

M I C H I G A N

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Statement of Senator Carl Levin on Introducing the Stop Tax Haven Abuse Act

Section 108 - Closing the Dividend Tax Loophole

Section 108 of this bill is the second new addition to the Stop Tax Haven Abuse Act. It is aimed at closing down a tax loophole that has enabled offshore hedge funds and others to use complex financial gimmicks, including transactions involving equity swaps and offshore stock loans, to dodge billions of dollars in U.S. taxes over the last ten years. This loophole contributes to the estimated \$100 billion in unpaid taxes that Uncle Sam loses each year from offshore tax abuses. With financial disasters hitting this country from every direction, we can no longer afford to ignore this offshore tax dodge. It is time to shut it down.

The section is straightforward. It amends the Internal Revenue Code to make it clear that non-U.S. persons cannot escape payment of U.S. taxes on U.S. stock dividends by participating in structured financial transactions that recast taxable stock dividend payments as allegedly tax-free "dividend equivalent" or "substitute dividend" payments. The bill eliminates this offshore tax dodge by requiring that dividend, dividend equivalent, and substitute dividend payments made to non-U.S. persons all receive the same tax treatment – as taxable income subject to withholding.

Right now, foreigners who invest in the United States enjoy a minimal tax burden. For example, non-U.S. persons who deposit money with a U.S. bank or securities firm pay no U.S. taxes on the interest earned. They pay no U.S. taxes on capital gains. U.S. citizens do pay taxes on that income, but the tax code lets foreign investors operate without tax in an effort to attract foreign investment.

But there is one tax on the books that even foreign investors are supposed to pay. If they buy stock in a U.S. company, and that stock pays a dividend, the non-U.S. stockholder is supposed to pay a tax on the dividend. The general tax rate is 30%, unless their country of residence has negotiated a lower rate with the United States, typically 15%.

In addition, to make sure those dividend taxes are paid, U.S. law requires the person or entity paying a stock dividend to a non-U.S. person to withhold the tax owed Uncle Sam before any part of the dividend leaves the United States. If the "withholding agent" fails to retain and remit the dividend tax to the IRS, and the tax is not paid by the dividend recipient, the tax code makes the withholding agent equally liable for the unpaid taxes. That's the law. But the reality is that many non-U.S. stockholders never pay the dividend taxes they owe.

An investigation conducted by the Permanent Subcommittee on Investigations, which I chair, resulted in a staff report and hearing in September 2008, which showed that foreign entities, primarily offshore hedge funds and foreign financial institutions, use two common schemes to dodge their dividend tax obligations to the U.S. government—equity swaps and stock loans.

Swaps sound complicated, but they are essentially a financial bet -- in the case of equity swaps a bet on the future of a stock price. Under the swap, a financial institution promises to pay, say, a hedge fund an amount equal to any price appreciation in the stock price and the amount of any dividend paid during the term of the swap. The payment reflecting the dividend is referred to as a "dividend equivalent." In return, the hedge fund agrees to pay the financial institution an amount equal to any price depreciation in the stock price. The financial institution hedges its risk by holding the physical shares of stock that were "sold" to it by the hedge fund. It also charges a fee, which usually includes a portion of the tax savings that the hedge fund will obtain by dodging the withholding tax.

The swap gives the hedge fund the same economic risks and rewards that it had when it owned the physical shares of the stock. So why hold a swap instead of the stock itself? Because under the tax code, dividend payments are taxed, but dividend equivalent payments made under a swap are not.

Dividend equivalent payments made under a swap are tax free, because, in 1991, the IRS issued a series of regulations to determine what types of income will be treated as coming from the United States and therefore taxable. These so-called "source" rules treat U.S. stock dividends as U.S. source income, because the money comes from a U.S.

corporation. But the 1991 regulation takes the opposite approach with respect to swaps. It deems swap agreements to be "notional principal contracts" and says that the "source" of any payment made under that contract is to be determined, not by where the money came from, but by where it ends up. In other words, the payment's source is the country where the payment recipient resides.

That approach turns the usual meaning of the word, "source," on its head. Instead of looking to the origin of the payment to determine its "source," the IRS swap rule looks to its end point – who receives it. That "source" is not really a "source" by any known definition of the word. It is the opposite – not the point of origin but the end point.

