

Project

Economic Crime and Money Laundering

Subject: Money Laundering and Investments from Offshore Companies (Banking and Financial Sector, Real Estate Operations).

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Introduction

The Criminal Code of Georgia, article 184, provides the following definition of money laundering: “legalization of illegal income, or giving a legal form to money or property, as well as the concealment of a source, place, allocation, movement, identity of the real owner or proprietor of the property, or concealment of proprietary rights.” The Code does not specify specific types of criminal activities known for generating illegal resources and encompasses all types of illegal income.

Offshore zones are among the most important elements used for money laundering purposes. Offshore zones are a part of any country with low taxes, a strict regime of bank secrecy and classified commercial information, minimal reserve requirements of a central bank, and the absence of restrictions on currency exchange. Apart from that, as a rule, offshore zones have simplified procedures for registration and licensing of juridical entities and financial companies.

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In some of the offshore zones the level of protection of bank secrecy and classified commercial information is so strict that authorities refuse to disclose secret information even in cases of serious violations of the laws of other countries.

Because of these conditions, juridical entities are created or purchased in such offshore zones, which formally represent independent subjects of commercial transactions, though actually they are under the full control of specific individuals (in our case, under the full control of Georgian citizens). Confidentiality of their owner is achieved through the mechanism of nominal ownership of stock. During registration of a company, only the name of its nominal owner is recorded, while the identity of the actual owner is not subject to disclosure.

Chapter 1. History of the Topic

The main objective of this paper is to study the activities of offshore companies on the territory of Georgia. The development of the principles of free market economy, revocation of state monopoly on the means of production, and the recognition of private property as the principle basis for economic relations, affected Georgia in a number of ways. However, in combination with a weak legislative base, the inability of the law enforcement to combat economic crime, and drug trafficking through Georgia, the aforementioned changes created a favorable environment for money laundering and offshore investments.

One important factor is the existence of a stable banking sector in Georgia, which could easily be used for allocation of illegal cash into banking channels, as well as for further transfer of these resources to various parts of the world. Moreover, in Georgia, one could perform such operations without violating the law, due to insufficient legal restrictions and uncoordinated work by the state's controlling institutions. It is important that the use of offshore companies in this sector might be facilitated by the requirements for the amount of capital of commercial banks. In Georgia, there are no limitations for opening and operating bank accounts by offshore companies. Cash transactions simplify the concealment of income and allocation of illegal money into banking channels, often making it impossible to control the flow of monetary resources.

Georgia provides fertile ground for offshore investments in the real estate sector. Purchasing real estate does not oblige offshore companies to identify their owners, or to register in state tax institutions. This often hinders the process of data collection on investments and property purchased by such companies. Moreover, there are no restrictions on the purchase of securities, including stock, in cash payments.

Detection and analysis of the conditions facilitating offshore investments, along with reasons for the uncoordinated cooperation between Georgian state institutions, constitute the topics of this study.

Chapter 2. Methodology

The General Administrative Code, currently in force in Georgia, enables the collection of information on the activities of the offshore companies. Particularly useful are articles 16, 27 and 50 of the Code, which envisage accessibility and transparency of the information that state institutions possess.

For this study, meetings and dialogues were conducted directly with the employees of those organizations which have or should have had specific information pertaining to offshore companies. On the basis of the collected information, the legislative base that supports or enables relevant state institutions not to collect or collect insufficient data on performed offshore investments has been examined. The analysis of the legislative base was necessary in order to identify the organizations responsible for the collection of certain information, which, in reality, they do not collect. The most difficult problem was the delays of state institutions in providing relevant information. Efforts to avoid the disclosure of information were common.

It was not much easier to overcome the inexperience and incompetency of the employees of these institutions in regards to the topics of the study. Sometimes they simply did not understand the meaning of different requests. The reasons for such incompetence were related primarily to the unavailability of relevant training and the lack of special legislation in the field of offshore investments and money laundering.

The main shortcoming of this methodology is the collection of primary data by other people. Thus, the risk always existed that the data would be distorted. This might be explained by the negligence and corruption on the part of the public officials.

