maintain jurisdiction-specific statistics regarding abusive transactions.

While the full extent of Cayman involvement in offshore illegal activity is unclear, U.S. officials were able to point to specific criminal investigations and prosecutions involving the Cayman Islands. Over the past five years IRS field agents have requested information regarding suspected criminal activity by U.S. persons in 45 instances pertaining to taxpayers or subjects in the Cayman Islands. 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, money laundering, and 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.

IRS and Department of Justice (DOJ) officials stated that particular aspects of offshore activity present challenges related to oversight and enforcement. Specifically, these challenges include lack of jurisdictional authority to pursue information, difficulty in identifying beneficial owners due to the complexity of offshore financial transactions and relationships among entities, and lengthy processes involved with completing offshore examinations.

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Despite these challenges, U.S. officials consistently report that cooperation by the Cayman Islands government in enforcement matters has been good. Further, both the International Monetary Fund (IMF) and the Caribbean Financial Action Taskforce (CFATF) have cited the Cayman Islands for its efforts to comply with international standards, such as those related to anti-money-laundering and terrorist-financing activities. However, Cayman Islands government officials and senior partners from Maples and Calder stated that their role in helping the U.S. ensure compliance with U.S. tax laws is necessarily limited. Cayman Islands government officials stated that they cannot administer other nations' tax laws and are not aware of any jurisdiction that undertakes such an obligation as a general matter. Senior partners from Maples and Calder stated that complying with U.S. tax obligations is the responsibility of the U.S. persons controlling the offshore entities, and that they require all U.S. clients to obtain onshore counsel regarding tax matters before they will act on their behalf. Cayman officials told us that until a request is made by the U.S. for tax-related assistance, the Cayman Islands government is "neutral" and does not act for or against U.S. tax interests.

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## 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 legally minimizing their U.S. taxes and illegally avoiding their obligations.

Balancing the need to ensure compliance with our tax and other laws while not harming U.S. business interests and also respecting the

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sovereignty of the Cayman Islands and similar jurisdictions undoubtedly will be a continuing challenge for our nation.

Chairman Baucus, Senator Grassley, and members of the committee, this concludes my testimony. I would be happy to answer any questions you may have at this time.

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## Contact 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; Perry Datwyler; S. Mike Davis; Robyn Howard; Brian James; Danielle Novak; Melanie Pappasian; Ellen Phelps Ranen; Ellen Rominger; Jeffrey Schmerling; Shellee Soliday; Andrew Stephens; Jessica Thomsen; and Jonda VanPelt.

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