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Statement of Senator Carl Levin
Permanent Subcommittee on Investigations Hearing:
Tax Haven Abuses: The Enablers, The Tools & Secrecy

This morning, this Subcommittee is releasing the results of a year-long, bipartisan investigation into tax haven abuses. I want to thank our Chairman Norm Coleman and his staff for the support they have given to this investigation, which included the issuance of more than 70 subpoenas, the scheduling of more than 80 interviews, and the review of more than 2 million pages of documents. I believe the findings are explosive: the report blows the lid off tax haven abuses that make use of sham trusts, shell corporations, and fake economic transactions to help some people dodge taxes owed to the U.S. Treasury.

Experts estimate that tax haven abuses by individuals cost the U.S. Treasury between $40 billion and $70 billion every year in taxes that are owed but not collected. Ultimately, that tax gap must be made up by average, honest taxpayers whose faith in the fairness of our tax system is eroding.

Our report lays out six case studies illustrating the scope and seriousness of the problem. Today's hearing focuses on two of them.

Inside the Black Box

The key features of offshore tax havens are low or no taxes and a legal system that favors secrecy over transparency. Tax havens sell secrecy to attract business. And they are very successful. About 50 tax havens operate in the world today. Those tax havens have, in effect, declared war on honest U.S. taxpayers, by giving tax dodgers the means to avoid their tax bills and leave them for others to pay.

These schemes are shrouded in the secrecy of tax havens because they can't stand the light of day. Trusts and shell corporations established in offshore secrecy jurisdictions operate in a legal black box that allows them to hide assets, mask who controls them, and obscure how their assets are used.

An armada of "offshore service providers," lawyers, bankers, brokers, and others then joins forces to exploit the black box secrecy and help clients skirt U.S. tax, securities, and anti-money laundering laws. Many of the firms concocting or facilitating these schemes are respected names here in the United States.

Our focus today is on two different schemes. The first scheme was used to avoid paying taxes on stock option compensation and investment income flowing from it. The second hid income from capital gains. At its core, each scheme relied on a key deception made possible by tax haven secrecy.

Wyly Case Study

The first case study looks at the tax haven schemes of Sam and Charles Wyly. For thirteen years, the Wylys used the black box and its facilitators to direct and enjoy the benefits of hundreds of millions of dollars in stock option income that they sent offshore to supposedly independent entities.

Between 1992 and 2005, Sam and Charles Wyly transferred over 17 million stock options and warrants worth about $190 million to a complex array of 19 offshore trusts and 39 shell corporations. The 19 offshore trusts were either established by the Wylys or named them as beneficiaries. These trusts owned the 39 shell corporations in the Isle of Man or the Cayman Islands. In return for most of the stock options, the offshore corporations gave the Wylys private annuities designed to make payments starting many years later. The Wylys took the position, on the advice of legal counsel, that because they exchanged their stock options for annuities of equivalent value, they didn't have to pay any taxes on the compensation until the annuities paid out.

In the meantime, the offshore entities began cashing in the stock options. The proceeds were invested in securities, Wyly hedge funds, Wyly businesses, and real estate. The Subcommittee traced about $500 million in offshore dollars invested in Wyly business investments, about $85 million used to acquire or improve real estate used by Wyly family members, and about $30 million spent on art, furnishings, and jewelry for the personal use of Wyly family members. In addition, about $140 million of the offshore dollars went back to the Wylys in the form of loans funneled through a Cayman shell corporation called Security Capital.

This chart sums up the Wyly offshore empire. It started with untaxed stock option compensation, most of which -- $124 million -- remains untaxed today. It grew with untaxed investment gains. And it provided a ready source of untaxed, offshore cash for loans or other uses the Wylys wanted.

The key deception in this scheme is the Wyly claim that the 58 offshore trusts and corporations were independent. Under U.S. law, the tax on the income of a truly independent trust is paid by the trustees. But if a U.S. person controls the trust's assets and investments, then the trust's income is generally taxable to that person.

The claim that the offshore trusts were independent of the Wylys is contradicted by overwhelming evidence. This is not a case where the Wylys handed over their stock options and awaited the annuity payments, while independent trustees operated the trusts. Instead, for thirteen years, the Wylys and their representatives continually told the trusts what to do – when to exercise the stock options, when to sell the shares, and what to do with the money. The Wylys conveyed their directions through so-called "trust protectors," individuals selected by the Wylys, who worked for the Wylys, and who were empowered to fire any offshore trustee. The protectors transmitted the Wyly directions to the offshore trustees who consistently carried them out.

