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# The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds

Chris Horton

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## NOTES

### The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds

Chris Horton\*

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## I. INTRODUCTION

On August 19, 2009, the Swiss banking giant UBS agreed to turn over to the Internal Revenue Service ("IRS") information regarding 4,450 accounts suspected of containing undeclared assets.<sup>1</sup> The agreement represented a "major step forward with the IRS's efforts to pierce the veil of bank secrecy and combat offshore tax evasion."<sup>2</sup> It is estimated that tax evasion will cost the United States over \$100 billion this year in lost tax revenues.<sup>3</sup>

While being the largest hedge fund domicile and fifth largest banking provider in the world, the Cayman Islands is also well known for being a tax haven.<sup>4</sup> Although many U.S. individuals and corporations invest legally in the Cayman Islands,<sup>5</sup> it is suspected that many U.S. hedge fund investors do not declare their investments.<sup>6</sup> John M. Mathewson, former owner of Guardian

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1. Wayne Tompkins, *UBS to divulge 4,450 Account Names, More Expected*, THE DAILY BUS. REV., Aug. 19, 2009, available at [http://www.dailybusinessreview.com/news.html?news\\_id=56889&stripTemplate=1](http://www.dailybusinessreview.com/news.html?news_id=56889&stripTemplate=1); Settlement Agreement, United States v. UBS AG, No. 09-20423 (S.D. Fla. Aug. 20, 2009).

2. Press Release, Department of Justice, Remarks by IRS Commissioner Doug Shulman on UBS (Aug. 19, 2009), available at [http://www.usdoj.gov/tax/txdv09\\_IRS\\_Commissioner\\_Remarks.htm](http://www.usdoj.gov/tax/txdv09_IRS_Commissioner_Remarks.htm).

3. STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SECURITY & GOVERNMENTAL AFFAIRS, 110TH CONG., TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 1 (Comm. Print 2008), available at [http://hsgac.senate.gov/public\\_files/071708PSIRReport.pdf](http://hsgac.senate.gov/public_files/071708PSIRReport.pdf).

4. STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, 110TH CONG., DIVIDEND TAX ABUSE: HOW OFFSHORE ENTITIES DODGE TAXES ON U.S. STOCK DIVIDENDS 14 (Comm. Print 2008), available at <http://levin.senate.gov/newsroom/supporting/2008/091108DividendTaxAbuse.pdf>; Timothy V. Addison, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOBAL LEGAL STUD. 703,719-21 (2009); Martin A. Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956 (2004) (discussing tax evasion by U.S. persons in the Cayman Islands and TIEAs).

5. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, REP. TO THE CHAIRMAN AND RANKING MEMBER, COMM. ON FINANCE, U.S. S., CAYMAN ISLANDS: BUSINESS AND TAX ADVANTAGES ATTRACT U.S. PERSONS AND ENFORCEMENT CHALLENGES EXIST 4 (2008), available at <http://www.gao.gov/new.items/d09677t.pdf> (stating that U.S. tax exempt entities, such as university endowments and pensions funds, invest in hedge funds legally).

6. Lee A. Sheppard & Martin A. Sullivan, *Offshore Explorations: Caribbean Hedge Funds, Part 1*, 118 TAX NOTES 95, 106 (2008) (noting that tax evasion must be

Bank and Trust located in the Cayman Islands, testified in a Senate hearing that “clients opening an offshore account were doing so for tax evasion . . . .”<sup>7</sup> Moreover, retired Manhattan district attorney Robert Morgenthau believes that “Switzerland is not the No. 1 problem any more. The Caymans is the biggest problem . . . .”<sup>8</sup>

U.S. investors suspected of evading taxes in the Cayman Islands also allegedly invest in Cayman Islands hedge funds. These investors could be either U.S. citizens and corporations or non-U.S. citizens and corporations who use a Cayman fund to “facilitate significant investment in the United States.”<sup>9</sup> Investors in the Cayman Islands aim to evade dividend taxes.<sup>10</sup> Individuals are also suspected of setting up “complex networks of domestic and offshore entities” in order to hide their schemes.<sup>11</sup> In most cases, the corporation or individual invests as an exempted company, 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.”<sup>12</sup> Thus, the individual or corporation has a Cayman Islands bank account and invests in the Cayman Islands merely to evade U.S. taxes.

In reaction, the U.S. government has recently increased its focus on wealthy Americans evading taxes through foreign countries. IRS Commissioner Shulman stated that “[i]nternational enforcement is a top priority for the Treasury Secretary and me.”<sup>13</sup> Victor Song, deputy chief of the IRS’s criminal investigations division said international tax evasion is “near and dear to the commissioner’s heart” and “[e]verybody’s revved up to deal with this

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placed high on the list of reasons U.S. investors invest in Cayman Islands hedge funds); see also *DIVIDEND TAX ABUSE*, *supra* note 4, at 15 (citing Report of the President’s Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, at 41 (1999), available at <http://www.treas.gov/press/releases/reports/hedgfund.pdf>).

7. *Role of U.S. Correspondent Banking in International Money Laundering Before the Permanent Subcomm. On Investigations*, 107th Cong. (2001) (statement of John M. Mathewson), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107\\_senate\\_hearings&docid=f:71166.wais](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_senate_hearings&docid=f:71166.wais).

8. Ken Stier, *After UBS, Swiss Continue to Fight for Bank Secrecy*, *TIME*, Mar. 5, 2010, available at <http://www.time.com/time/world/article/0,8599,1968425,00.html>.

9. *BUSINESS AND TAX ADVANTAGES*, *supra* note 5, at 16.

10. *BUSINESS AND TAX ADVANTAGES*, *supra* note 5, at 28-34.

11. *BUSINESS AND TAX ADVANTAGES*, *supra* note 5, at 33.

12. *BUSINESS AND TAX ADVANTAGES*, *supra* note 5, at 12.

13. Remarks by IRS Commissioner Shulman, *supra* note 2.

issue . . . .”<sup>14</sup> The current tax battle is not just a national issue. In February 2008, the United Kingdom, Italy, France, Spain, and Australia announced that they had initiated an informal enforcement action against Liechtenstein’s LGT Bank.<sup>15</sup> More recently, the German Finance Minister stated “[t]here’s no future for bank secrecy. It’s finished. It’s time has run out.”<sup>16</sup> Nevertheless, the IRS’s current fight against the wealthy has stalled. On January 21, 2010, Switzerland’s Federal Administrative Court ruled in favor of a U.S. UBS account holder and ordered the Federal Tax Administration to not disclose account data to the IRS.<sup>17</sup>

This article will argue that the IRS v. UBS settlement was not a “major step forward”<sup>18</sup> in the fight against tax evasion; the only way for the U.S. government to take a major step forward is by passing legislation aimed at curbing tax evasion practices. The first section will define hedge fund and address laws that have made the Cayman Islands the largest hedge fund domicile in the world. This section will also address the chief tax evasion practices the IRS suspects is taking place in the Cayman Islands. The second section will analyze the relationship between the U.S. and the Cayman Islands in regard to tax evasion. This section will examine the methods that the United States has used to curb tax evasion: in particular, establishing the Organisation for Economic Co-operation and Development and the Tax Information Exchange Agreements. Section three will discuss the IRS v. UBS case and its settlement agreement. Next, the article will examine whether the IRS would have similar success with Cayman Islands hedge funds through a “John Doe” summons. It will also analyze the issues the U.S. government faces with the UBS settlement agreement and future legal action against the Cayman Islands. The article will conclude with a forecast of what hedge fund corpo-

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14. Joyce E. Cutler, *International Enforcement a Global Issue for Foreseeable Future, Officials Emphasize*, INT’L TAX MONITOR, Oct. 29, 2009.

15. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 2 (“In February 2008, a global tax scandal erupted after a former employee of a Liechtenstein trust company provided tax authorities around the world with data on about 1,400 persons with accounts at LGT Bank in Liechtenstein.”).

16. Stier, *supra* note 8.

17. Press Release, Medienmitteilung, Legal Assistance Proceedings in the Case of UBS (Jan. 22, 2010), available at [http://www.bundesverwaltungsgericht.ch/20100122/mmamtshilfeurteil\\_e.pdf](http://www.bundesverwaltungsgericht.ch/20100122/mmamtshilfeurteil_e.pdf); Bloomberg News, *U.S.-UBS Deal is Undermined by Swiss Ruling*, N.Y. TIMES, Feb. 27, 2010, available at <http://www.nytimes.com/2010/02/27/business/global/27ubs.html>; Lee A. Sheppard, *U.S. Justice Department Reacts to Swiss Disclosure Case*, 57 TAX NOTES INT’L 412 (2010).

18. Remarks by IRS Commissioner Shulman, *supra* note 2.

rations and their investors in the Cayman Islands will do to prepare for an anticipated focus by the IRS on the Cayman Islands.

## II. HEDGE FUNDS AND THE CAYMAN ISLANDS

### A. *Defining Hedge Funds*

Hedge funds have grown exponentially in the past decade. “From 1998 to early 2007, the estimated number of [hedge] funds grew from more than 3,000 to more than 9,000 and assets under management from \$200 billion to more than \$2 trillion globally.”<sup>19</sup> Despite this, U.S. hedge funds are “lightly regulated”<sup>20</sup> and have “no universally accepted definition.”<sup>21</sup> Black’s Law Dictionary defines a hedge fund as “a specialized investment group usually organized as a limited partnership or offshore investment company that offers the possibility of high returns through risky techniques such as selling short or buying derivatives.”<sup>22</sup>

In testimony given before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, the Government Accountability Office’s Orice Williams characterized hedge funds as: (1) “a pooled investment vehicle that is privately managed and often engages in active trading of various types of securities and commodity futures and options;” and (2) “[one that is exempt] from certain securities laws and regulations, including the requirement to register as an investment company.”<sup>23</sup>

At the request of the Securities and Exchange Committee (“SEC”), the staff of the Commission’s Division of Investment Management and Office of Compliance Inspections and Examinations “undertook a fact-finding mission aimed at reviewing the operations and practices of hedge funds.”<sup>24</sup> The SEC staff listed the following characteristics of hedge funds: (1) “an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which

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19. *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges: Testimony Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises, H.R.*, 111th Cong. 1 (2009) (statement of Director of Financial Markets and Community Investment Orice M. Williams), available at <http://www.gao.gov/new.items/d09677t.pdf>.