The result is that when a financial institution makes a dividend equivalent payment to an offshore client under a swap agreement, the tax code provides that the payment is from an offshore "source." So the swap payment is free of any U.S. tax. In our example, the U. S. financial institution makes the swap payment to the offshore hedge fund, minus its fee, and stiffes Uncle Sam for the amount of taxes that should have been sent to the IRS. The swap is then terminated, and the stock is "sold" back to the hedge fund. Under this gimmick, the hedge fund ends up in the same position as before the swap, as a stockholder, except it has pocketed a dividend payment without paying any U.S. tax.

Stock loans are also used to dodge dividend taxes. These transactions pile a stock loan on top of a swap to achieve the same allegedly tax-free result.

The first step is that the client with an upcoming dividend lends its stock to an offshore corporation controlled by the financial institution. This offshore corporation promises, as part of the loan agreement, to forward any dividend payments back to the client.

The next step is that offshore corporation enters into a swap with the financial institution that controls it, referencing the same type of stock and number of shares that is the subject of the stock loan. Essentially, two related parties are placing a bet on the stock, which makes no economic sense except, once that stock pays the dividend, the swap arrangement allows the financial institution to send it as an allegedly tax-free dividend equivalent payment to the offshore corporation it controls. The offshore corporation then forwards the same amount to the client. Because the payment is sent to the client as part of a stock loan agreement, it is called a "substitute dividend." The tax code treats substitute dividends in the same way as the underlying dividend. So if the underlying dividend came from a U.S. corporation, the substitute dividend would normally be taxed as U.S. source income.

But in this transaction, the parties claim the substitute dividend is tax-free by invoking the wording of an obscure IRS Notice 97-66 never intended to be applied to this situation. That notice says that when two parties in a stock loan are outside of the United States and subject to the same dividend tax rate, they don't have to pay the dividend tax when passing on a substitute dividend. The assumption is that the tax was already paid by another party in the lending transaction. Some tax lawyers have seized on the wording to claim that this IRS Notice, which was intended to prevent over-withholding, could be used to eliminate dividend withholding entirely, so long as one offshore party passes on a substitute dividend to another offshore party subject to the same dividend tax rate. The IRS testified at the Subcommittee hearing that Notice 97-66 was never intended to be interpreted that way, but in the ten years since it was issued and abusive stock loans have exploded, the IRS has never put that in writing.

The end result in our example is that the client pockets a substitute dividend payment – minus the financial institution's fee – without paying any tax. The stock loan is terminated, and the stock is returned to the client. The big advantage of this approach over a swap is that the client doesn't have to explain why he got his stock back after the transaction. The stock was, after all, only on loan.

Tax dodging was clearly the economic purpose of the two transactions just described. While there are many types of legitimate swap and stock loan transactions, the Subcommittee investigation found that in these cases, such transactions were conducted primarily to dodge U.S. taxes and not for legitimate business purposes. In some of the most extreme examples, the client owned U.S. stock both before and after each transaction. Neither the swap nor the stock loan altered the client's market risk. The only risk involved in either transaction was that Uncle Sam would catch on and assess the dividend taxes that should have been paid but weren't.

To make it harder for Uncle Sam to catch on and prove what is going on, financial institutions have added more complexity, more bells and whistles, to these so-called "dividend enhancement" transactions. But the purpose of the transactions remains the same – to enable clients to escape paying the taxes they owe. In the September 2008 hearing and report released by the Subcommittee, we described how specific financial institutions and hedge funds used swaps and stock loans to duck U.S. stock dividend taxes. We disclosed, for example, that Morgan Stanley helped clients, from 2000 to 2007, dodge payment of U.S. dividend taxes of over \$300 million. Lehman Brothers estimated that in one year alone, 2004, it helped clients dodge U.S. dividend taxes amounting to

perhaps \$115 million. UBS enabled clients, from 2004 to 2007, dodge \$62 million in dividend taxes, but last year stopped offering the Cayman stock loans that produced that figure. Maverick Capital, which runs several offshore hedge funds, disclosed that its offshore hedge funds used dividend enhancement products sold by multiple firms to escape dividend taxes from 2000 to 2007, totaling nearly \$95 million. Citigroup even admitted to the IRS that it had failed to withhold dividend taxes on certain swap transactions from 2003 to 2005, and voluntarily paid missing taxes totaling \$24 million. The Subcommittee investigation documented, in short, a whole swath of unpaid dividend taxes from just a handful of firms.

Section 108, if enacted into law, would prevent non-U.S. persons from avoiding their U.S. dividend tax obligations by recasting dividend payments as allegedly tax-free dividend equivalent or substitute dividend payments. Instead, all payments of dividend-based amounts would be treated consistently.