The offshore entities exercised options and traded shares from three companies, Michaels Stores Inc., Sterling Software Inc. and Sterling Commerce Inc., where the Wylys were founders and directors. The Wylys, on the advice of counsel, generally did not include the stock holdings of the offshore entities in their SEC filings, claiming, again, that the offshore entities were independent. When the offshore entities opened securities accounts at Bank of America and were asked to name their beneficial owners as required by new U.S. anti-money laundering laws, they refused to do so, claiming again they were independent. Bank of America allowed the accounts to operate without getting the information required by law.

By promoting the fiction that the trusts were independent, the Wylys participated in a 13-year sham to circumvent U.S. tax, securities, and anti-money laundering requirements.

POINT Case Study

The Wyly case study traces the building of an offshore empire over 13 years. The next case study, by contrast, focuses on one-time, abusive tax shelter transactions.

This scheme used the tax haven black box to facilitate the creation of a fake stock portfolio with phantom securities used to generate billions of dollars of fake losses. Once again, the armada was hard at work, generating hefty fees for themselves by designing complex partnership structures, circular transactions, and impenetrable legal opinions to justify the deferral or elimination of taxes owed on $2 billion in real capital gains.

A Seattle-based securities firm called Quellos designed, promoted, and implemented the tax shelter known as POINT – Personally Optimized Investment Transaction – which it sold to five wealthy clients in six separate transactions.

The POINT strategy was designed to be impossible to pierce. Take a look at this chart. It's a bowl of spaghetti and may look comical, but the sobering fact is that these six transactions cost the Treasury about $300 million in lost revenue – revenue which, if these transactions aren't reversed, will have to be made up by honest taxpayers.

POINT worked like this. Quellos put together a list of high tech stocks, together worth about $9.5 billion, many of which had stock prices that were expected to drop.

The list went to a shell corporation in the Isle of Man called Jackstones. Although Jackstones did not actually own any of the stocks, it conducted a fake stock sale to another shell corporation called Barnville. On paper, Barnville paid $9.5 billion which, of course, it didn't have. Barnville then immediately lent the stock back to Jackstones in exchange for the same enormous sum, and the money which didn't exist then became security for the loan of the non-existent stock. Because the two companies did these deals simultaneously, the amounts of stock and cash they owed each other cancelled out. In a sleight of hand worthy of Houdini, Barnville was left with a huge paper portfolio. Barnville then picked from its paper portfolio a selection of stocks with the amount of capital losses needed by a client to offset their capital gains, and transferred those losses to a trading partnership owned by the client.

So, to review, a phony Isle of Man corporation sold stock it didn't own to another phony Isle of Man corporation for money it didn't have. The fake stock was lent back with fake cash as security for repayment of the loan, and the fake loss on the stock price was transferred out to offset real gains. No real economic activity took place, but one critical thing happened – a $9 billion paper portfolio was created. This paper portfolio originated with Jackstones and Barnville, shell operations with no employees, no offices, and paid-in capital of £2 – that's about $5 each.

The final step in the POINT scheme was for Barnville to sell the paper losses to wealthy individuals, including Haim Saban and Robert Wood Johnson IV. These clients used the paper losses to offset real capital gains. Mr. Saban used POINT to offset about $1.5 billion in capital gains; Mr. Johnson offset about $143 million. Together, the fees they paid to Quellos, the lawyers, the bankers, and others totaled about $75 million. One more proof that this sordid tale was used to concoct tax losses is the fact that the greater the paper loss generated for a client, the greater the fees charged by Quellos.

The POINT tax shelter included transactions to create the appearance of a complex investment with real economic substance. In reality, the transactions were expertly designed to remove all risk, using circular transactions that cancelled out or were unwound. A 5-year warrant, for example, which was included in the transactions to produce the illusion of a profit potential, was always terminated before any profits were realized. In a transaction involving Mr. Saban, an $800 million loan and stock purchase were added to provide a patina of economic substance, but the way the transaction was structured, it could not realize a profit in comparison to the transaction's fees and other costs. For example, the cost of a collar that capped possible profits at 8% of the total investment reduced a $130 million profit to $13 million, which was then dwarfed by fees totaling $53 million.