20. DIVIDEND TAX ABUSE, *supra* note 4, at 13.

21. STAFF REP. TO THE SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

22. BLACK’S LAW DICTIONARY 876 (8th ed. 2004).

23. Overview of Regulatory Oversight, *supra* note 19, at 1.

24. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 21, at viii.

is not registered as an investment company under the Investment Company Act;" (2) "[they have a] fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation;" (3) "[their] hedge fund advisory personnel often invest significant amounts of their own money into the hedge funds that they manage;" and (4) "[many of them] seek to achieve a positive, absolute return rather than measuring their performance against a securities index or other benchmark."<sup>25</sup>

### *B. The Issue of Tax Evasion and Cayman Islands Hedge Funds*

The Cayman Islands has the largest amount of hedge funds in the world. As of October 10, 2009, the Cayman Islands Monetary Authority<sup>26</sup> listed 9,862 mutual funds as registered under the Cayman Islands Mutual Funds Law.<sup>27</sup> Of the 9,862 mutual funds registered, "a vast majority of the funds" fall within the definition of a hedge fund.<sup>28</sup>

Many of the hedge funds in the Cayman Islands are registered at the Ugland House, the center of a United States Government Accountability Office investigation.<sup>29</sup> The investigation was conducted "to study what is known about the business activities of

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25. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 21, at viii; see Lartease Tiffith, *Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA's Lead*, 27 NW. J. INT'L L. & BUS. 497, 499-500 (2007).

26. CAYMAN ISLANDS MONETARY AUTHORITY, OUR PRINCIPAL FUNCTIONS (2009), [http://www.cimoney.com.ky/about\\_cima/about.aspx?id=66&ekmensel=e2f22c9a\\_10\\_30\\_btnlink](http://www.cimoney.com.ky/about_cima/about.aspx?id=66&ekmensel=e2f22c9a_10_30_btnlink) (last visited Jan. 10, 2010) (describing the Cayman Islands Monetary Authority's four principal functions as: 1) "[t]he issue and redemption of Cayman Islands currency and the management of currency reserves;" 2) "[t]he regulation and supervision of financial services, the monitoring of compliance with money laundering regulations, the issuance of a regulatory handbook on policies and procedures and the issuance of rules and statements of principle and guidance;" 3) "[t]he provision of assistance to overseas regulatory authorities, including the execution of memoranda of understanding to assist with consolidated supervision;" and 4) "[t]he provision of advice to the Government on monetary, regulatory and cooperative matters").

27. CAYMAN ISLANDS MONETARY AUTHORITY, LIST OF MUTUAL FUNDS REGISTERED/LICENSED WITH THE CAYMAN ISLANDS MONETARY AUTHORITY (2009), [http://www.cimoney.com.ky/Stats\\_Reg\\_Ent/stats\\_reg\\_ent.aspx?id=256&ekmensel=e2f22c9a\\_14\\_84\\_256\\_6](http://www.cimoney.com.ky/Stats_Reg_Ent/stats_reg_ent.aspx?id=256&ekmensel=e2f22c9a_14_84_256_6) (last visited Jan. 10, 2010).

28. CAYMAN ISLANDS MONETARY AUTHORITY, ANNUAL REPORT – 1 JULY 2006 – 30 JUNE 2007 56 (2007), [http://www.cimoney.com.ky/about\\_cima/about\\_feedra.aspx?id=458&terms=annual+report](http://www.cimoney.com.ky/about_cima/about_feedra.aspx?id=458&terms=annual+report) (stating that "[a]lthough Cayman Islands legislation refers to 'mutual funds,' the vast majority of the funds registered in this jurisdiction fall within the loose definition of a 'hedge fund'") (last visited Jan. 10, 2010).

29. BUSINESS AND TAX ADVANTAGES, *supra* note 5.

U.S. taxpayers involving Uglad House in the Cayman Islands.”<sup>30</sup> The investigation found “[m]any of the 18,857 entities registered at the Uglad House are U.S. connected”<sup>31</sup> and Americans who do business in the Cayman Islands do so to gain legal and illegal tax advantages under U.S. law.<sup>32</sup> It is estimated that thirty-eight percent of the 18,857 entities using the Uglad House as an address are hedge funds or private-equity funds.<sup>33</sup> Thus, around 7,000 of the 9,862 mutual funds registered under the Cayman Islands Mutual Funds Law have a registered office at the Uglad House. What then has led to the Cayman Islands’ growth as a hedge fund leader?

### 1. Reasons for the Cayman Islands Growth into Hedge Fund Leader

The Cayman Islands have benefited from a number of laws and political characteristics. Part of the Cayman Islands’ success can be attributed to a stable political and economic environment.<sup>34</sup> Furthermore, the Cayman Islands has benefited from “[e]xcellent infrastructure in terms of telecommunications and other utilities, and a reliable air service.”<sup>35</sup>

Paul Byles, former head of policy at the Cayman Islands Monetary Authority (“CIMA”), believes that the Cayman Islands’ success as a hedge fund venue can be best explained by the total financial package the country offers.<sup>36</sup> “[The] Cayman Islands is number one for structured finance; number one for hedge fund registrations; number two for captive insurance; and the leading offshore centre for banking. There is no other jurisdiction that ranks so highly across so many different sectors.”<sup>37</sup> Market leadership in the various sectors stems from “excellent institutional and physical infrastructure . . . designed to establish a flexible regulatory environment that is suited to the complex needs of global capital and provides more efficient vehicles to manage the multi-jurisdictional structure of complex international financial

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30. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 1.

31. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 10.

32. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 26.

33. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 14.

34. James Eedes, *Special Supplement: Cayman Islands - Offshore, On Target, Boasting Top Institutional and Physical Infrastructures the Cayman Islands has Grown to Become the World's Fifth Largest Financial Centre*, THE BANKER, July 1, 2006, reprinted in 2006 WLNR 13057675.

35. *Id.*

36. *Id.*

37. *Id.*



transactions.”<sup>38</sup>

In reality, the Cayman Islands has grown into the fifth largest banking center and largest hedge fund venue in the world because of its lax banking, taxation, and mutual fund laws. These laws have led to the characterization of the Cayman Islands as a “tax haven.”<sup>39</sup> The Organisation for Economic Co-Operation and Development (“OECD”) has developed a list of four characteristics that define a tax haven: “no or only nominal taxes, a lack of effective exchange of information, a lack of transparency, and no substantial activity (for example, investments that are purely tax driven).”<sup>40</sup> The following laws exhibit all four characteristics.

### *a. Banking Laws*

In 1976, the Cayman Islands passed strong banking secrecy laws, known as the Confidential Relationships Law.<sup>41</sup> While banking secrecy laws have helped the financial industries in the Cayman Islands grow, the laws have also brought scrutiny due to the “lack of effective exchange of information [and] lack of transparency . . . .”<sup>42</sup> The banking laws are the key reason why tax evasion flourishes in the Cayman Islands.

The Confidential Relationships Law applies to “all confidential information with respect to business of a professional nature which arises in or is brought into the islands and to all persons coming into possession of such information at any time thereafter . . . .”<sup>43</sup> Confidential information is defined as information concerning any property which the recipient thereof is not authorized by the principal to divulge (other than in the normal course of business).<sup>44</sup> However, the law does not apply to any professional person acting in the normal course of business or with consent, a constable of the rank of Inspector investigating an offense committed within the Cayman Islands. It also does not apply to an offense that occurred outside the Cayman Islands but would be an offense against its own laws, the Financial Secretary and the CIMA, or a bank that finds it necessary to have the confidential information

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38. *Id.*

39. Addison, *supra* note 4, at 719-21.

40. See Addison, *supra* note 4, at 705-06; OECD, *Harmful Tax Competition: an Emerging Global Issue*, at 22 (1998), available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf>.

41. Confidential Relationships (Preservation) Law (2009) (Cayman Is.).

42. See Addison, *supra* note 4, at 706.

43. Confidential Relationships (Preservation) Law § 3(1) (2009) (Cayman Is.).

44. *Id.* § 2.

for the protection of the bank's interest.<sup>45</sup>

John M. Mathewson testified in front of a Senate subcommittee about his experiences with the banking secrecy laws in the Cayman Islands as sixty percent shareholder of an entity named Guardian Bank, a Caymanian bank.<sup>46</sup> Mr. Mathewson noted that "the Cayman Islands has a confidentiality law whereby it is a crime to divulge account information."<sup>47</sup> He further added

you can take it one step further by having a corporation . . . we provided directors for that corporation . . . the individual account-holder never had to sign anything or have his name visible to anyone . . . the only one who was aware that this U.S. citizen . . . was the beneficial owner of a corporation was [ ] the Guardian Bank.<sup>48</sup>

A U.S. investor can open an account with a Cayman Islands bank, create a corporation account and use that corporation to invest in a hedge fund. The account information is then hidden from the IRS and the only one who ever knows that the U.S. investor is using a Cayman Islands corporation to invest and evade taxes is the Cayman Islands bank.<sup>49</sup>

However, banking secrecy is not absolute in the Cayman Islands. The Confidential Relationships Law has exceptions where information may be divulged or obtained and also gives directions regarding the seizure of confidential evidence.<sup>50</sup> The Confidential Relationships Law also cross-references the Tax Information Authority Law. The Tax Information Authority Law applies for the purpose of the provision of information in taxation matters on request to a scheduled country.<sup>51</sup> The Tax Information Authority Law is a codification of the Tax Information Exchange Agreements between the Cayman Islands and other countries.<sup>52</sup>

### *b. Tax Laws*

The tax laws in the Cayman Islands establish another charac-

45. *Id.* at § 3(2).