The section also authorizes the Treasury Secretary to issue regulations addressing several related issues. Treasury is directed, for example, to issue regulations to reduce possible over-withholding on dividend equivalents or substitute dividends, but only where the taxpayer can establish that the tax was previously withheld from an earlier payment. Treasury is also directed to issue regulations to impose withholding when dividend equivalent payments are netted with other payments under a swap contract, when dividend equivalent payments are made under other financial instruments, such as an option or forward contract, or when a substitute dividend is netted with fees and other payments. Finally, the section makes it clear that nothing in the legislation should be construed to limit the authority of the IRS Commissioner to collect taxes, interest, and penalties on dividend equivalent or substitute dividend payments made prior to the date of enactment of the bill.

Let me be clear. I do not oppose structured finance transactions used for legitimate purposes, including swaps and stock loans that facilitate capital flows, reduce capital needs, or spread risk. What I oppose, and what Section 108 would stop is the misuse of financial transactions to undermine the tax code, rob the U.S. treasury, and force honest Americans who play by the rules to shoulder the country's tax burden. What this section is intended to stop are dividend-based transactions whose economic purpose is nothing more than tax dodging.

Section 109- PFIC Reporting Requirement

Section 109 is the third and final new addition to the Stop Tax Haven Abuse Act. The purpose of this provision is to strengthen disclosure requirements for foreign corporations used as the personal investment vehicles of U.S. individuals. These corporations are sometimes established in offshore secrecy jurisdictions, making it particularly difficult for the IRS to detect them and establish links to the U.S. beneficiaries. The tax obligations of these corporations, known as passive foreign investment corporations or PFICs, are set out in Sections 1291-1298 of the tax code. U.S. persons who are direct or indirect shareholders of a PFIC are currently required to complete a Form 8621 providing certain information about the PFIC to the IRS. While the IRS has issued proposed regulations governing PFIC reporting, they have not yet been finalized.

Section 109 of the bill would codify the PFIC reporting requirements set out in the proposed regulations, with one additional requirement. Specifically, PFIC reporting would be required not only by U.S. persons who have an ownership interest in a PFIC, but also by any U.S. person who, directly or indirectly, causes the PFIC to be formed, or who sent assets to or received assets from the PFIC during the relevant tax year.

The need for expanded reporting obligations was highlighted during the Subcommittee's investigative work which showed that, in too many cases, ownership requirements were not enough to trigger reporting obligations for offshore corporations. For example, the Subcommittee found numerous instances in which a U.S. person asked an offshore service provider to form an offshore corporation, lodge ownership of the new corporation in one or more offshore shell companies under the provider's control, and then operate the new corporation as the U.S. person directed, despite the absence of any direct ownership interest. This arrangement, which may have been designed to evade tax or other legal obligations that attach to corporations directly or indirectly owned by a U.S. person, nevertheless provided U.S. persons with beneficial interests in offshore corporations that effectively operated at their discretion.

To ensure that such offshore corporations are subject to the same reporting requirements as PFICs in which a U.S. person is a direct or indirect shareholder, the new Section 109 would require Forms 8621 to be filed by any U.S. person who formed a PFIC, sent assets to it, received assets from it, was a beneficial owner of it, or had beneficial interests in it. This expanded reporting requirement is intended to prevent any U.S. person who established, capitalized, or profited from a beneficial interest in a PFIC -- whether or not that beneficial interest was evidenced by legal documentation -- from arguing that they had no reporting obligation for that PFIC, because they lacked a formal ownership interest in it.

Finally, Section 109 is intended to require reporting by U.S. persons who have a beneficial interest in a PFIC; it is not intended to impose reporting requirements on persons who perform ministerial tasks associated with a PFIC, including tasks associated with a PFIC's formation, management, contributions or distributions.

