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OPINION

Crypto's Tax Shelter Problem

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Playing hide-and-seek from tax havens is hardly a new game, but for blowup-prone crypto companies and investors, it's an increasingly problematic one. (Part of the crypto column series.)

By Leah McGrath Goodman   January 11, 2023

Among the many stunning statements made by FTX's chief executive, John J. Ray III, shortly before the arrest of Sam Bankman-Fried, the disgraced founder and ex-CEO of the bankrupt Bahamas cryptocurrency exchange, one stood out: "Mr. Bankman-Fried, whose connections and financial holdings in the Bahamas remain unclear to me, recently stated to a reporter on Twitter, 'F--- regulators, they make everything worse,'" Ray observed in a declaration to the U.S. Bankruptcy Court for the District of Delaware.

Then came the kicker: Bankman-Fried, ensconced in his princely Bahamas digs, cursing the regulators, had "suggested the next step for him," according to Ray, "was to win a jurisdictional battle versus Delaware."

In other words, Bankman-Fried, the 30-year-old crypto wunderkind from California accused by U.S. authorities of money laundering, defrauding customers and lenders, committing securities and commodities conspiracy, and violating campaign-finance laws, seems to have been under the impression that he might sidestep U.S. agencies, regulators, and law enforcement from his beachy tax shelter idyll.

He appears to have been mistaken. But the story of FTX is just the latest flashpoint in a litany of crypto controversies over the past few years in which the financial secrecy of tax shelters has featured prominently.

The now-defunct hedge fund Three Arrows Capital was based in Singapore, but last year it registered in the British Virgin Islands as its founders infamously plunked down $50 million for a 170-foot yacht — christened the "Much Wow" — while the fund slid into bankruptcy. Before the FTX debacle, one of the biggest cryptocurrency flameouts of 2022 erupted when the price of Terra's Luna token spiked, then dropped to nearly zero, with its creator, Terraform Labs, operating from the popular crypto tax shelter of South Korea.

Playing hide-and-seek among crypto's toy villages, in fact, has become a hallowed pastime. Tether and its Bitfinex cryptocurrency exchange, charged by the U.S. Commodity Futures Trading Commission with serious regulatory violations and forced to pay tens of millions in civil fines in 2021, is owned and operated by iFinex, based in Hong Kong and registered in the British Virgin Islands. Meanwhile, Binance also dodged questions for years about exactly where it was based, with many believing it was in Malta before it was revealed that the crypto exchange was registered in the Cayman Islands. (When asked directly at a conference where his company was based, Binance's co-founder and CEO, Changpeng Zhao, refused to say, quipping, "This is the beauty of blockchain, right, so you don't have to … like, where's the Bitcoin office, because Bitcoin doesn't have an office.")

The list of offshore crypto cataclysms traces as far back as crypto itself. However, FTX may be the worst yet. FTX was set up as an exchange in Hong Kong in 2019 before moving on to the Bahamas in 2021. But its holding company, FTX Trading Ltd., was based in St. John's, the capital of the Caribbean twin-island nation of Antigua and Barbuda, which declined to give FTX a trading license, citing regulators' failure to understand FTX's business model. Late last year, Antigua and Barbuda's prime minister, Gaston Browne, said that denying FTX a trading license had "spared us some embarrassment." All of these places are renowned crypto tax havens. Bankman-Fried's arrest on December 12 by the Royal Bahamas Police Force and extradition to the U.S. on December 21 — the darkest day of the year, in daylight hours and, arguably, for crypto — was an unqualified shambles. Astonishment gripped the courtroom as Bankman-Fried, his hands shaking, demanded to see the federal indictment against him before consenting to his extradition. His Bahamian lawyer expressed abject shock that his client had somehow managed to emerge from jail to make an unexpected public appearance. Initially, Bankman-Fried and his legal team indicated that he would resist extradition, as Bahamian and U.S. authorities wrangled over who would take charge of the mess and FTX's sprawling crypto assets.

That tug of war is far from over, as authorities, both onshore and off, struggle to disentangle FTX's assets from customer funds following the November collapse of Bankman-Fried's $32 billion crypto empire. Bankman-Fried returned to the U.S., where the Federal Bureau of Investigation took him into custody, but by the new year he was already out on bail and cloistered at his parents' Palo Alto, California, home, under house arrest, chatting up the likes of best-selling author Michael Lewis, doing interviews with journalists and crypto influencers, and, according to Ray, continuing to make “erratic and misleading public statements” about how his company went pear-shaped and who is to blame.

Last week, Bankman-Fried pleaded not guilty to all eight counts of the U.S. criminal charges leveled against him. A trial has been set for October. The Securities and Exchange Commission and the Commodity Futures Trading Commission also brought charges, with the SEC accusing him of defrauding investors and customers alike, and the CFTC alleging his actions led to the estimated loss of $8 billion of customer deposits. High-level executives at FTX who worked closely with Bankman-Fried have pleaded guilty to federal criminal charges in connection with the FTX collapse and have agreed to cooperate with prosecutors as key witnesses to the alleged crimes. If convicted on all charges, Bankman-Fried faces up to 115 years in prison.