46. Role of U.S. Correspondent Banking, *supra* note 7.

47. Role of U.S. Correspondent Banking, *supra* note 7.

48. Role of U.S. Correspondent Banking, *supra* note 7.

49. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 22-23 (explaining "know-your-customer" and Qualified Intermediary program and citing one Liechtenstein bank that thought the practical effect of these programs "was to preserve bank secrecy for non-U.S. accountholders, since the foreign financial institution was under no obligation to disclose any client names").

50. Confidential Relationships (Preservation) Law § 3(2, 4) (2009) (Cayman Is.).

51. Confidential Relationships (Preservation) Law (2009) (Cayman Is.).

52. See discussion *infra* Section III.B.

teristic of the OECD's definition of a tax haven: "no or only nominal taxes."<sup>53</sup> The Cayman Islands has no direct tax laws, "meaning no income tax, no capital gains tax, no estate and inheritance tax, and no taxes on financial transactions."<sup>54</sup> Thus, a corporation set up as a hedge fund in the Cayman Islands only has to pay a fee to set up the corporation, around \$600 U.S.,<sup>55</sup> and pay the annual Mutual Funds Law fee.<sup>56</sup> The hedge fund would then not have to pay U.S. income tax or any of the other taxes attributable to an American corporation.

*c. Mutual Funds Law*

The third law that contributes to the Cayman Islands' success as a hedge fund venue is the Mutual Funds Law. In 1993, the Cayman Islands enacted the Mutual Funds Law and the hedge fund industry has flourished ever since.<sup>57</sup> The Mutual Funds Law defines a "mutual fund" as a "company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments."<sup>58</sup> This definition is broad and the "vast majority of the funds registered in [the Cayman Islands] fall within the loose definition of a 'hedge fund.'"<sup>59</sup> Providing investors with flexible regulations, the Mutual Funds Law has enabled hedge funds to thrive and hedge fund managers to be creative with investments.

The CIMA is the designated body that regulates hedge funds.<sup>60</sup> The CIMA's main duty is to grant and deny licenses of mutual funds. Other CIMA duties include: general review of the mutual fund business, issuing an annual report, supervision and enforcement of the Mutual Funds Law, imposition of conditions on Mutual Funds Licenses, appointment of a person to advise the fund and to assume controls of a fund.<sup>61</sup> The CIMA provides hedge funds with a regulatory body with well defined powers, providing

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53. See Addison, *supra* note 4, at 705-06.

54. Eedes, *supra* note 34.

55. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 27.

56. Mutual Funds Law, pt. II § 9 (2009) (Cayman Is.).

57. Eedes, *supra* note 34.

58. Mutual Funds Law, pt. I § 2 (2009) (Cayman Is.).

59. CAYMAN ISLANDS MONETARY AUTHORITY, ANNUAL REPORT, *supra* note 28.

60. Mutual Funds Law, pt. V § 29 (2009) (Cayman Is.).

61. *Id.*

for an “effective regulatory regime.”<sup>62</sup>

Moreover, the Mutual Funds Law provides investors with “a wide scope in terms of investment objectives and fund structure while mandating full transparency.”<sup>63</sup> The Mutual Funds Law provides transparency by requiring that funds file a “current offering document.”<sup>64</sup> The Mutual Funds Law defines an offering document as “describ[ing] the equity interests in all material aspects; and contain[ing] such other information as is necessary to enable a prospective investor in the mutual fund to make an informed decision as to whether or not to subscribe for or purchase the equity interests.”<sup>65</sup> At the same time, investors have flexibility in their investment objectives and fund structure.<sup>66</sup> A fund’s only structural requirements are that

each promoter is of sound reputation; the administration of the mutual fund will be undertaken by persons who have sufficient expertise . . . and by persons who are fit and proper . . . and the business of the mutual fund and any offer of equity interests in it will be carried out in a proper way.<sup>67</sup>

As seen above, the transparency requirement combined with a broad definition of mutual fund, a well-defined regulatory body, and limited constraints on investment objectives have led to the growth of the Cayman hedge fund industry. The regulatory regime enacted through the Mutual Funds Law is “effective without being intrusive.”<sup>68</sup>

## 2. Tax Evasion the IRS Could be Looking to Investigate

Domestically, hedge funds usually take on a limited partnership or general partnership form.<sup>69</sup> Thus, the hedge fund is taxed as a partnership and investors are viewed as limited partners. The investors are then singularly taxed for federal income tax purposes.<sup>70</sup> The goal of the domestic hedge fund is to eliminate

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62. Eedes, *supra* note 34.

63. Eedes, *supra* note 34.

64. Mutual Funds Law, pt. II § 4 (2009) (Cayman Is.).

65. Mutual Funds Law, pt. II § 4(6) (2009) (Cayman Is.).

66. See Eedes, *supra* note 34.

67. Mutual Funds Law, pt. II § 5(2) (2009) (Cayman Is.).

68. Eedes, *supra* note 34.

69. Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 364-67 (2007).

70. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 21, at 9 (“[I]ncome is taxed only at the level of the individual investor.”).

being taxed as a corporation or a publicly traded partnership to avoid double taxation.<sup>71</sup> “Typically, a hedge fund falls within the ‘private placement’ safe harbor for avoiding classification as a publicly traded partnership.”<sup>72</sup>

However, many U.S. hedge funds have begun to associate themselves with offshore hedge funds.<sup>73</sup> These offshore hedge funds are located in places like the Cayman Islands. “An offshore hedge fund is not a U.S. person for federal income tax purposes.”<sup>74</sup> Many offshore hedge funds are organized as foreign partnerships or corporations and do not file U.S. tax returns.<sup>75</sup> These offshore hedge funds are suspected of contributing to U.S. tax evasion in a number of ways.

### *a. Dividend Tax Abuse*

The main abuse that the U.S. government believes is taking place in Cayman Islands hedge funds is dividend tax abuse. “A dividend is a distribution by a corporation of a portion of its earnings to its stockholders, with the amount distributed based upon the number of shares held by each stockholder.”<sup>76</sup> The total amount of dividends paid to the stockholder for the given year must be reported to the IRS and the stockholder must report all dividends received on their tax return.<sup>77</sup> The individual tax rate on the dividends paid to a U.S. person is fifteen percent.

U.S. tax law differs with its treatment of dividends paid to non-U.S. persons.<sup>78</sup> Non-U.S. persons are subject to a tax rate of thirty percent on the dividend payment and the thirty percent is

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71. Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAWYER 133, 139 (2003).

72. *Id.*; I.R.C. § 7704(b) (2008).

73. DIVIDEND TAX ABUSE, *supra* note 4, at 14.

74. Ordower, *supra* note 69, at 362.

75. DIVIDEND TAX ABUSE, *supra* note 4, at 14.

76. DIVIDEND TAX ABUSE, *supra* note 4, at 11.

77. DIVIDEND TAX ABUSE, *supra* note 4; I.R.C. § 861(a)(2)(A) (2004).

78. The following tax laws apply to countries that do not have a tax treaty with the United States which set a lower rate of withholding tax. DIVIDEND TAX ABUSE, *supra* note 4, at 11. Further, “if the withholding agent is a non-U.S. financial institution operating outside the United States, other rules apply, including in some cases Qualified Intermediary agreement[s] which may specify different disclosure obligations.” DIVIDEND TAX ABUSE, *supra* note 4, at 12. However, the GAO report does not state that the Cayman Islands have any similar agreement with the United States that would lessen the withholding tax. See BUSINESS AND TAX ADVANTAGES, *supra* note 5. Furthermore, the report gives six case histories to illustrate dividend tax abuse and three of the cases used the Cayman Islands to evade a thirty percent withholding tax. BUSINESS AND TAX ADVANTAGES, *supra* note 5.

required to be “withheld at the source” of the dividend payment.<sup>79</sup> U.S. tax law defines the “withholding agent” as any person that has “control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding.”<sup>80</sup> In 2003, “about \$42 billion in U.S. stock dividends were paid to non-U.S. corporations, from which only about 4.5% or \$1.9 billion was withheld.”<sup>81</sup>

In November 1997, the IRS issued Notice 97-66.<sup>82</sup> This notice created confusion and allowed financial institutions to aggressively interpret the taxation laws regarding substitute dividend payments.<sup>83</sup> By interpreting Notice 97-66 aggressively, financial institutions concluded that substitute dividend payments regarding foreign-to-foreign parties were not subject to any withholding tax.<sup>84</sup> The process works where a U.S. financial institution sets up an offshore corporation or uses a pre-existing offshore corporation that it owns and controls to borrow U.S. stock from an offshore client anticipating a dividend payment.<sup>85</sup> Next, the offshore corporation could sell the stock, so it would not pay a dividend itself, and “simultaneously enter[ ] into a swap agreement with its affiliated financial institution.”<sup>86</sup> Following issuance of the dividend, the financial institution could pay “a tax-free ‘dividend equivalent’ payment under the swap agreement to the offshore corporation which, in turn, paid the same amount back to the offshore client from which it had borrowed stock.”<sup>87</sup> The substitute dividend payment would then be between two foreign parties. Financial institutions claim that these substitute payments regarding foreign-to-foreign parties are not subject to withholding tax.

The U.S. government believes that these abusive practices involve sophisticated transactions such as dividend related swap<sup>88</sup>

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79. DIVIDEND TAX ABUSE, *supra* note 4, at 11; I.R.C. § 871(a)(1)(A) (Supp. 2008) (amended 2010); I.R.C. § 881(a)(1) (amended 2010); I.R.C. § 1441(a, b) (2005); I.R.C. § 1442(a) (2005).