Chapter 3. Outline and Analysis of the Problem

თქვე მან გოალ ოფ ტპის სტუდუ ის ტო იდენტოფუ ტპე აცტუალ ვოლუპე ოფ ოფფსპორე ინვესტმენტს ინ ტპე ეორგიან ეცონომუ, ტპე მეტპოდს ოფ მაკინგ სუცპ ინვესტმენტს ანდ ტპე ფაცტორს ფაცილიტატინგ ორ პრევენტინგ ტპემ.

ნ ინვესტიგატიონ ოფ ტპე ვოლუპე ოფ ოფფსპორე ინვესტმენტს წოულდ გივე უს ან იდეა აბოუტ ტპე სპარე ოფ ილლეგალ მონეე ტურნოვერ (პიდდენ ტახეს ანდ რესოურცეს ოფ ცლეარლე ცრიმინალ ორიგინ) ინ ტპე ცოუნტრუ; ი.ე. ტპე სპარე ოფ მონეტარუ რესოურცეს აცცუმულატედ ტპროუგპ ილლეგალ ოპერატიონს ინ ტპე ეორგიან ეცონომუ.

This information would also enable us to see whether or not black money, invested via offshore companies, creates opportunities for seizing economic levers and pressuring political authorities. Therefore, the practical importance of this information is multifaceted.

Guided by the assumption that the banking and financial sectors are of crucial importance for legalizing black money, the owners of such resources often try to gain control of banking institutions. This provides them with an opportunity to allocate illegal cash or other criminal resources to bank accounts more safely and then legally transfer them abroad to corresponding accounts. This is all the more profitable due to the fact that interest rates in Georgia are high, on average 25 to 30 percent annually.

The most effective legal way to gain control over banking institutions is to hold a controlling amount of shares. This enables the owner to recruit appropriate staff for the bank's management. But current legislation prohibits one shareholder or a group of shareholders operating jointly, to hold a share exceeding 25 percent for commercial banks (Law "On Commercial Bank Operations", article 10). This means that no one has the opportunity to gain full control of a banking institution alone or through subordinated juridical entities. In accordance with article 1 of this law, the term "a group of partners (shareholders) operating jointly" is interpreted as a group of close relatives/partners or shareholders connected by mutual commercial interests.

It is here that fertile ground for offshore investments is created. Any person interested in having full control over a bank may purchase additional stock through an offshore company. This is performed through the purchase of a registered offshore company, or by the registration of a new one. The advantage of such an operation is that the identity of the actual owner of an offshore company is, as a rule, strictly confidential, and only the names of nominal owners can be disclosed to the public.

Information provided by the Banking Supervisory Administration states that in accordance with the data of the Banking Supervisory Administration of the National Bank, offshore companies own shares in 5 of the 25 commercial banks currently operating in Georgia.

This constitutes 4 percent of the total assets of the sector. The greatest share, 50 percent of two banks, JSC “Georgian Bank” and JSC “Bank Georgian Capital,” is owned by juridical entities registered in the Marshall Islands. A company registered in the offshore zone of Dutch Antilles holds 22 percent of the JSC “TBC Bank.” Another offshore company owns 24 percent of the JSC “Georgian Public Bank.” (Former “Agrobank”) At present, the management of the Banking Supervisory Administration, (Head of the Administration M.Kikoria and the Deputy head M. Chlaidze) cannot specify the territories where juridical entities are registered, and despite an official request, the “Public Bank” has not yet presented relevant documents to the National Bank. A juridical entity registered in the offshore zone of Liechtenstein owns 6 percent of the commercial bank JSC “Silk Road.” According to the existing data, juridical entities registered in the US Virgin Islands, do not own shares in Georgian banks. However, the Banking Supervisory and Regulatory Administration of the National Bank of Georgia collects data only about the owners of shares that are greater than 5 percent, in accordance with the Law “On Commercial Bank Operations”, article 3, point 1, sub-point “e,” and the Order 84 of the President of the National Bank of Georgia, dated September 10, 1998. Thus, we may assume that some unidentified offshore companies might possess less than 5 percent of shares in Georgian banks.