With the indefatigable Bankman-Fried girding for a fight and FTX’s records spotty at best, this case may drag on for years. Ray, an insolvency lawyer who’s worked on some of the largest corporate failures in history (from Nortel Networks to Enron), has called the FTX bankruptcy “unprecedented” in his 40 years of legal and restructuring experience, citing “a complete failure of any internal controls or governance whatsoever.” Records were so horrendous at FTX, he told lawmakers during his December congressional testimony, that “we are, in many respects, starting from near-zero in terms of the corporate infrastructure and record-keeping that one would expect to find in a multibillion-dollar international business.”

The scope of the investigation is enormous, with Ray assembling a team of forensic analysts, investigators, tax consultants, and cybersecurity experts to track money flows and asset transfers among FTX’s convoluted web of entities spanning the globe, which Ray said comprises billions of individual transactions and dozens of terabytes of data. With the FTX companies located in so many far-flung places, his team is especially focused on cross-border recoveries, protecting digital assets against the risk of theft and unauthorized transfers while also maximizing the value of the assets recovered for FTX investors and customers. “We are working around the clock to locate and secure the property of the estate, a substantial portion of which may be missing, misappropriated, or not readily traceable due to the lack of proper record-keeping,” he said.

The combination of crypto — a word literally derived from the word “crypt,” meaning “secret” or “hidden” — and tax shelters, which offer financial secrecy, tax optimization, and, as often as not, questionable legal malleability for the right price, proves a toxic brew when crypto companies go under. Regulators are loath to admit it, but it’s a near-impossible task to unwind the Gordian knot. “It’s going to take well over a decade to clean this mess up,” James Angel, an associate professor of finance at Georgetown University who specializes in global financial markets, told *Institutional Investor*. “While a lot of people are trying to follow the rules, some will go to the jurisdictions where the regulators will ask the fewest questions, whether you are running an illegal tax shelter or an almost-legitimate crypto scheme.”

In the case of FTX, the November bankruptcy filings showed 134 entities and affiliates based in tax havens such as Delaware and South Dakota, but also low-to-no-tax secrecy jurisdictions across the globe, including the British Virgin Islands, Antigua and Barbuda, the Bahamas, the Cayman Islands, Panama, the Seychelles, Turkey, Nigeria, Australia, Singapore, South Korea, Japan, Hong Kong, and others.

FTX's entities had highly complex ownership structures and were deeply intertwined — so much so that when Bankman-Fried signed over control of what he called FTX's "top companies" to Ray as FTX's new CEO, the spelling of the name of one of the seven entities didn't match the spelling in other documents filed (the entity appeared as Cedar Grove Technologies Services Ltd. on Bankman-Fried's signing page and as Cedar Grove Technology Services Ltd. in the corporate ownership statement). While there's nothing inherently suspicious about a misspelling, it shows just how jumbled the list of even FTX's top companies got.

When grouped into four silos representing FTX's main business lines, all were controlled by Bankman-Fried, Ray stated in his declaration to the U.S. Bankruptcy Court. The fact that this intricate hierarchy, carefully traced, leads back to Bankman-Fried and his inner circle of colleagues — many of them living offshore in a luxury resort together with their hands on the levers — highlights why the secrecy of crypto and tax shelters, taken together, is a dangerous pairing. "FTX Group's collapse appears to stem from the absolute concentration of control in the hands of a very small group of grossly inexperienced and unsophisticated individuals who failed to implement virtually any of the systems or controls that are necessary for a company that is entrusted with other people's money or assets," Ray told lawmakers in his testimony.

Each of FTX's four lines of business, Ray explained, are embroiled in the quagmire. They are: FTX U.S., a spot trading and digital asset exchange serving an estimated 1 million American users; Alameda Research LLC, FTX's crypto hedge fund, which claimed assets of $13.5 billion at the end of September (this figure Ray does not trust, as FTX's records were poor); FTX entities Clifton Bay Investments LLC and FTX Ventures Ltd., which housed private investments totaling more than $2 billion at the end of September (another figure Ray said he does not trust, as some records are missing); and FTX's Bahamas digital asset trading platform and exchange, run by FTX Trading Ltd., based in St. John's in Antigua and Barbuda.

While details remain scant, Ray's early findings show that the Bahamas-based cryptocurrency exchange, operating offshore under the brand name FTX.com, was behind much of the trouble, dipping into billions of dollars of customer funds to be used for discretionary trading and investments by FTX's crypto hedge fund, Delaware-based Alameda Research, founded in 2017 and FTX's original entity. Both were controlled by Bankman-Fried, according to Ray, with transactions involving nearly 500 investments from FTX funds and assets lacking complete documentation.

