

THE CAYMAN ISLANDS AND UNITED STATES TAX INFORMATION EXCHANGE AGREEMENT: IS IT A SHAM OR ONE-SIDED?

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Introduction

On 27th November 2001 the Government of the United Kingdom, including the Cayman Islands, and the United States signed a new agreement on the exchange of information on taxes (the Agreement)² relating to the Cayman Islands. The timing of the Agreement should not have been entirely surprising, since on 18th May 2000 the Cayman Islands had signed a Commitment Letter to the Organisation For Economic Cooperation and Development (OECD). The Letter committed the Cayman Islands in particular to a programme of effective exchange of information in tax matters. The Agreement with the US, signed at the US Department of the Treasury in Washington DC on the 27th November 2001, is an important step in fulfilling the commitment to the OECD. Further similar agreements between Cayman and certain other OECD members may be anticipated. In response to the Agreement, Robert M. Morgenthau, the Manhattan District Attorney was reported³ as calling the Agreement a sham, at least in part because the Agreement will not come into effect until 1st January 2004. Whereas in fact, the timing conforms to the timetable set by the OECD, of which the United States is a member.

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² The Agreement can be read with press releases <http://www.cimoney.com.ky/>

³ *New York Times*, 8th December 2001, *Manhattan Prosecutor Criticizes Caymans Tax Pact*.

This article examines the Agreement in detail and highlights some of the legal problems that will be raised in its operation. The conclusion is, that far from being a sham, the Agreement is proof that the Cayman Islands take very seriously their role as a leading international financial centre. The Agreement is criticised as one-sided and lacking in procedural safeguards for the United States taxpayer. It is hoped that the Cayman Islands enabling legislation will deal with the issues raised in this article and the points listed in the conclusions.

It is a widely recognised rule⁴ of private international law that one state will not assist in the direct enforcement of a foreign revenue claim.⁵ However, the rule may be overridden by an agreement between states. The Agreement of 27th November 2001 overrides the widely recognised rule. It is right to explain that even when the Agreement comes into effect the Cayman Islands courts will not actually enforce US tax claims. This accords with decisions of the English courts.⁶ Recovery of US tax will remain strictly a matter for the United States courts.

To adopt a phrase used by the Attorney General of the Cayman Islands, the Agreement is not *self-executing*. The Cayman Islands will need to bring into effect local legislation to establish a competent authority under Article 4 of the Agreement, to be called the Cayman Islands Tax Co-operation Authority.

Once local legislation is in effect, the Confidential Relationships (Preservation) Law, (1995 Revision) will not protect the confidential information held, when there is a valid request from the United States and an order from the Tax Co-operation Authority, since the Law states it has no application to the seeking, divulging or obtaining of confidential information – in accordance with this or any other Law.⁷

One-Sided

The agreement is one-sided because the taxes covered in Article 3 are federal income taxes. There are no federal income taxes in the Cayman Islands and therefore it is

⁴ Dicey & Morris, *Conflicts of Laws* (13 Edn Sweet & Maxwell) Rule 3, p.89.

⁵ P. Baker, 'The Transnational Enforcement of Tax Liabilities', *British Tax Review*, 1993, No 5, 313.

⁶ *Government of India v Taylor* [1955] AC 491; *QRS 1 Aps v Frandsen* [1999] 1 WLR 2169 CA.

⁷ Section 3(2)(c) The Confidential Relationships (Preservation Law), (1995 Revision), originally enacted 1976.

only US taxes to which the Agreement applies. The supply of information will be entirely in one direction in favour of the United States.