The Banking Supervisory and Regulatory Administration has mentioned in its letter that it does not have an official list of offshore zones and that it uses the document of the International Monetary Fund, dated March 14, 2003, in which 36 countries are included in the list of offshore financial centers. Unfortunately, an official list of offshore zones does not exist in Georgia and the National Bank of Georgia possesses no such document, while central banks of other countries, including the Central Bank of Russia, have standard acts of this type. Decree number 500 of the Central Bank of Russia, dated February 12, 1999 includes a list of 48 offshore countries and territories.

The absence of a standard act identifying offshore zones was also confirmed by the Ministry of Justice of Georgia, which is legally responsible for the registration of all standard acts in Georgia. (the law “On Standard Acts”) The lack of an official list of offshore zones complicates the identification and registration of investments from these zones.

It should be noted that the document of the International Monetary Fund, dated March 14, 2003, includes an evaluation of the situation in offshore zones globally and differs significantly from the FATF data, dated February 14, 2003, on those countries and territories that avoid cooperation in anti-money laundering activities. The FATF list is limited to 10 countries, including Cook Islands, Egypt, Guatemala, Indonesia, Mtangari, Nauru, Nigeria, Philippines, St.Vincent and Grenadines and Ukraine. The list is focused on countries providing favorable conditions for the legalization of “black money,” due to a weak legislative base and insufficient state control.

For this paper the issue of credit unions was also researched. The law on non-banking deposit institutions, or credit unions, was passed by the Parliament of Georgia on July 4, 2002. In accordance with article 1 of this law, these financial institutions are established in the organizational and legal form of cooperative societies and their shareholders can only be physical entities. Because of this, offshore companies are unable to invest in this sector.

Offshore investments in the real estate sector of Georgia were also investigated. It is well known that the purchase of real estate can be one of the final stages of money laundering, when criminals and their accomplices privatize real estate; but juridically, such purchases might be registered under the name of an offshore company.[1]

In order to obtain general data on the offshore companies operating businesses on the territory of Georgia, a request was sent to the State Department of Statistics, which in accordance with article 14 of the law “On Statistics,” # 1071, dated November 12, 1997, is responsible for a

Unified State Register of enterprises and organizations that would contain data on all juridical and physical entities engaged in public or entrepreneurial activities on the territory of Georgia. According to the reply from the State Department of Statistics, dated May 23, 2003, in the Unified State Register database of enterprises and organizations, there were no companies registered in offshore zones, including the US Virgin Islands.

This reply from the State Department of Statistics might mean that offshore companies do not operate on the territory of Georgia, or that they operate in our country without relevant registration in the statistical institutions. The first assumption is unreasonable since we have already seen that they own more than 4 percent of stock just in the banking sector, with 50 percent ownership of some banks. Offshore companies are shareholders in the leading banks of Georgia (e.g. TBC Bank) which produce significant annual profit and distribute dividends to their shareholders, including offshore companies. Profit gained in the form of dividends is subject to taxation, in accordance with the Tax Code of Georgia. Therefore, these companies should be registered in the revenue institutions of Georgia, in accordance with the Tax Code of Georgia and Order 155, article 6, of the President of Georgia, dated April 7, 2002. These legislative documents oblige all taxpayers to obtain an identification number and to register with the revenue services. In order to be registered, all juridical and physical entities, engaged in economic activities, must submit a certificate of registration to the Unified State Register of the State Department. Therefore, the lack of such information in the statistical organizations proves that offshore companies operate in Georgia without necessary registration.

The Tax Department of the Ministry of Finance of Georgia also confirmed that they do not have any data about offshore companies; i.e. these companies are not registered with any tax organizations. One can conclude that offshore companies operate in Georgia and gain profit (a

fact that the data of the Supervisory Service of the National Bank of Georgia confirms), but neither the statistics nor the tax departments know about it.

In accordance with the Civil Code of Georgia, articles 183 and 311, the registration of proprietary rights on real estate is the responsibility of the Real Estate Public Register. The data about the volume of the property owned by juridical entities registered in offshore zones was requested from this Register. However, in its reply the Public Register claimed that it possesses no such data. In a conversation, the staff of the Public Register explained that they only have data on the owners of certain lots of real estate and not on the types or sizes of real estate owned by juridical entities. This answer does not mean that offshore companies do not own real estate in Georgia; it simply reflects the inadequacy of the registration system.