80. DIVIDEND TAX ABUSE, *supra* note 4, at 12.

81. DIVIDEND TAX ABUSE, *supra* note 4, at 13.

82. I.R.S. Notice 97-66, 1997-2 C.B. 328, 1997, *available at* WL 701873.

83. DIVIDEND TAX ABUSE, *supra* note 4, at 19-20.

84. DIVIDEND TAX ABUSE, *supra* note 4, at 19.

85. DIVIDEND TAX ABUSE, *supra* note 4, at 20.

86. DIVIDEND TAX ABUSE, *supra* note 4, at 20.

87. DIVIDEND TAX ABUSE, *supra* note 4, at 20.

88. See JOINT COMMITTEE ON TAXATION: DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL, 111TH CONG., 15-17 (Comm. Print 2009), 2009, *reprinted in* WL 2996018 (explaining swap transactions).

and loan transactions,<sup>89</sup> among other things.<sup>90</sup> The financial institutions structure the swap and loan transactions to enable their non-U.S. clients “to enjoy all the benefits of owning shares of U.S. stock, including receiving dividends, without paying the tax applicable to those dividends.”<sup>91</sup> In effect, the financial institutions are “investing synthetically through equity swaps”<sup>92</sup> allowing for the same dividend returns as a stock and “disguising who owns the stock in order to help their offshore hedge fund clients avoid withholding the tax.”<sup>93</sup> The investors in the offshore hedge funds could be non-U.S. persons or corporations set up abroad to disguise that they are U.S. persons.

The IRS most likely believes that these practices are the primary tax evasion tools utilized in the Cayman Islands. A tax lawyer at Greenburg Traurig, Mark H. Leeds, recently stated that the IRS increasingly viewed equity swaps as “evidence of tax avoidance.”<sup>94</sup> Losses caused by dividend tax abuse is unknown; however, Lehman Brothers estimated that \$115 million was lost in 2004 alone.<sup>95</sup>

### *b. Individual Tax Evasion*

Other investors in the Cayman Islands evade taxes through complex schemes meant to hide the true investor. “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 depended on the accuracy and completeness of the self-disclosure.”<sup>96</sup> Thus, individuals can set up shell corporations in the Cayman Islands and a bank account in the Cayman Islands for the corporation so that the corporation is protected under the bank secrecy laws.<sup>97</sup> The individual can then invest in Cayman Islands hedge funds through the corporate bank account. By operating as a foreign person or a shell corporation, the U.S. person can evade taxes on U.S. source income because the U.S. does not withhold taxes on sources such

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89. See *id.* at 17-21 (explaining loan transactions).

90. See DIVIDEND TAX ABUSE, *supra* note 4, at 13-22.

91. DIVIDEND TAX ABUSE, *supra* note 4, at 3.

92. JOINT COMMITTEE ON TAXATION, *supra* note 89, at 5.

93. Lynnley Browning, *Banks' Derivatives Activity Falls Under I.R.S. Scrutiny*, N.Y. TIMES, Jan. 21, 2010, at B4, available at WLNR 1265790.

94. *Id.*

95. DIVIDEND TAX ABUSE, *supra* note 4, at 34 & n.113.

96. BUSINESS AND TAX ADVANTAGES, *supra* note 5, at 5.

97. See discussion *supra* Section II(B)(1)(a).

as interest and capital gains paid to foreigners.<sup>98</sup> “If a U.S. person can arrange to receive investment income through means that permit the U.S. person to appear to be a foreign person, the U.S. investor may be able to evade U.S. income tax entirely.”<sup>99</sup> This is typified by the UBS v. IRS case where UBS helped facilitate tax evasion with U.S. clients.

### III. TAX EVASION: HISTORICAL ANALYSIS OF THE UNITED STATES AND CAYMAN ISLANDS

Reacting to billions lost in tax revenue, the U.S. and OECD have targeted tax havens in an attempt to curb tax evasion. The efforts, though, have been largely unsuccessful.<sup>100</sup> Instead, capital has continued to move freely between the U.S. and tax havens such as the Cayman Islands.

#### A. *Organisation for Economic Co-operation and Development*

The OECD was founded in 1961 as an intergovernmental organization dedicated to promoting democracy and free market economy around the world.<sup>101</sup> The OECD states that it “provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies.”<sup>102</sup> In 1998, the OECD began a “shame campaign against tax havens” with the publication of “Harmful Tax Competition: An Emerging Global Issue.”<sup>103</sup> Within the publication, the OECD listed four characteristics that define a tax haven.<sup>104</sup> It also announced that “a future report would include all states it considered uncooperative tax havens” but would remove any tax haven from its list “if the tax haven pledged to reduce and eventually eliminate policies the OECD considered harmful.”<sup>105</sup> As an example, according to the OECD,

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98. JANE G. GRAVELLE, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 19 (2009), [http://assets.opencrs.com/rpts/R40623\\_20090709.pdf](http://assets.opencrs.com/rpts/R40623_20090709.pdf).

99. S. COMM. ON SELECT REVENUE MEASURES OF THE HOUSE COMM. ON WAYS AND MEANS, TAX COMPLIANCE AND ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES (2009), <http://www.jct.gov/x-23-09.pdf>.

100. Addison, *supra* note 4, at 704.

101. OECD, *About OECD*, [http://www.oecd.org/pages/0,3417,en\\_36734052\\_36734103\\_1\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1_1,00.html) (last visited Jan. 11, 2010).

102. *Id.*

103. Addison, *supra* note 4, at 714.

104. Addison, *supra* note 4, at 705-6; *Harmful Tax Competition: An Emerging Global Issue*, *supra* note 41.

105. Addison, *supra* note 4, at 714.



the Cayman Islands committed to the OECD and is considered a cooperative tax haven.<sup>106</sup>

The OECD's promise to remove any tax haven who pledged to reduce and eventually eliminate harmful policies required only "symbolic statements" that these tax havens vowed to change.<sup>107</sup> The OECD provided no economic incentives but instead offered a country the opportunity to be left off of a list that could potentially bring negative marketing.<sup>108</sup> "As a result . . . key member states, including the U.S., withdrew their support and the cooperation commitment agreement with tax havens systematically fell apart."<sup>109</sup> Thus, the OECD's publication and cooperation commitment did little more than raise global awareness.

### *B. Tax Information Exchange Agreements*

With this in mind, the U.S. began adopting Tax Information Exchange Agreements ("TIEA").<sup>110</sup> TIEAs can typically be defined by three characteristics: 1) "provide for the exchange of information on requests for both criminal and civil tax matters;" 2) "provide for the exchange of information even if such information relates to a person who is not a resident or national of the U.S. or a TIEA partner;" and 3) "provide for the disclosure of information regardless of local confidentiality laws that may prohibit such disclosure, including laws relating to bank secrecy or bearer shares."<sup>111</sup>

Within the last ten years, the U.S. has entered into TIEAs with fourteen countries.<sup>112</sup> Following their pledge to the OECD to reduce and eliminate harmful policies, the Cayman Islands entered into a TIEA with the U.S. in 2001.<sup>113</sup> This TIEA was codified in the Tax Information Authority Law in the Cayman

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106. OECD, THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2001 PROGRESS REPORT 8 (2001), <http://www.oecd.org/dataoecd/60/28/2664438.pdf>.

107. Addison, *supra* note 4, at 715.

108. Addison, *supra* note 4, at 714-15.

109. Addison, *supra* note 4, at 716.

110. Addison, *supra* note 4, at 717.

111. Addison, *supra* note 4, at 717 (citing Press Release, U.S. Department of the Treasury, Testimony of Treasury Acting International Tax Counsel John Harrington Before the Senate Finance Committee on Offshore Tax Evasion).

112. Addison, *supra* note 4, at 717.

113. Press Release, U.S. Department of the Treasury, Treasury Secretary O'Neill's Signing Ceremony Statement: United States and United Kingdom Sign Agreement to Exchange Information with Respect to the Cayman Islands (Nov. 27, 2001), *available at* <http://www.treas.gov/press/releases/po823.htm>.

Islands.<sup>114</sup> The Tax Information Authority Law was most recently revised in July, 2009.<sup>115</sup> The agreement has been criticized because it applies “only if the IRS has a valid reason for suspecting a specific taxpayer of criminal tax evasion.”<sup>116</sup> It requires the IRS to provide the Cayman Islands Tax Information Authority with: the identity of the tax payer under investigation, the nature of the information requested, purpose for which the information is sought, reasonable grounds for believing the information is in the Cayman Islands, the name and address of any person believed to be in possession of the information, and a declaration that the information would be obtainable in the U.S. under its laws.<sup>117</sup> These requirements make it appear that “the value of information exchange is primarily limited to confirmation rather than discovery of tax evasion.”<sup>118</sup> The Cayman Islands government has even publicly stated that the agreement “eliminate[s] fishing expeditions.”<sup>119</sup>

#### IV. IRS v. UBS

Despite the IRS' frustrations utilizing the OECD and TIEAs, it has recently made progress in targeting tax evaders through the “John Doe” summons process. Recently, it entered into a settlement agreement with Switzerland-based UBS.<sup>120</sup> The IRS filed a “John Doe” summons<sup>121</sup> on the UBS bank to request information regarding U.S. taxpayers who may be using Swiss bank accounts to evade federal income taxes.<sup>122</sup> This was especially important for Cayman Islands hedge funds and their investors because the IRS similarly suspects hedge fund corporations and their investors of

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114. See Tax Information Authority Law (2009) (Cayman Is.), available at [http://www.tia.gov.ky/pdf/Tax\\_Information\\_Authority\\_Law\\_\(2009\\_Revision\).pdf](http://www.tia.gov.ky/pdf/Tax_Information_Authority_Law_(2009_Revision).pdf) [hereinafter Cayman Tax Law].