The Agreement: An Evidence Gathering Mechanism

For the avoidance of any doubt, by Article 1 of the Agreement, assistance shall be provided by the Cayman Islands to the United States through exchange of information at the investigation stage. There is no requirement that there must be a US criminal indictment prior to a valid request being made under the Agreement. The Agreement is an evidence gathering mechanism. Article 6 permits Tax Examinations of persons in Cayman by the United States (probably using The Inland Revenue Service, Criminal Investigation Division IRS CID). Subject to The Cayman Islands Tax Co-operation Authority controlling the conduct of Tax Examinations, the IRS CID will be able to travel to the Cayman Islands and to both interview persons in the Cayman Islands and to examine records held in the Cayman Islands, with the prior written consent of the persons concerned. It remains to be seen whether Cayman law will in the future compel professionals in Cayman to be interviewed about client tax matters whether or not they consent. By Article 5 (4) the United States will be enabled to obtain evidence in the form of depositions of witnesses and authenticated copies of original records admissible in the courts of the United States for the purpose of criminal prosecution in cases of tax evasion.

Banking Information

Under Article 5 (4) the Cayman Islands must ensure that the Cayman Tax Co-operation Authority has the power to obtain information held by banks and other financial institutions and information regarding the beneficial ownership of companies, shares, units in investment funds and, in the case of trusts, information about settlors, trustees and beneficiaries. In accordance with Cayman's anti-money laundering legislation, Financial Services Providers in Cayman are required, as a matter of Cayman law,⁸ subject to certain exemptions, to hold satisfactory evidence of identity of beneficial owners of bank accounts and companies. The evidence of client identity is usually held in the form of certified copy passports. In the case of trusts, there may be examples of Cayman STAR⁹ trusts with US beneficiaries who

⁸ Proceeds of Criminal Conduct Law (2000 Revision); Money Laundering Regulations & Guidance Notes.

⁹ The Special Trusts (Alternative Regime) Law, 1997.

do not have standing to enforce the trust as a matter of Cayman law¹⁰ and may not even know that they are beneficiaries and so could not know of their US tax liability as a beneficiary. It is not clear how that particular problem regarding certain trusts will be dealt with.

Entry into Force

Under Article 12 from 1st January 2004 information can be requested in connection with US criminal tax evasion; from 1st January 2006 it can be requested in connection with the enforcement of US civil tax claims.

Information that relates to earlier tax years: excluded or not?

At the date of writing, it remains uncertain whether requests for information will only be valid if they relate to criminal tax evasion during periods, which commence on 1st January 2004 or later. It is also perhaps not certain whether as part of an ongoing investigation into alleged tax evasion in a tax year after 1st January 2004 there can be a valid request for the production of information and documents that relates back to and includes earlier years.

Criminal Tax Evasion Defined in Article 4

Criminal tax evasion means wilfully, with dishonest intent to defraud the public revenue, evading or attempting to evade any tax liability where an affirmative act constituting an evasion or attempted evasion has occurred. The tax liability must be of a significant or substantial amount, either as an absolute amount or in relation to an annual tax liability, and the conduct involved must constitute a systematic effort or pattern of activity designed or tending to conceal pertinent facts from or provide inaccurate facts to the tax authorities of either party.

The definition lacks safeguards for the taxpayer. The question of whether there has been dishonest intent is a matter that ought properly to be judicially determined prior to the release of information and not by a statutory body or administrative tribunal. The use of the words systematic effort or pattern of activity suggests that the evasion may need to encompass more than one tax year to fall within the definition. If that analysis is correct, then no evasion (as defined) could occur until the tax year of

¹⁰ Supra, Sec 7.

2005. An alleged evasion in the tax year of 2004 may not be sufficient to be treated as a pattern of activity.

What is A Significant or Substantial Amount?

Nowhere in the Agreement is the term *significant or substantial amount* defined. Nor is it clear whether the *significant or substantial amount* test will continue to apply to civil tax matters after 1st January 2006. It is submitted that the test is too vague and requires clarification.