It should be mentioned, that in accordance with the current Georgian legislation, farming land can only be owned by Georgian citizens or a juridical entity registered in Georgia. (Law “On Ownership of Farm Land”, article 4, June 14, 2000) Thus, farm land could be considered secure from offshore investments. Non-farming land and other types of real estate are not subject to the abovementioned legislation. Although, in accordance with the law, Georgian citizens and Georgian juridical entities were awarded exclusive rights to the ownership of non-farming lands (the Law “On Privatizing Non-farming Lands that are Used by Physical Entities and Georgian Juridical Entities,” and “On Management and Allocation of State Owned Non-farming Lands,” article 11, October 28 1991) However, there are no restrictions on transferring the ownership of the property, and property could easily be donated to juridical entities registered in offshore zones. This is made possible by the law “On Land Registration,” article 2, item 3, dated November 14, 1996.

In accordance with the Civil Code of Georgia, article 183, notarization is required for the transfer of real estate ownership. This means that in order to purchase real estate in Georgia,

offshore companies have to use the services of notaries, which report to the Ministry of Justice and the Notary Chamber of Georgia. Both institutions were approached for information on real estate purchases by offshore companies. In response it was stated that these two institutions do not receive information on physical and juridical entities participating in real estate deals (see Appendices 2 and 6). Thus, neither of the institutions possesses any information about deals made by offshore companies via notary services, or about the worth of the real estate purchased by these companies.

In the letter of the Notary Chamber of Georgia, dated July 9, 2003, it is mentioned that the Chamber receives information submitted by notaries on the number of monthly notary acts and on the fees for performing these acts. The notary fee for the registration of a real estate purchase and sale is calculated from the price of the purchase/sale. However, it should be emphasized that in reality, the purchase/sale agreement almost never reflects the actual cost of the property. This could be explained in the following way: in accordance with the law “On Fees for Performing Notary Acts,” article 5, the cost of a notary act is calculated on the basis of the cost declared by both of the sides of the deal. The mechanism to determine the actual cost is not in place. Such conditions make it easy for interested persons to deliberately register a much lower price during the purchase of real estate.

It should also be mentioned that in accordance with article 36 of the “Rules of Performing Notary Acts,” while authorizing a transaction involving a juridical entity registered abroad, a notary can request documentation about the registration of the said juridical entity. This means that offshore juridical entities should be identified and registered during real estate transaction. Unfortunately, this rule has certain shortcomings. A notary is not obliged to request, from a juridical entity registered abroad, documents proving their registration in the Tax and Statistics Department of Georgia. This enables offshore juridical entities to purchase real estate without

registration in these institutions and accordingly, without registration of their economic activities in Georgia. This happens despite the fact that the purchase of real estate implies levying property taxes on these entities, while non-obligatory registration of these entities in revenue services allows them to avoid paying taxes. The same applies when offshore companies purchase stock of a juridical entity. As it was already mentioned, notaries do not present data to any of the state institutions about the deals made by offshore companies with notary participation.

As stated before, in Georgia there are no limitations on purchasing property or services in cash. Order 667, of the President of Georgia, has ruled the statement of the Cabinet Council of Georgia, dated June 14, 1994, “On Management of Cash Desk Service in Administrative Bodies, Enterprises, Organizations and Institutions of Georgia,” to be unconstitutional. The latter envisaged a ban on payments made in cash between juridical entities (article 1.3 of the Statement) except in the cases outlined in standard acts. Since that period, payments in cash between juridical entities are not subject to restrictions on the territory of Georgia. Thus, by paying in cash during the purchase of property, a juridical entity might not leave any evidence of the actual amount of cash paid.

The above assumptions were confirmed by notaries from various cities of Georgia, in particular, by a notary from Batumi, Khatuna Kalandarishvili and a notary from Tbilisi, Nino Gakhokidze.