As is well known across Wall Street, taking customers' funds without their permission or knowledge is a third rail for any financial firm. It can not only permanently ruin one's career, but also lead to a lengthy prison sentence, such as the one Bankman-Fried is now facing. FTX, under the direction of Bankman-Fried, is accused of commingling customer money with FTX's own corporate funds for years, with Alameda "borrowing" funds held at FTX.com, according to Ray, "to be utilized for its own trading or investments without any effective limits." This is how one of the world's largest cryptocurrency exchanges left an estimated 1 million creditors around the world facing billions of dollars in losses.

“The scale of the misuse of customer funds here is unprecedented,” says Campbell Harvey, a professor of finance who specializes in blockchain and decentralized finance at Duke University. “Because so much of it is a paperless trail, it’s extremely difficult to do the forensics on this. This is offshore, so there’s basically no oversight, but it’s not necessarily an issue of being offshore as much as it being opaque.”

Throughout the bankruptcy proceedings, Ray made no secret of his distrust of Bahamian authorities, much to their chagrin. His references to Bankman-Fried’s “connections” and “financial holdings” in the Bahamas in his declaration to the U.S. Bankruptcy Court was a tacit acknowledgement of his understandable concern that Bankman-Fried’s erstwhile billions may have had some sway over the island nation’s authorities and regulators. Indeed, the Bahamian authorities received information as early as November 9, two days before FTX filed for bankruptcy in the U.S., about FTX’s commingling of customer funds when the former co-CEO of FTX Digital Markets, Ryan Salame, told Christina Rolle, executive director of the Securities Commission of the Bahamas, during a phone call that customer funds were being used to “cover financial losses of Alameda,” according to a court filing. But Bankman-Fried’s arrest in the Bahamas took place more than a month later, only after the U.S. attorney for the Southern District of New York shared a sealed indictment with the Bahamian government.

The Securities Commission of the Bahamas suspended FTX Digital Markets’ license and, reportedly with Bankman-Fried’s assistance, seized the Bahamas-based exchange’s digital assets, consisting of FTX tokens, Ethereum, and other cryptocurrencies. The Bahamas regulators valued the haul at $3.5 billion in mid-November, but FTX’s new leadership in the U.S. issued a statement last week claiming the amount had somehow shrunk to $167 million, based on spot prices of the assets, and did “not have substantial value.” FTX’s leadership demanded that the Securities Commission of the Bahamas “clear up any confusion created by their recent statements and provide the public with accurate information concerning the cryptocurrency seized and how it was valued.”

It is worth noting that Bahamas-based FTX Digital Markets was one of the only solvent subsidiaries of the Antigua-based FTX Trading Ltd. holding company at the time of FTX’s November bankruptcy filing — hence the tussle between the Bahamas and the U.S., both of which are jockeying to protect billions of dollars of customer funds and assets.

This is one of the great drawbacks of using an offshore crypto exchange, warns Duke’s Harvey. While offshore hedge funds and other firms cater to high-end clients who can afford to do their due diligence, exchange investors and customers may not have the same luxury. “If you’re a customer investing in an offshore, unregulated exchange and there’s no insurance, no protections, why would you want to take that risk?” he says.

Mounting tensions between the U.S. and the Bahamas came to a head amid hacks and the theft of hundreds of millions of dollars at FTX as it filed for bankruptcy, with Ray accusing the Bahamian regulators of violating U.S. bankruptcy procedures and the Securities Commission of the Bahamas complaining that Ray’s public comments had “the impact of promoting mistrust of public institutions in the Bahamas.” The two sides finally came to a détente at the end of last week, agreeing to cooperate to maximize the recovery of assets for investors, exchange customers, and other stakeholders. While the deal was subject to the approval of both the U.S. Bankruptcy Court and the Supreme Court of the Bahamas, Ray said it provided a “path forward” to resolve outstanding differences, although “there are some issues where we do not yet have a meeting of the minds.”

This week, FTX's lawyers told the judge presiding over the Delaware bankruptcy that more than $5 billion of cash and other liquid assets have been located at FTX, with the company also planning to sell more than 300 other non-strategic investments worth an additional $4.6 billion. The assets reflect a book value dating back to FTX's bankruptcy filing in November, so may be subject to change. They are also separate from an estimated $425 million of assets held by the Bahamian authorities, FTX's lawyers said. How much all of it will be worth by the time the liquidations and fire sales have been completed is anybody's guess.

All of this is to be expected when so many tentacles of a crypto empire reside offshore. Considering how much was hidden from view, Georgetown's Angel argues that if Bankman-Fried had made a killing offshore via FTX, minting billions instead of losing them, it's possible no one would have been the wiser.

"As an engineer from a tech school myself, I can kind of sympathize with a bunch of people from very sharp schools who think they know everything," Angel says. "The problem even smart people have is they don't know what they don't know. These guys were moving so fast, no one was looking over their shoulder. If Sam Bankman-Fried's bets had worked out, he would have been hailed as a visionary."

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