Lack of Safeguards for the US Taxpayer

Taxation is fundamentally concerned with the relationship between the rights of the individual and the rights of the State.¹¹ Where a tax law bites it is not voluntary. The earliest methods of taxation involved no more than a demand for money, backed by the threat of force against the taxpayer or his property if he failed to pay. In modern democratic society, governments legitimise their demands through legislation.¹² Power is a relational matter; here it is a function of the resources controlled by the State as the source of the threat¹³ and the vulnerability of the taxpayer. Tax is peculiarly the creature of statute and as a matter of English law there is no equity in the interpretation of a tax statute.

Lord Wilberforce put the matter in the following terms in 1980:¹⁴

A subject is only to be taxed on the clear words, not on intendment or the equity of an Act.

Equity on the other hand insists on higher standards than those of the market place¹⁵ and concerns the disinterested discharge of obligations of trust and confidence.

¹¹ Shipwright & Keeling, Revenue Law 1997.

¹² Malcolm Gammie, *Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom* in Graeme S. Cooper Ed, 'Tax Avoidance and the Rule of Law' 1997, p.181.

¹³ T.Milburn and K. Watmen, 'On the Nature of Threat 29 (1981)' in Murray, Rau and Sherman, *Processes of Dispute Resolution, The Role of Lawyers*, New York: Foundation Press.

¹⁴ *Ramsay v IRC* [1981] STC 174, 179; [1982] AC 300, 323.

¹⁵ P.J.Millett, *Equity's Place in the Law of Commerce*, (1998) 114 LQR 214.

Whereas, especially in the commercial world, the discharge of a tax obligation is simply a cost of doing business. In Judge Learned Hand's words: *Nobody owes any public duty to pay more than the law demands; taxes are enforced enactments not voluntary contributions!*

In cases of alleged criminal tax evasion; the liberty of the individual may be directly at stake and the issue of justice is raised. Therefore, it is especially important that there should be safeguards for taxpayers where exchange of information (or disclosure of information under compulsory powers) are concerned. Everyone is entitled to have adequate protection for legally privileged documents and information. The protection ought to extend to other professionals, such as accountants, who provide similar advisory services. However, unless the accountant is also a professional legal adviser it would seem that under Article 4 communications with an accountant are not privileged. Furthermore, under Article 4 of the Agreement, *items held with the intention of furthering a criminal purpose are not subject to legal privilege*. As Morritt J commented in *Dubai Bank v Galadari (No. 6)*¹⁶ the original crime (in this case the alleged tax evasion) will not by itself displace litigation privilege.¹⁷ So privilege will apply to legal advice sought from a professional legal adviser in relation to the alleged tax evasion after the crime has been committed. Otherwise, as Lord Denning, MR observed: *No person faced with an allegation...could safely ask for legal advice*.¹⁸ There will need to be a determination of whether the taxpayer had *dishonest intent* when there is a claim of legal privilege in a tax evasion investigation between 1st January 2004 and 1st January 2006; to determine whether criminal tax evasion has occurred and what information and documents may be legally privileged. The relevant intention is that of the US taxpayer. In the United States the US Constitution guarantees due process and trial by jury. Under the common law that applies in Cayman, the issue of the intention of the taxpayer ought to be determined by a jury to the legal standard of beyond a reasonable doubt. Whereas, the Cayman Tax Co-operation Authority is anticipated to be a statutory body exercising administrative authority over persons in Cayman and the US taxpayer and his documents. The intention of the US taxpayer ought to be determined by a jury having been properly directed on the law by a judge and not decided by an administrative tribunal or a statutory body.

¹⁶ (1991) *The Times*, 22nd April.

¹⁷ C. Passmore, *Privilege CLT Professional Publishing*, 1998, p.228.

¹⁸ *Buttes Gas & Oil v Hammer (No 3)* [1981] QB 223 p. 246.

No Fishing Expeditions: But Requests Not Restricted to Matters Concerning Only US Citizens

Under Article 5 clause 5 the United States is required to provide certain basic information including the identity of the US taxpayer under examination or investigation and the name and address of the person in Cayman believed to be in control or possession of the information requested. The taxpayer will need to be identified by name and there can be no fishing expeditions. However, by Article 2 the Agreement also covers information held in the Cayman Islands relating to nationals and residents of third party States, provided always that the request relates to a matter concerning US federal income tax.