Mr. Saban told the Subcommittee staff that POINT was not sold to him as an investment strategy; it was sold to him as a way to avoid taxes that he otherwise would have had to pay on a big capital gain. In his words, he was promised "tax deferral ad infinitum" on a $1.5 billion capital gain, and that's what he paid for.

The key deception in POINT was the fake offshore portfolio that generated fake stock losses sold to partnerships with a false business purpose. The end result was $2 billion in real and taxable capital gains that were supposedly erased.

Professional Blinders

One of the most disturbing aspects of the POINT scheme was the degree to which reputable professionals aided and abetted this abusive tax shelter. Each of the facilitators -- the lawyers, bankers, and brokers -- played critical roles, pulled in hefty fees, but then acted surprised at what the Subcommittee found when it lifted the lid off the black box. Most claimed they had been unaware that no securities had actually been bought or sold, and no real losses generated. No one knew who was behind the tax haven corporations with the $9 billion portfolio, Jackstones and Barnville. The professionals hid behind shaky legal opinions to justify their roles and donned blinders to block out indicators of the sordid business they were involved in. Each participant essentially told the Subcommittee: "I was only responsible for my little piece of this. I didn't know the other parts. It's not my fault."

- Quellos, the architect of the sham, says it doesn't know who owns Barnville and Jackstones.

- EURAM, the UK company that served as the agent in all the deals between Barnville and Jackstones and was paid millions in fees, says it doesn't know who is behind the shell corporations.

- HSBC, the global bank that loaned hundreds of millions of dollars to fuel some of these transactions and knew it was financing deals set up to avoid taxes, says it didn't know who Barnville and Jackstones were, didn't know about key steps in the transactions, and relied on the tax opinions provided by legal counsel.

- The Cravath Swaine partner who put the law firm's seal of approval on POINT and made $125,000 in fees, says he didn't know about the fake trades or the role of Barnville and Jackstones.

- Bryan Cave, another law firm that put its seal of approval on POINT and made over $1 million in fees, disavows knowledge of how the paper portfolio was formed and of the corporations that formed it.

Could it be true that the banks and brokers and lawyers who participated in POINT didn't know what they were involved with? Or is it that they didn't <u>want</u> to know?

Conclusion

The Wyly chart and the POINT chart say it all. They show how broken the system is, and how serious the tax haven abuses have become.

These tax haven abuses are eating away at the fabric of the U.S. tax system, and undermining U.S. laws intended to safeguard our capital markets and financial systems from financial crime. It is long, long past time for our country to shut down their use by U.S. citizens.

One of the reforms recommended in our report would address the key deceptions in the two case studies examined here: the fake economic activity offshore and the fake independence of the offshore trusts and corporations.

This reform would create a presumption regarding who controls an offshore entity and what purpose it is serving, if that entity is located in a jurisdiction deemed to be a tax haven by the U.S. Treasury Secretary. Today, the government has the burden of proving that an individual controls a tax haven trust or shell corporation. It is time to reverse that presumption.

In other words, if you create a trust or corporation in a tax haven jurisdiction, send it assets, or benefit from its actions, Congress should reform the tax law to presume that you control it, that any income is your income, and treat that income and that entity accordingly for tax, securities, and money laundering purposes. An individual could still establish that an offshore entity was independent, but the burden of proof would be on that individual, not the government.

Congress should also enact S. 1565, the Tax Shelter and Tax Haven Reform Act that Senator Coleman and I introduced last year which, among other provisions, would authorize the Treasury Secretary to issue a list of tax havens that don't cooperate with U.S. tax enforcement and eliminate U.S. tax benefits for income in those jurisdictions. The ability to penalize uncooperative tax havens would hand our government a mighty club to combat tax haven abuses.

This hearing and the report we are releasing today shine a needed spotlight into the black box of offshore tax havens. It reveals a system that is corrupt and corrupting. Honest Americans are footing the bill for tax haven abuses, and we need to shut those abuses down.

Thank you, Mr. Chairman, for the important role you and your staff have played in this matter. Bipartisanship has been the hallmark of this Subcommittee, and you are helping to preserve that critically important tradition. I look forward to the testimony of our witnesses.

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