It is interesting that in accordance with the Georgian law “On Support of Investment Activities and Grants,” dated November 12, 1996, foreign investors are obliged to register an investment that they have made in Georgia, but the law does not envisage actual sanctions for unregistered economic activity by foreign investors in Georgia. In accordance with article 6 of the abovementioned law, a Georgian Investment Center was established at the Ministry of Trade and Foreign Economic Relations with one of the functions of “Identifying Foreign Countries and

Companies Operating in Georgia.” (article 6, item “e” of the law) The agency has stated that it does not have information on investments and commercial activities of offshore companies on the territory of Georgia; though, presumably this agency is required by law to have such information. In accordance with order 5, dated January 12, 2001, a juridical entity of public law, with the same goals and objectives, was established at the Ministry of Foreign Affairs of Georgia (article 3 of the mentioned order), but this institution does not operate at all.

Apart from the institutions mentioned above, necessary information was requested from the Customs Department of Georgia and the Chamber of Control of Georgia. The Chamber of Control claimed that it did not have the requested information, while Mr. L. Chanturishvili, the chief lawyer of the Revision Department of the Chamber of Control stated that his organization also did not have such information.

Conclusions

This paper proves that today conditions for money laundering through offshore investments in Georgia are rather favorable. The research demonstrated that such investments have taken place within the banking sector and this information was more or less known to the supervisory agencies. However, investments made by such companies in other sectors are left beyond the state’s attention. Moreover, supervisory agencies do not possess information about the size and intensity of these investments. Authorities know nothing of the type of economic activities of offshore companies as well. Thus, at a first glance, an illusion is created that such activities do not take place at all. Inconsistency between the data obtained from the National Bank, National Investment Agency, the Department of Statistics and the Tax Department make it clear that such activities do indeed take place. On the basis of the surveyed materials, the following conclusions can be made:

1. Georgia does not have a legislative base for regulating investments from foreign and/or offshore companies that would not only monitor their activities, but control them. Tax laws and statistical services are also imperfect. Revenue collection systems that are in place in Georgia are not regulated and do not enable the control of cash flow.

2. Coordination between Georgian state supervisory agencies is very weak. They do not maintain relevant databases, which would enable monitoring of investments from offshore companies in Georgia. Often data is not submitted to state institutions at all.

3. Most public administrators are totally unfamiliar with the problem outlined herein and have no experience in this field.

4. Due to the abovementioned reasons, Georgian state institutions do not have (rather, it is impossible to have) actual data on offshore investments and the laundering of “black money.”

Significance of this Research and Practical Recommendations

The results of this research reflect the weaknesses of Georgian legislation and state structures with regards to offshore investments. Our research shows that the state is not ready to handle the problem efficiently. The paper points out specific legislative acts that should be amended and standard acts that should be passed in order to remedy the situation.

In order to improve the existing situation several measures should be recommended:

1. Changes in legislation;
2. Improvement of coordination among institutions and their databases;
3. Raising the level of awareness of administrative officers.

Changes in legislation implies the creation of a standard list of offshore zones. This would facilitate the development of a unified approach for state institutions towards companies registered in offshore zones. Notaries should be prohibited from notarizing deals involving

foreign juridical entities without evidence of their registration in the statistics and revenue institutions of Georgia. Notaries should also be obligated to notify relevant state institutions (the Department of Statistics, the Ministry of Justice, and the Agency for Foreign Investments) about deals made by offshore companies. It is also necessary to create a legislative mechanism ensuring the registration of actual costs of property purchased or sold by offshore companies on the territory of Georgia.

Apart from the abovementioned points, it is essential to improve the exchange of information and coordination among state institutions on operations conducted by offshore companies. This requires passing a number of standard acts obligating these institutions to systematize information on offshore activities and to notify each other about them. It is very important to improve the existing databases of state institutions (e.g. real estate public register) in order to maximize their usefulness. It would also be prudent to train administrative officers on the issues of offshore investments and legalization of “black money,” in order to raise their awareness of the issue.

Topics and Subjects for Further Research

In order to fully deal with the problem of offshore investments and legalization of black money through investments in Georgia, it would be reasonable to focus further research on the offshore stock of Georgian juridical entities and the means of establishing local juridical entities for participation in various projects. In order to accomplish this, the data of the independent stock registrars and the National Commission of Securities might be important. It would also be interesting to study the issue of allocation of resources within state securities, operations of currency exchange and the legislation regulating it.

It would also be useful to study whether the enforcement of the law on preventing legalization of illegal income passed by the Georgian Parliament on June 6, 2003 would solve any of the problems described in the paper.

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