Similar Circumstances Test

By Article 7 (4) the United States will not be able to obtain information, which it would not be able to obtain in similar circumstances under its own laws. And by Article 5 clause 5 (f) the US must declare that the request conforms to US law and administrative practice and that the information would be obtainable in the US. Since US Know-Your-Client anti-money laundering legislation does not require US banks and brokers to hold copy passports of beneficial owners because of concerns regarding privacy, it is arguable that the same information would not be obtainable in the US. US banks and brokers generally do not hold that type of documentation because at the time of writing they are not required under US law to do so.

Can the Taxpayer Be Told of A Request? Is There A Right to A Fair Hearing?

Under the Agreement the US taxpayer has no right to be told that there has been a request to exchange information about him and there is no mechanism to challenge that exchange on the grounds, for example, that it would disclose legally privileged documents or confidential information. Nothing in the Agreement requires that when information is exchanged, the US taxpayer be shown the information that has been received and given a full opportunity to explain that information. There is no mechanism to challenge requests for information. Although arguably there must remain a right to apply to the Court for Directions under the Court's inherent jurisdiction or by application for Judicial Review. The fundamental principles of *audi alterum partem* (the right to a fair hearing) and natural justice are breached. The taxpayer ought to be given a reasonable opportunity of making a representation to the Cayman Tax Co-operation Authority when a request is received concerning him alleging criminal tax evasion. In the UK the Human Rights Act 1998 and Art 6 of the European Convention on Human Rights enshrine rights to fairness and equality of arms. The principle of equality of arms involves striking a fair balance

between the parties, in order that each party has a reasonable opportunity to present his case under conditions which do not place him at a substantial disadvantage *vis-a-vis* his opponent.¹⁹ It is submitted that the same principles, whilst not yet enshrined in Cayman law, should nevertheless be persuasive to the Cayman court.

Article 8 requires that information exchange should be kept confidential and should only be disclosed to persons officially concerned with the collection of taxes or the prosecution of criminal tax evasion. In practice, it would seem that the US taxpayer in respect of whom information is exchanged may not be told what information has been obtained about him (or the source of that information) unless the information is actually used in a US court against him. That will make it very difficult for the taxpayer to provide an explanation for the information. There have been examples of investigations where tax authorities have identified the wrong person: the taxpayer may need to spend time and money dealing with the investigation when, had he been told at an early stage what information was held about him, he could have shown very quickly that the information related to another person but of a similar name.

Proceeds of Criminal Conduct Law (Pccl) (2000 Revision): The Horns of A Dilemma?

The alleged evasion of US federal income taxes will not by itself be a reportable offence under the PCCL. However, the question of whether the taxpayer may be informed that there is a request for information under the Agreement, is further complicated in the event that the Cayman Financial Services Provider (FSP) has a suspicion that the US taxpayer might have also committed an offence that would have been an offence had it been committed in Cayman and meets the dual-criminality test. In such circumstances the PCCL requires that the FSP make a report²⁰ regarding the suspicion of the crime (but not the tax evasion) to The Reporting Authority. The taxpayer must not be informed of the report under the PCCL since that might constitute the offence of tipping-off.²¹ However, arguably the taxpayer might still be told of the request from US authorities to the Cayman Tax Co-operation Authority without being told of any report being made under the PCCL. There is nothing in the Agreement that restricts information requests to investigations that are pure tax matters. However the Agreement ought not to be used to investigate other criminal activity or to short-circuit the well-established

¹⁹ Tim Otty, *Money Laundering and Human Rights*, NLJ 4th May, 2001, p.634.

²⁰ PCCL Sec 27.