115. *Id.*

116. Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 501 n.254 (2007); See Sullivan, *supra* note 4, at 962.

117. Tax Information Authority Law, pt. IV § 11(3) (2009) (Cayman Is.).

118. Sullivan, *supra* note 4, at 961.

119. Sullivan, *supra* note 4, at 962.

120. Settlement Agreement, *supra* note 1.

121. Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 63-79 (2004) (analyzing the evolution of third party summonses into the inquisitorial “John Doe” summons).

122. See IRS, INTERNAL REVENUE MANUAL – 34.6.3 SUMMONS ENFORCEMENT ACTIONS, [http://www.irs.gov/irm/part34/irm\\_34-006-003.html](http://www.irs.gov/irm/part34/irm_34-006-003.html) (last visited Jan. 11, 2010).

evading federal income taxes.<sup>123</sup>

### A. *United States Turns Attention to UBS*

Following *UBS v. IRS*, IRS Commissioner Doug Shulman stated that “[i]nternational tax evasion will continue to be a top priority.”<sup>124</sup> The IRS seeks to work with other countries and the Justice Department.<sup>125</sup> The increased focus of the IRS on an issue that has been a problem for years can be attributed to a number of factors.

First, Senator Carl Levin, chairman of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, has increased awareness of the issue with hearings on offshore tax havens, banks and accounts. Senator Levin has followed these hearings with proposed legislation addressing these problems.<sup>126</sup> During the past two years, the subcommittee investigative hearings have focused on how U.S. taxpayers use offshore tax havens to hide assets and evade taxes. While the hearings are not the first of their kind, they<sup>127</sup> take a fresh and detailed approach to investigating how and why U.S. taxpayers are able to evade taxes abroad. As part of these efforts, investigations into the extent tax haven banks have assisted U.S. taxpayers, the extent to which tax haven banks have manipulated the Qualified Intermediary Program<sup>128</sup> and how U.S. banks have facilitated these processes have occurred.<sup>129</sup>

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123. See Jenny Strasburg & Jesse Drucker, *IRS Steps Up Scrutiny of Offshore Funds*, WALL ST. J., June 25, 2009, available at <http://online.wsj.com/article/SB124588728596150643.html>; Ronal D. Orol, *IRS Could Target Off-Shore Hedge-Fund Investors Next*, WALL ST. J., Aug. 24, 2009, available at <http://online.wsj.com/article/SB125113164822654187.html>.

124. Remarks by IRS Commissioner Shulman, *supra* note 2.

125. Cutler, *supra* note 14.

126. Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:s506is.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s506is.txt.pdf).

127. See, e.g., TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS, AND SECRECY BEFORE THE PERMANENT SUBCOMM. ON INVESTIGATIONS, 109th Cong. (2006); U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS BEFORE THE PERMANENT SUBCOMM. ON INVESTIGATIONS, 108th Cong. (2003); WHAT IS THE U.S. POSITION ON OFFSHORE TAX HAVENS? BEFORE THE PERMANENT SUBCOMM. ON INVESTIGATIONS, 107th Cong. (2001); CRIME AND SECRECY: THE USE OF OFFSHORE BANKS AND COMPANIES BEFORE THE PERMANENT SUBCOMM. ON INVESTIGATIONS, 98th Cong. (1983).

128. See Martin A. Sullivan, *Economic Analysis: Proposals to Fight Offshore Tax Evasion*, 123 TAX NOTES 264, 265-7 (explaining the IRS Qualified Intermediary Program).

129. See TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3; See DIVIDEND

Second, in February 2008, “a former employee of a Liechtenstein trust company provided tax authorities around the world with data on about 1,400 persons with accounts at LGT Bank in Liechtenstein.”<sup>130</sup> The result was an IRS announcement that it had begun enforcement actions against more than 100 U.S. taxpayers holding Liechtenstein accounts.<sup>131</sup> Senator Levin’s cause and the subcommittee’s investigative hearings and reports were strengthened by a global issue appearing on news feeds daily.

Finally, in May 2008, a second global tax scandal surfaced when a private banker formerly employed by UBS AG, Bradley Birkenfield was arrested by American authorities on charges of “having conspired with a U.S. citizen and a business associate to defraud the IRS of \$7.2 million in taxes owed on \$200 million of assets hidden in offshore accounts in Switzerland and Liechtenstein.”<sup>132</sup> He pled guilty to conspiracy to defraud the United States, marking the “first time that the United States criminally prosecuted a Swiss banker for helping a U.S. taxpayer evade payment of U.S. taxes.”<sup>133</sup> Following Mr. Birkenfield’s arrest and subsequent plea, UBS entered into a Deferred Prosecution Agreement (DPA), admitting it helped U.S. taxpayers evade taxes, and agreeing to pay \$780 million to the U.S. government.<sup>134</sup>

All of these incidents have come at the most opportune time for the IRS. The IRS has a supportive political party in place that backs an international tax evasion focus.<sup>135</sup> Furthermore, the IRS is recovering millions of dollars that could help a cash pinched administration.<sup>136</sup>

### *B. United States Action*

On June 30, 2008, the IRS filed a petition for leave to serve “John Doe” summonses on U.S. taxpayers who had accounts with UBS in the Southern District of Florida.<sup>137</sup> The “John Doe” sum-

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TAX ABUSE: HOW OFFSHORE ENTITIES DODGE TAXES ON U.S. STOCK DIVIDENDS, *supra* note 4.

130. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 2.

131. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 2.

132. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 2.

133. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 3.

134. Martha Brannigan, *Federal Taxes: IRS Agents Hunting Offshore Tax Cheats*, MIAMI HERALD, Apr. 28, 2009, at C1, reprinted in 2009 WLNR 7958010.

135. Sullivan, *supra* note 4, at 960 (demonstrating that during the presidency of George W. Bush, conservatives fiercely opposed OECD efforts to curb international tax evasion).

136. Brannigan, *supra* note 134.

137. Ex Parte Pet. for Leave to Serve John Doe Summ. to U.S. Taxpayers not Filing

monses were filed pursuant to Sections 7402(a), 7609(f) and 7609(h) of the Internal Revenue Code.<sup>138</sup> Section 7609 permits service after a court proceeding determines that there is 1) an “ascertainable group or class of persons,” 2) reasonable basis to believe the group may be violating tax laws, and 3) inability to procure information through alternate means.<sup>139</sup> On July 1, 2008, U.S. District Court Judge Joan A. Lenard authorized the IRS to serve the “John Doe” summons on UBS.<sup>140</sup> The summons directed “UBS to produce records identifying U.S. taxpayers with accounts at UBS in Switzerland who elected to have their accounts remain hidden from the IRS.”<sup>141</sup>

On July 21, 2008, Internal Revenue Agent Arthur S. Brake issued the “John Doe” summons to UBS.<sup>142</sup> The summons directed UBS to appear before the IRS on August 8, 2008 to “give testimony and produce for examination, certain books, papers, or other data as described in the summons.”<sup>143</sup> Separate from the “John Doe” summons, UBS entered into a DPA with the U.S.<sup>144</sup> The DPA was in response to the IRS charging UBS with “participating in a conspiracy to defraud the United States and its agency the IRS in violation of 18 U.S.C. § 371.”<sup>145</sup> UBS agreed to pay the U.S. \$780 million, provide the government with the identities and account information of certain U.S. clients and recognize that the DPA did not prevent any claims or defenses in the “John Doe” summons.<sup>146</sup> The next day, the IRS filed a petition to enforce the “John Doe” summons claiming that UBS had failed to respond by not appearing on August 8, 2008.<sup>147</sup>

### C. *Swiss and UBS Reaction*

In response to the petition to enforce the “John Doe” sum-

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Forms W-9 or 1099 on Accounts at UBS AG, Subsidiaries, Affiliates, United States v. UBS AG, No. 08-21864 U (S.D. Fla. June 30, 2008).

138. See I.R.C. § 7609 (2005); I.R.C. § 7402 (1972).

139. I.R.C. § 7609 (f).

140. Press Release, Department of Justice, Federal Judge Approves IRS Summons for UBS Swiss Bank Account Records (July 1, 2008), available at <http://www.justice.gov/tax/txdv08584.htm>.

141. *Id.*

142. Pet. to Enforce John Doe Summons ¶ 9, United States v. UBS AG, No. 09-20423 (S.D. Fla. Feb. 19, 2009).

143. *Id.*

144. Deferred Prosecution Agreement, United States v. UBS AG, No. 09-60033 (S.D. Fla. Feb. 18, 2009).

145. *Id.* ¶ 1.

146. *Id.* ¶ 3.

147. Pet. to Enforce John Doe Summons, *supra* note 142, ¶ 11.

mons, the Swiss government filed an amicus brief<sup>148</sup> accusing the U.S. government of violating a U.S.-Switzerland bilateral tax treaty.<sup>149</sup> The “John Doe” summons was criticized for not being supported by evidence.<sup>150</sup> In its amicus brief, Switzerland stated that “the Tax Treaty<sup>151</sup> . . . does not authorize ‘fishing expeditions’ such as the summons at issue in this case . . . [and] that a request for information should include some degree of specificity.”<sup>152</sup>

Switzerland also cited their bank secrecy laws and accused the U.S. government of infringing on its sovereignty. “Switzerland’s laws prohibit the release of confidential information to foreign governments when the request has not been made through authorized intergovernmental channels.”<sup>153</sup> The brief further argued that “if the Court were to order UBS to produce evidence from Switzerland, and backed that order with coercive powers, the Court would be substituting its own authority for that of the competent Swiss authorities, and therefore would violate Swiss sovereignty and international law.”<sup>154</sup> In particular, the Swiss government argued that forcing UBS to release confidential information would violate Swiss secrecy laws and could lead to criminal convictions.

