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Government Focusing on Abusive Offshore Transactions

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Senate Subcommittee Report on Tax Haven Abuses Joint Committee on Taxation Options for Closing the Tax Gap Government and Public Perception Continued Use of Offshore Trusts and Corporations

Recent US government hearings and reports have focused on abusive international tax planning and the unscrupulous promoters selling those plans. These government investigations should serve as a reminder to all professionals involved in international tax planning that international trust structures, their underlying corporations and transactions between them must be real and have economic substance.

Senate Subcommittee Report on Tax Haven Abuses

The Permanent Subcommittee on Investigations of the Senate Homeland Security and Governmental Affairs Committee held a hearing on August 1 2006 entitled "Tax Haven Abuses: The Enablers, The Tools & Secrecy". In conjunction with the hearing, the subcommittee released a 400-page report, the culmination of a multi-year investigation into offshore tax evasion. The report examines six jurisdictions - Belize, the British Virgin Islands, the Cayman Islands, the Isle of Man, Panama and St Kitts & Nevis - and presents case histories on the use of offshore trusts and corporations to circumvent US tax, securities and anti-money laundering laws.⁽¹⁾

Witnesses at the hearing included securities firms, banks, law firms, US taxpayers, a trust protector and tax and securities experts. In some instances the taxpayers interviewed by the committee had pleaded guilty to

tax crimes related to offshore transactions. The witnesses detailed real-life tax evasion schemes that used sham trusts, shell corporations and false economic transactions to conceal US citizens' control of offshore assets. The subcommittee found that offshore service providers were using trustees, directors and officers who consistently complied with client directions when managing offshore trusts or shell corporations established by those clients so that the offshore trusts and shell corporations were not acting independently.

The Internal Revenue Service (IRS) is increasingly investigating and prosecuting offshore tax evasion through tax-shelter abuses. Both the IRS and the subcommittee seek to reduce the United States' more than \$300 billion tax gap - taxes owed but not paid. In legitimate planning, it has always been and continues to be imperative that the independence of corporations and trusts be respected and that those persons in positions of fiduciary responsibility act accordingly.

Joint Committee on Taxation Options for Closing the Tax Gap

On October 19 2006 the Joint Committee on Taxation released a report outlining options for closing the tax gap. This non-partisan committee consisting of members from both the Senate and the House made five recommendations for improving information reporting. The five recommendations are in addition to those in a 430-page report released on January 27 2005.⁽²⁾

One of the new recommendations addresses reporting requirements for individuals with interests in offshore bank accounts or offshore trusts. The committee recommended that a due diligence requirement be imposed on return preparers to determine whether a taxpayer is required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, or Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipts of Certain Foreign Gifts. The US Treasury estimates that the current rate of compliance in filing Form TD F 90-22.1 may be less than 20%. The committee expressed the opinion that increased filings would improve the ability of the IRS to detect unreported income and abusive transactions resulting from the use of offshore accounts.

In the January 2005 report the committee recommended that the entity classification rules (commonly referred to as a 'check the box election') be modified to reduce opportunities for tax avoidance. Currently, Form 8832, Entity Classification Election, can be used to classify a domestic or foreign entity as a corporation or partnership or to be disregarded as a separate entity. This single-page filing has simplified the entity election procedure for both domestic and foreign entities. However, the committee believed that the check the box election has also created some unintended tax-avoidance opportunities as applied to foreign entities. In particular, the committee felt that the availability of single-member disregarded entities has rendered it easy in many cases to avoid current taxation. The committee proposed that an organization must be treated as a corporation for federal tax purposes if the organization (i) is a separate business entity organized under foreign law and (ii) has only a single member.

Government and Public Perception

Only a portion of the tax gap is attributable to tax evasion taking place through offshore transactions, but the exotic nature of the offshore locations and negative public perception make it a political hot button. Evidence of this can be seen in some of the findings in the tax haven abuses report:

"2. Corporate and financial secrecy laws and practices in offshore tax havens make it easy to conceal and obscure the economic realities underlying a great number of financial transactions with unfair results unintended under US tax and securities laws.

3. Corporate and financial secrecy laws and practices in offshore tax havens are intended to make it difficult for US law enforcement, creditors and others to learn whether a US person owns or controls an allegedly independent offshore trust or corporation. They also intentionally make it difficult to identify the beneficial owners of offshore entities.

4. US persons, with the assistance of lawyers, brokers, bankers, offshore service providers and others, are using offshore trusts and shell corporations in offshore tax havens to circumvent US tax, securities and anti-money laundering requirements."

Although lawmakers and reputable professionals in offshore jurisdictions have been hard at work over the years modifying their laws, meeting the demands of the Organization for Economic Cooperation and Development (OECD) Financial Action Task Force and strengthening the fiduciary standards under which they operate, the US perception remains negative as a result of criminals and wrongdoers.

The OECD, of which the United States is a member, has worked to eliminate anonymously owned companies. Even though such companies have been nearly eradicated offshore, US single-member limited liability companies remain available to international investors and some state laws do not require that information on beneficial owners be kept or disclosed. The foreign owner, being neither citizen nor resident, is not necessarily required to file US tax returns or pay tax on non-US source income, a result similar to that in a no-tax offshore jurisdiction.

Continued Use of Offshore Trusts and Corporations

The value of offshore trusts and corporate structures in legitimate succession planning cannot be overstated. The trust laws of Cayman, Bermuda and similar jurisdictions allow for flexibility and long-term care of

family fortunes and values. Professional advisers are often working for international families where the matriarch and patriarch are neither US citizens nor US residents. Given the apparent US suspicion of all things offshore, it is incumbent on the professional adviser to proceed in a manner that supports the integrity of the trust and corporate structures, documenting and maintaining all paperwork and transactions in order to evidence that they are real and have economic substance.

Since the international family may at some time have US residents or citizens among its members, tax planners must keep the US perspective in mind. Some of the eight changes recommended by the tax haven abuses report are aimed at the law and accounting firms, banks and investment advisers that the report says promote tax evasion schemes relying on complexity, secrecy and compartmentalizing information to avoid accountability.

The recommendations also call for US laws to include a presumption that trusts and shell corporations located in jurisdictions designated as tax havens are under the control of the US person supplying or directing the use of the offshore assets. In addition, the committee calls for loans that are treated as trust distributions under US tax law to be expanded to include not just cash and securities, as under existing law, but also loans of real estate and personal property of any kind including artwork, furnishings and jewellery. Receipt of cash or other property from a foreign trust, other than in an exchange for fair market value, should, the committee recommends, also result in treatment of the US person as a US beneficiary.

Given the heightened US scrutiny of offshore structures, professional advisers should take deliberate steps to document the validity of offshore activities. Doing so will help those families engaged in legitimate offshore planning to distinguish themselves from the unscrupulous offshore promoters and their abusive tax schemes.

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Endnotes

(1) The full report can be accessed at

http://hsgac.senate.gov/_files/TaxHvnAbRPT.pdf.

(2) The committee's press release can be found at

<http://www.senate.gov/~finance/press/Gpress/2005/prg101906a.pdf>.

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