²¹ *Supra* Sec 25 (1).

procedures in the MLAT²² agreement between Cayman and the United States.

Disclosure to Third Parties

By Article 8 (4) information provided to the United States may not be disclosed to any third party. However, the confidentiality imposed under Article 8 (4) appears to conflict with the decision of the United States Federal Court of Appeal – affirmed by the US Supreme Court – in the *Burbank* case, *US v A L Burbank & Co* (1976) 525F 2d 9 and (1976) 96 S. Ct. 2647. In *Burbank*, information was sought by the US IRS to pass on to the Canadian Revenue under the terms of a Double Taxation Agreement – no US tax liability was in issue – the US courts held that the information could be obtained for purposes of exchange alone.²³ Furthermore, once documents are in the US, there would seem to be nothing to prevent a third party obtaining copy documents by serving a grand-jury subpoena - as has been shown in recent litigation between the US and the French bank *Credit Lyonnais*.²⁴

Safeguards Undermined?

It is submitted that the words used in the last part of Article 9 undermine safeguards for taxpayers. By Article 9, the rights and safeguards secured to persons are unaffected, unless those safeguards act as impediments to access to the information. However, safeguards will almost always act as impediments to access to the information. So there is a real danger of the existing safeguards being fundamentally undermined.

Costs

Whilst there is provision in Article 10 for the reimbursement of direct out of pocket costs of the Cayman Islands Government as a party to the Agreement, including costs of litigation, there is no explicit provision to reimburse the costs incurred by Cayman banks, law firms and financial service providers or US taxpayers. Many

²² The Mutual Legal Assistance (United States of America) Law (1999 Revision) originally enacted 1986.

²³ P. Baker, *Double Taxation Conventions and International Tax Law* 2nd Edn, Sweet & Maxwell, para 26-03.

²⁴ *Wall Street Journal* 6th Sept 2001. At issue is a document that the French government supplied on the basis that it would not be shown to the US Justice Department – it has been.

documents may need to be examined and the names of unconnected persons will need to be redacted. It is submitted that these costs cannot simply be absorbed by the private sector. There should be a mechanism whereby US authorities requesting the information should directly or indirectly bear the true costs of providing the information. After all, since valid requests must meet the significant or substantial amount test – there should be no difficulty for the US authorities in bearing the costs.

Conclusions and Suggestions

The Cayman Islands will need to bring into effect local legislation to establish the Cayman Islands Tax Co-operation Authority and bring the Agreement into practical operation by 1st January 2004. It is submitted that the law under which the Tax Co-operation Authority is established should provide:

- A judicial mechanism to determine whether any of the information requested is legally privileged.
- A judicial mechanism to determine whether criminal tax evasion (as defined) has occurred by the determination of whether there has been *dishonest intent* by the taxpayer.
- A clear statement of what is a *significant or substantial amount* within the definition of criminal tax evasion.
- A mechanism for the taxpayer to be informed of the request and to be given the opportunity to challenge the request.
- That the costs of dealing with requests and any associated litigation be reimbursed to Cayman financial service providers, directly or indirectly by the United States.
- Clarification that in no case may a valid request be made under the Agreement to the Cayman Tax Co-operation Authority for information relating to tax years prior to 1st January 2004.
- Clarification that persons in Cayman, unless they consent, will not be required, as a matter of Cayman law, to attend US IRS Tax Examinations relating to US taxpayers.
- Explicit protection under the law, should be given to Cayman financial service providers, from any civil liability for breach of contract or breach of confidentiality owed to a client, as a consequence of providing

information pursuant to a legal Order from the Cayman Tax Co-operation Authority.

Take Professional Legal Advice

US taxpayers with interests in Cayman have the opportunity to put their tax affairs in order before the Agreement takes effect and those US taxpayers who may have concerns, should take professional legal advice. One is left wondering however, whether the Cayman law will provide sufficient certainty prior to 1st January 2004, to enable full advice to be given.