After the IRS filed for leave to serve the “John Doe” summons, the Swiss government entered into talks with the U.S. government to “broaden the scope of treaty requests to which Switzerland can reply.”<sup>155</sup> The first meeting was held on April 28, 2009, and the Swiss government sent a diplomatic note the next day setting forth “its concerns regarding the threat this case poses to the negotiation of the proposed amendments to the Tax Treaty.”<sup>156</sup>

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148. Brief for Switzerland as Amici Curiae with Letter to U.S. State Department, *United States v. UBS AG*, No.09-20423 (S.D. Fla. Apr. 30, 2009) [hereinafter *Switzerland Amicus Br.*].

149. Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, U.S.-Switz., Oct. 2, 1996, S. Treaty Doc. No. 105-8 [hereinafter *US-Swiss Treaty*].

150. *Switzerland Amicus Br.*, *supra* note 148.

151. *US-Swiss Treaty*, *supra* note 149 (updating the 1951 income tax treaty between the United States and Switzerland).

152. *Switzerland Amicus Br.*, *supra* note 148, Argument § III.

153. *Switzerland Amicus Br.*, *supra* note 148, Argument § II.

154. *Switzerland Amicus Br.*, *supra* note 148, Argument § II.

155. *Judge Asks if IRS Summons Against UBS Represents Obama Administration's Position*, DAILY TAX REPORT, May 12, 2009, available at [http://daytona.law.miami.edu:2346/btac/T11100/split\\_display.adp?fedfid=12373537&vname=dtrnot&wsn=537508000&searchid=10107455&doctypeid=13&type=date&mode=doc&split=0&scm=T11100&pg=0](http://daytona.law.miami.edu:2346/btac/T11100/split_display.adp?fedfid=12373537&vname=dtrnot&wsn=537508000&searchid=10107455&doctypeid=13&type=date&mode=doc&split=0&scm=T11100&pg=0).

156. *Switzerland Amicus Br.*, *supra* note 148, Statement of Relevant Facts § E.

*D. United States Right to Enforce "John Doe"  
Summons*

Despite the Swiss government's objections, the IRS pushed forward with the "John Doe" summons. On April 30, 2009, UBS submitted its own brief opposing the petition to enforce the "John Doe" summons.<sup>157</sup> The IRS responded by arguing that Congress had given the IRS broad summons authority, that the U.S. had proven a *prima facie* case to enforce the "John Doe" summons and that international comity favored enforcement.<sup>158</sup>

Responding to Switzerland's amicus brief, the IRS argued that it has broad summons authority and that the "John Doe" summons should be enforced.<sup>159</sup> The IRS also cited the Supreme Court's approval of the "John Doe" summons process under I.R.C. § 7602(a) (2008).<sup>160</sup> Shortly after the Supreme Court's decision in *Bisceglia*, Congress passed the Tax Reform Act of 1976 governing third party summonses, specifically, "John Doe" summonses.<sup>161</sup> The IRS argued that the Supreme Court's decision, coupled with legislation, affirmed that the IRS has "broad and expansive summons power." Moreover, the IRS claimed that they met the elements required under I.R.C. § 7609(f) (2005).<sup>162</sup> The IRS also argued that "if a party fails or refuses to comply with a summons, the United States may file an action to compel compliance."<sup>163</sup> Filing an action to compel compliance, the IRS asserted that it had established a *prima facie* case for enforcement by proving four necessary elements: "the summons was issued for a legitimate purpose; the summoned information may be relevant to that purpose; the summoned information is not already in the possession of the [IRS]; and the IRS has complied with all the administrative

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157. *Switzerland Says IRS Summons Against UBS Violates Tax Treaty, Threatens Agreement*, DAILY TAX REPORT, May 4, 2009, available at [http://daytona.law.miami.edu:2346/btac/T11100/split\\_display.adp?fedfid=12358223&vname=dtrnot&wsn=539208000&searchid=10107604&doctypeid=13&type=date&mode=doc&split=0&scm=T11100&pg=0](http://daytona.law.miami.edu:2346/btac/T11100/split_display.adp?fedfid=12358223&vname=dtrnot&wsn=539208000&searchid=10107604&doctypeid=13&type=date&mode=doc&split=0&scm=T11100&pg=0).

158. Memo Supporting Petition to Enforce 'John Doe' Summons, *United States v. UBS AG*, No. 09-20423 (June 30, 2009).

159. *Id.*

160. *Id.*; see *United States v. Bisceglia*, 420 U.S. 141, 156 (1975).

161. Camp, *supra* note 121, at 63-71 (describing Congress' enactment of § 7609(f) and (h) which lay out three elements that must be met by the IRS to issue a "John Doe" summons); Memo Supporting Petition to Enforce 'John Doe' Summons, *supra* note 158, Argument § I.

162. Memo Supporting Petition to Enforce 'John Doe' Summons, *supra* note 158, Argument § I.

163. Memo Supporting Petition to Enforce 'John Doe' Summons, *supra* note 158, at Argument § II; see also I.R.C. § 7604(b) (1988).

requirements of the [IRS].”<sup>164</sup>

If a party refuses to comply with the “John Doe” summons, a court can hold the party in contempt and impose sanctions.<sup>165</sup> The IRS cited two Eleventh Circuit decisions affirming district court contempt sanctions where the U.S. attempted to obtain information located abroad from banks to prove that this case fell within settled U.S. law.<sup>166</sup> Moreover, the IRS concluded that the court would not be abusing its powers by enforcing the summons.<sup>167</sup>

### *E. Settlement Agreement*

The U.S. government’s response to Switzerland’s amicus brief sparked a number of responses by the Swiss Government, the IRS and UBS.<sup>168</sup> Finally, on August 12, 2009, the U.S. and UBS announced that they had settled the ongoing litigation, ending their year-long battle.<sup>169</sup> Pursuant to the settlement agreement, UBS agreed to produce account information concerning approximately 4,450 accounts to the Swiss Federal Tax Administration on a rolling basis.<sup>170</sup> Additionally, the United States and the Swiss Confederation also “agreed on an information exchange mecha-

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164. Memo Supporting Petition to Enforce ‘John Doe’ Summons, *supra* note 158, Argument § II; *see also* United States v. Powell, 379 U.S. 48, 57-58 (1964).

165. Memo Supporting Petition to Enforce ‘John Doe’ Summons, *supra* note 158, at Argument § III.

166. *In re Bank of Nova Scotia*, 691 F.2d 1384 (11th Cir. 1982) (affirming the district court’s contempt sanctions where a foreign bank refused to comply with a grand jury subpoena because the records were located in a jurisdiction where banking privacy laws existed); *In re Grand Jury Proceedings: Union Bank of Switzerland v. United States*, 946 F.2d 904 (11th Cir. 1991) (affirming the district court holding UBS in contempt of court and rejecting UBS argument that UBS Panama was not subject to the *in personam* jurisdiction of the U.S. courts).

167. Memo Supporting Petition to Enforce ‘John Doe’ Summons, *supra* note 158, Argument § III.

168. *See* UBS AG Mot., United States v. UBS AG, No. 09-20423 (S.D. Fla. June 30, 2009) (seeking an order requiring the government to disclose the number of accounts already identified through alternative means); United States Response to UBS AG Motion, United States v. UBS AG, No. 09-20423 (S.D. Fla. July 6, 2009) (opposing UBS AG motion seeking an order requiring U.S. to answer interrogatories); Swiss Government’s Amicus Curiae Brief, United States v. UBS AG, No. 09-20423 (S.D. Fla. July 7, 2009) (responding to IRS memo supporting the enforcement of the “John Doe” summons); United States Supplemental Response to UBS AG Reply, United States v. UBS AG, No. 09-20423 (S.D. Fla. July 12, 2009); United States Response to Switzerland Memo, United States v. UBS AG, No. 09-20423 (S.D. Fla. July 12, 2009).

169. J.P. Finet, *DOJ Announces Settlement With UBS; Final Terms of Agreement Not Released*, DAILY TAX REPORT, Aug. 13, 2009, available at <http://bnataxreport.com> (follow Daily Tax Report: News Archive; then follow August 13, 2009; then follow Tax Decisions & Rulings; then follow Financial Institutions: DOJ Announces Settlement with UBS; Final Terms of Agreement Not Released).

170. Settlement Agreement, *supra* note 1, ¶ 3.



nism that is intended to achieve the U.S. tax compliance goals of the UBS summons while also respecting Swiss sovereignty.”<sup>171</sup> The separate agreement between the U.S. and Swiss Confederation allows for the exchange to be processed as a treaty request.<sup>172</sup> Moreover, UBS was required to send out notices to U.S. persons whose accounts were subject to the treaty request, notifying that their information would be provided to the IRS.<sup>173</sup> Within the notices, UBS was required to encourage each U.S. person to consult with a qualified tax consultant and take advantage of the IRS’ Voluntary Disclosure Practice.<sup>174</sup> However, the IRS set the voluntary disclosure deadline at September 23 (later extended to October 15),<sup>175</sup> and stated that once the Swiss government sent the U.S. government a name, the individual is no longer eligible.<sup>176</sup>

The U.S. claims that it got what it wanted all along: “access to information about those UBS account holders most likely to have been involved in offshore tax evasion.”<sup>177</sup> In addition, the U.S. government scared more than 14,700 people into coming forward to report offshore accounts during the 60-day amnesty program that ended October 15.<sup>178</sup> IRS Commissioner Doug Shulman said that the overseas accounts reported ranged from \$10,000 to more than \$100 million.<sup>179</sup> He added that the amnesty program probably brought back into the U.S. tax system anywhere from \$7.5 billion to \$15 billion in taxable assets.<sup>180</sup>

In the meantime, the Swiss courts have ruled against the executive branch deal with the U.S. On January 21, 2010, Switzerland’s Federal Administrative Court made its first decision to prevent disclosure.<sup>181</sup> More recently, the Court ruled in favor of

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171. Settlement Agreement, *supra* note 1, pmb1.

172. Settlement Agreement, *supra* note 1, pmb1.; see Lee A. Sheppard, *Getting Serious About Offshore Evasion?*, 125 TAX NOTES 493, 494 (2009).

173. Settlement Agreement, *supra* note 1, ¶ 3; see Remarks by IRS Commissioner Shulman, *supra* note 2.

174. Settlement Agreement, *supra* note 1, ¶ 3-4.

175. Press Release, IRS, IRS Extends Deadline for Taxpayers to Voluntarily Disclose Offshore Assets (Sept. 21, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=213463,00.html>.

176. Remarks by IRS Commissioner Shulman, *supra* note 2.

177. Remarks by IRS Commissioner Shulman, *supra* note 2, at 2.

178. Joyce Cutler, *Still Time to Report Offshore Account as Focus Stays International*, Officials Say, INT’L TAX MONITOR (Dec. 4, 2009), available at [http://daytona.law.miami.edu:2346/btac/T12117/split\\_display.adp?fedfid=15797310&vname=itmbul&wsn=499342000&searchid=10108436&doctypeid=13&type=date&mode=doc&split=0&scm=T12117&pg=0](http://daytona.law.miami.edu:2346/btac/T12117/split_display.adp?fedfid=15797310&vname=itmbul&wsn=499342000&searchid=10108436&doctypeid=13&type=date&mode=doc&split=0&scm=T12117&pg=0).

179. Cutler, *supra* note 14.

180. Cutler, *supra* note 14.

181. Swiss Federal Administrative Court’s Press Release, *supra* note 17.

two UBS clients who objected to their information being handed over to the IRS. In its most recent ruling, the Court ruled that “there were no reasons provided to show that this case differs from January’s test case, which is why the complaint is approved.”<sup>182</sup> The Swiss Court held that “Switzerland could lift bank secrecy laws only when there was evidence of tax fraud.”<sup>183</sup> It also reasoned that failing to complete tax forms or declare income was not evidence of tax fraud, but rather tax evasion.<sup>184</sup> Since these decisions, the Swiss government has attempted to get Parliament to approve the agreement.<sup>185</sup> Presently, the agreement has stalled and faces major obstacles.

## V. IRS v. CAYMAN ISLANDS?

The Cayman Islands attracts a large number of U.S. investors to hedge funds. These investments are legitimate in some circumstances but can also be for the purposes of tax evasion.<sup>186</sup> Past practices by the IRS have failed to curtail tax evasion.<sup>187</sup> However, with the new and seemingly improved focus of the IRS on international enforcement, the Cayman Islands hedge funds seem like a logical place for the IRS to make its next “big move.”<sup>188</sup> Yet, the “John Doe” summons the IRS employed in *UBS v. IRS* has still not been approved by Swiss courts. Nevertheless, the IRS has given hedge fund investors in the Cayman Islands an opportunity to come clean before the IRS “knock[s] on your door.”<sup>189</sup>

### A. *No New Treaty was Signed with Switzerland*

What is notable in the *UBS v. IRS* settlement, is that a new treaty was signed for the exchange of names.<sup>190</sup> This is important because it shows that the tax treaty already in place between the

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182. Katharina Bart, *Update: Swiss Court Backs UBS Clients Against Data Handover*, WALL ST. J. (Feb. 26, 2010), available at [http://online.wsj.com/article/BT-CO-20100226-711216.html?mod=WSJ\\_latestheadlines](http://online.wsj.com/article/BT-CO-20100226-711216.html?mod=WSJ_latestheadlines).

183. Bloomberg News, *supra* note 17.

184. Bloomberg News, *supra* note 17.

185. Catherine Bosley, *Swiss Party Against Approval of UBS Deal with Swiss*, REUTERS, Mar. 9, 2010, available at <http://www.reuters.com/assets/print?aid=USLDE6282GJ20100309>.

186. See Sheppard & Sullivan, *supra* note 6 (stating that offshore hedge funds offer opportunities for tax evasion).

187. See discussion *supra* Part III.

188. Strasburg & Drucker, *supra* note 123; Orol, *supra* note 123.

189. Brannigan, *supra* note 134.

190. See Settlement Agreement, *supra* note 1.

two countries was not changed.<sup>191</sup> Currently, Swiss courts will not approve of disclosure through the agreement because most of the account holders participated in tax evasion and not tax fraud.<sup>192</sup> Their interpretation of the current Tax Treaty<sup>193</sup> allows for exchange of information only when there is tax fraud. The previous relationship between the Swiss and American governments permitted tax evasion to flourish in Switzerland and yet, that relationship is the status quo. Legally and structurally, nothing changed the way the U.S. attacks international tax evasion.<sup>194</sup> No new legislation was passed in the United States.

Thus, the settlement means nothing more than a single incident of tax evasion thwarted by the IRS. The United States found a bank that admitted to aiding U.S. taxpayers evade taxes and a country that supported its bank doing this. Yet the U.S. only received 4,000 names and a \$780 million settlement from the bank.<sup>195</sup> It was a historic victory for the IRS but not a "major step" toward stopping international tax evasion. UBS was allowed to keep its banking and securities licenses and was allowed to remain in the Qualified Intermediary<sup>196</sup> Program.<sup>197</sup> Meanwhile, the Swiss government gets to keep banking secrecy.<sup>198</sup> The settlement was not a failure by any means. However, if the top priority is stopping international tax evasion,<sup>199</sup> the focus should be on changing the legal and structural elements that allow for tax evasion.

The only way for the U.S. government to combat international tax evasion is by changing its own rules. There are a number of legislative proposals in Washington that could change the landscape of international tax evasion.<sup>200</sup> The Stop Tax Haven Abuse Act, proposed by Senator Levin, is one piece of legislation that Congress is currently debating. The Act would subject hedge

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191. See US-Swiss Treaty, *supra* note 149.

192. *U.S.-UBS Deal is Undermined by Swiss Ruling*, *supra* note 17.

193. US-Swiss Treaty, *supra* note 149.

194. Sheppard, *supra* note 172, at 494.

195. Wayne Tompkins, *UBS to Divulge 4,450 Account Names, More Expected*, DAILY BUS. REV., Aug. 19, 2009.

196. Sullivan, *supra* note 128.

197. Sheppard, *supra* note 172, at 494.

198. Katharina Bart, *Update: Swiss Govt Backs Bank Privacy; Mulls Withholding Tax*, WALL ST. J., Dec. 16, 2009.

199. Remarks by IRS Commissioner Shulman, *supra* note 2.

200. See Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:s506is.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s506is.txt.pdf); Foreign Account Tax Compliance Act of 2009, H.R. 3933, 111th Cong. (2009), available at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.3933>.

funds to money laundering laws,<sup>201</sup> increase fines for those who failed to report offshore accounts, strengthen the “John Doe” summons process, determine offshore secrecy jurisdictions (including the Cayman Islands), and increase reporting requirements for offshore banks and securities firms.<sup>202</sup> The Foreign Account Tax Compliance Act introduced by House Ways and Means Committee Chair Charles Rangel would also change the current legal and structural elements permitting international tax evasion.<sup>203</sup> “The main thrust of the bill is to require foreign banks to monitor tax evasion by U.S. residents.”<sup>204</sup> The proposed bill gives foreign banks a choice: either help make bank secrecy a relic of the past or have access to our capital markets impeded.<sup>205</sup> Legislation is the only way for the U.S. to truly make the statement that tax evasion and bank secrecy must end.

*B. Switzerland is an Entirely Different Scenario than Cayman Islands Hedge Funds*

Another reason why legislation is the best route is that the means by which the IRS was able to achieve its goals in Switzerland might not work in other tax havens. It is crucial to focus on the circumstances that led to the “John Doe” summons and subsequent settlement. Because of the unique circumstances that were present in the UBS v. IRS case, the U.S. could not apply the same methods it did in that case to Cayman Islands hedge funds. There are a number of reasons why the “John Doe” summons employed in the UBS case would not be feasible in the case of the Cayman Islands.

First, examining the UBS v. IRS case, the IRS could file a “John Doe” summons only after arresting and charging Mr. Birkenfield. He cooperated with the U.S. government and during his deposition indicated that “it was his understanding that UBS had thousands of Swiss accounts opened by U.S. clients, the majority of which were undeclared and never disclosed to the IRS.”<sup>206</sup> Mr. Birkenfield also stated that UBS Switzerland had “\$20 billion of assets under management in the United States,

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201. Sheppard, *supra* note 172, at 500; *see also* DIVIDEND TAX ABUSE, *supra* note 4.

202. Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:s506is.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s506is.txt.pdf).

203. Sheppard, *supra* note 172, at 493.

204. Sheppard, *supra* note 172, at 493.

205. Sheppard, *supra* note 172, at 493.

206. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 87.

undeclared business, which earned the bank approximately \$200 million per year in revenues.”<sup>207</sup>

Moreover, UBS entered into the DPA with the United States, admitting that it helped U.S. taxpayers evade taxes.<sup>208</sup> Thus, in the case of UBS, the U.S. filed its “John Doe” summons with solid information from a UBS insider. The “John Doe” summons filed against UBS was not a fishing expedition.<sup>209</sup> Ed Davis, a Miami partner with Astigarraga Davis specializing in international tax issues said, “it’s not a fishing expedition. We know there are American bank accounts. The Swiss have admitted tax evasion. So if it’s a fishing expedition, it’s a fishing expedition in a barrel of fish.”<sup>210</sup>

If the IRS files a “John Doe” summons against either banks or hedge funds in the Cayman Islands, the “John Doe” summons would be much more inquisitorial and speculative in nature than the UBS summons. None of the factors present in UBS are present in the case of Cayman Islands hedge funds. The IRS currently has no Cayman Islands equivalent of Mr. Birkenfield who has pled guilty to tax evasion and no major bank or hedge fund that has admitted to helping U.S. taxpayers evade taxes through hedge fund investments. However, there are reports that show hedge fund investors in the Cayman Islands are evading taxes.<sup>211</sup> Furthermore, the IRS has announced in the press that hedge funds in places like the Cayman Islands are being watched and investigated by the agency.<sup>212</sup> Yet the agency has no direct lead like it did in the UBS case. Without more direct information, the IRS cannot go forward with another “John Doe” summons.

Second, the IRS had a target in the UBS case. UBS management coordinated an elaborate plan for wealthy Americans to hide their assets.<sup>213</sup> Mr. Birkenfield told authorities that UBS went as far as “smuggling diamonds in toothpaste tubes.”<sup>214</sup> Thus, the IRS was faced with a bank acting recklessly and an employee willing to tell all. On the other hand, the IRS currently has no similar

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207. TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, *supra* note 3, at 87.

208. Brannigan, *supra* note 135.

209. *Cf.* Camp, *supra* note 122, at 34 (noting that a “John Doe” summons is an inquisitorial fishing expedition).

210. John Pacenti, *IRS Fight with UBS Raises Tax Treaty Question*, BROWARD DAILY BUS. REV., May 18, 2009, reprinted in 2009 WLNR 21925783.

211. *See* DIVIDEND TAX ABUSE, *supra* note 4, at 15; BUSINESS AND TAX ADVANTAGES, *supra* note 5; *see also* Sheppard, *supra* note 6.

212. Strasburg & Drucker, *supra* note 124; Orol, *supra* note 124.

213. Pacenti, *supra* note 210.

214. Pacenti, *supra* note 210.

target in the Cayman Islands. There are over 9,000 mutual funds in the Cayman Islands, most of which are hedge funds.<sup>215</sup> That means there are over 9,000 targets that could be harboring tax evaders. Moreover, the IRS will not likely focus on an individual hedge fund because this would limit the number of detectable tax evaders. Instead, the IRS would target a major bank in the Cayman Islands that holds accounts of U.S. persons investing in hedge funds in the Cayman Islands. The CIMA reported 266 banks at the end of December 2009.<sup>216</sup> The chances of the IRS finding a similar situation to UBS where thousands of U.S. taxpayers are dodging taxes in the same bank or hedge fund are slim.

Without a major bank or hedge fund, or sufficient information on specific tax evasion in the Cayman Islands, the IRS would find it hard to similarly file a "John Doe" summons against a Cayman Islands hedge fund or bank. If the IRS were to file a "John Doe" summons against all hedge funds in the Cayman Islands, the outcry of injustice would be heard loud and far. The Cayman Islands would claim that their sovereignty has been infringed upon and the hedge fund industry would cry "fishing expedition." The difference would be that in the Cayman Islands hedge funds' case, they would be right in lodging this complaint.

Third, and most importantly, the IRS would be seeking out entirely different tax evaders than in Switzerland.<sup>217</sup> In the UBS case, the tax evaders were mostly wealthy individuals. In connection with UBS, the IRS has requested the names of individuals in the settlement agreement and has prosecuted only individuals. However, the Cayman Islands seem to involve large financial institutions and corporations participating in dividend tax abuse. The Cayman Islands might involve private individuals but most of the signs point to the Cayman Islands involving an entirely different tax evader.

The IRS achieved its goal in the UBS case and scared thousands into voluntary disclosure.<sup>218</sup> Now, the U.S. government must take the next step and pass legislation aimed at deterring international tax evasion. As evidenced by the national attention the settlement agreement received, and the lack of coverage with

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215. LIST OF MUTUAL FUNDS REGISTERED/LICENSED WITH THE CAYMAN ISLANDS MONETARY AUTHORITY, *supra* note 27.

216. CAYMAN ISLANDS MONETARY AUTHORITY, BANKING STATISTICS (2009), [http://www.cimoney.com.ky/stats\\_reg\\_ent/stats\\_reg\\_ent.aspx?id=200&ekmensel=e2f22c9a\\_14\\_72\\_200\\_6](http://www.cimoney.com.ky/stats_reg_ent/stats_reg_ent.aspx?id=200&ekmensel=e2f22c9a_14_72_200_6).

217. See discussion *supra* Section II(B)(2).

218. Cutler, *supra* note 178, at 434.

the current obstacles facing the settlement, the government might have gotten exactly what it wanted—thousand of taxpayers scared into disclosure. Only the future will tell how far Commissioner Shulman and Congress are willing to go. If the past is an indication, the government will move on after scaring thousands.<sup>219</sup>

C. *What Should Investors in Cayman Islands Hedge Funds Do?*

Even if the IRS does not go after hedge fund investors in the Cayman Islands, American investors are evading taxes are breaking the law. The question then is what should these investors do? The voluntary disclosure program ended October 15. However, the IRS says that taxpayers can still come forward and voluntarily report offshore accounts.<sup>220</sup> Ron Cimino, head of the Justice Department Tax Division's Western Section, said that the government works hard to "provide every incentive for your clients . . . to come back into the system to minimize the sanctions that could be imposed on them."<sup>221</sup> Cimino also said that taxpayers are "given an opportunity because the service is not focused in on you as a target."<sup>222</sup>

Furthermore, the Revised IRS Voluntary Disclosure Practice states that "a voluntary disclosure occurs when the communication is truthful, timely, complete."<sup>223</sup> It also states that a disclosure occurs when "the taxpayer shows a willingness to cooperate with the IRS in determining his or her correct tax liability; and the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable."<sup>224</sup> The program does not guarantee immunity from prosecution, but that it may result in withheld prosecutions.<sup>225</sup>

Also, American taxpayers investing in offshore hedge funds need to know that they should file a Report of Foreign Bank and Financial Accounts ("FBAR"). Until recently, attorneys and

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219. Sullivan, *supra* note 4, at 960 (summarizing that those in control during the presidency of George W. Bush fiercely opposed OECD efforts then passed TIEA's after 9/11 but only to look for terrorists).

220. Cutler, *supra* note 178.

221. Cutler, *supra* note 178.

222. Cutler, *supra* note 178.

223. IRS, REVISED IRS VOLUNTARY DISCLOSURE PRACTICE, <http://www.irs.gov/newsroom/article/0,,id=104361,00.html> (last visited Jan. 11, 2010).

224. *Id.*

225. *Id.*

accountants have commonly advised hedge fund investors that they did not have to file a FBAR report.<sup>226</sup> The IRS defines FBAR as a yearly report of a foreign financial account, including a bank account, brokerage account, mutual fund, unit trust, or other types of financial accounts.<sup>227</sup> If the person has a “financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country” that person must report the relationship.<sup>228</sup> The difficulty has always been how to define “person” as enumerated under the Code of Federal Regulation § 103.24 concerning the reporting of foreign financial accounts and on the FBAR form. In an announcement on June 5, 2009, the IRS stated that the definition of “person” was “a citizen or resident of the United States, a domestic partnership, a domestic corporation, or a domestic estate or trust.”<sup>229</sup> Moreover, IRS officials have recently “made comments indicating that certain U.S. investors in off-shore hedge funds must file an FBAR.”<sup>230</sup> Thus, even if the investor is not a American person and instead a foreign corporation, the investor should file an FBAR. The IRS extended this past year’s due date for filing FBAR’s because of the controversy and confusion over who had to file them.<sup>231</sup> Anyone who has an offshore hedge fund account should be cautious and file an FBAR given the IRS’ recent announcements.<sup>232</sup>

## VI. CONCLUSION

The IRS took a huge step forward in its fight against international tax evasion.<sup>233</sup> Switzerland might still have banking secrecy, but tax evasion by U.S. taxpayers in Switzerland seems less likely to occur.<sup>234</sup> Concern over international tax evasion, though, needs to be more than the flavor of the month. The U.S.

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226. Strasburg & Drucker, *supra* note 124.

227. IRS, REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS, <http://www.irs.gov/businesses/small/article/0,,id=148849,00.html> (last visited Jan. 11, 2010); *see also* Reports of Foreign Financial Accounts, 31 C.F.R. § 103.24 (2010).

228. Reports of Foreign Financial Accounts, 31 C.F.R. § 103.24 (2010).

229. Press Release, IRS, IRS Clarifies Requirement for Filing FBAR Form Due This Month (June 5, 2009), *reprinted in* 2009 WLNR 11300061.

230. Orol, *supra* note 124.

231. IRS, INTERNAL REVENUE BULLETIN: NOTICE 2009-62 (Aug. 31, 2009), [http://www.irs.gov/irb/2009-35\\_IRB/ar01.html#d0e25](http://www.irs.gov/irb/2009-35_IRB/ar01.html#d0e25).

232. Strasburg & Drucker, *supra* note 124; Orol, *supra* note 124.

233. *Oldest Swiss Bank Tells Clients to Sell U.S. Assets or Leave*, DAILY BUS. REV., Sept. 9, 2009 (finding that Switzerland’s oldest bank is telling wealthy clients to sell their U.S. assets or leave because of concerns after the UBS v. IRS settlement).

234. Bart, *supra* note 198 (“Switzerland will start assisting foreign states to pursue those citizens that use Swiss bank accounts to evade taxes.”).



government is heavily in debt and sorely needs the \$100 billion in estimated yearly tax losses. The only way for the government to truly fight international tax evasion is by passing legislation that will require offshore banks and securities firms to disclose U.S. accounts. Moreover, offshore tax havens, like the Cayman Islands, need to be held responsible for accounts held by Americans. The *IRS v. UBS* settlement was a remarkable but singular act in the fight against international tax evasion. The United States should do more than file a “John Doe” summons against Cayman Islands hedge funds. It should change the landscape of international banking and investing.