Section 201- Stronger Penalty for Failure to Make Required Securities Disclosures

In addition to tax abuses, the 2006 Subcommittee investigation into the Wyly case history uncovered a host of troubling transactions involving U.S. securities held by the 58 offshore trusts and corporations associated with the two Wyly brothers. Over the course of a number of years, the Wyllys had obtained about \$190 million in stock options as compensation from three U.S. publicly traded corporations at which they were directors and major shareholders. Over time, the Wyllys transferred these stock options to the network of offshore entities they had established. The investigation found that, for years, the Wyllys had generally failed to report the offshore entities' stock holdings or transactions in their filings with the Securities and Exchange Commission (SEC). They did not report these stock holdings on the ground that the 58 offshore trusts and corporations functioned as independent entities, even though the Wyllys continued to direct the entities' investment activities. The public companies where the Wyllys were corporate insiders also failed to include in their SEC filings information about the company shares held by the offshore entities, even though the companies knew of their close relationship to the Wyllys, that the Wyllys had provided the offshore entities with significant stock options, and that the offshore entities held large blocks of the company stock. On other occasions, the public companies and various financial institutions failed to treat the shares held by the offshore entities as affiliated stock, even though they were aware of the offshore entities' close association with the Wyllys. The investigation found that, because both the Wyllys and the public companies had failed to disclose the holdings of the offshore entities, for 13 years federal regulators had been unaware of those stock holdings and the relationships between the offshore entities and the Wyly brothers.

Corporate insiders and public companies are already obligated by current law to disclose stock holdings and transactions of offshore entities affiliated with a company director, officer, or major shareholder. Current penalties, however, appear insufficient to ensure compliance in light of the low likelihood that U.S. authorities will learn of transactions that take place in an offshore jurisdiction. To address this problem, Section 201 of our bill would establish a new monetary penalty of up to \$1 million for persons who knowingly fail to disclose offshore stock holdings and transactions in violation of U.S. securities laws.

Sections 202 and 203 - Anti-Money Laundering Programs for Hedge Funds and Company Formation Agents

The Subcommittee's August 2006 investigation showed that the Wyly brothers used two hedge funds and a private equity fund controlled by them to funnel millions of untaxed offshore dollars into U.S. investments. In addition, multiple Subcommittee investigations provide extensive evidence on the role played by U.S. company formation agents in assisting U.S. persons to set up offshore structures. Moreover, a Subcommittee hearing in November 2006 disclosed that U.S. company formation agents are forming U.S. shell companies for numerous unidentified foreign clients. Some of those U.S. shell companies were later used in illicit activities, including money laundering, terrorist financing, drug crimes, tax evasion, and other misconduct. Because hedge funds, private equity funds, and company formation agents are as vulnerable as other financial institutions to money launderers seeking entry into the U.S. financial system, the bill contains two provisions aimed at ensuring that these groups know their clients and do not accept or transmit suspect funds into the U.S. financial system. Currently, unregistered investment companies, such as hedge funds and private equity funds, are the only class of financial institutions under the Bank Secrecy Act that transmit substantial offshore funds into the United States, yet are not required by law to have anti-money laundering programs, including Know Your Customer, due diligence procedures, and procedures to file suspicious activity reports. There is no reason why this sector of our financial services industry should continue to serve as a gateway into the U.S. financial system for substantial funds of unknown origin. Seven years ago, in 2002, the Treasury Department proposed anti-money laundering regulations for these companies, but never finalized them. In 2008, the Department withdrew them with no explanation. Section 202 of the bill would require Treasury to issue final anti-money laundering regulations for unregistered investment companies within 180 days of the enactment of the bill. Treasury would be free to draw upon its 2002 proposal, but the bill would also require the final regulations to direct hedge funds and private equity funds to exercise due diligence before accepting offshore funds and to comply with the same procedures as other financial institutions if asked by federal regulators to produce records kept offshore.

In addition, Section 203 of the bill would add company formation agents to the list of persons subject to anti-money laundering obligations. For the first time, those engaged in the business of forming corporations and other entities, both offshore and in the 50 States, would be responsible for knowing the identity of the person for whom they are forming the entity. The bill also directs Treasury to develop anti-money laundering

regulations for this group. Treasury's key anti-money laundering agency, the Financial Crimes Enforcement Network, testified before the Subcommittee in 2006, that it was considering drafting such regulations but has yet to do so.

We expect and intend that, as in the case of all other entities required to institute anti-money laundering programs, the regulations issued in response to this bill would instruct hedge funds, private equity funds, and company formation agents to adopt risk-based procedures that would concentrate their due diligence efforts on clients that pose the highest risk of money laundering.

Section 204 - IRS John Doe Summons

Section 204 of the bill focuses on an important tool used by the IRS in recent years to uncover taxpayers involved in offshore tax schemes, known as the John Doe summons. Section 204 would make three technical changes to make the use of John Doe summons more effective in offshore and other complex investigations.

A John Doe summons is an administrative IRS summons used to request information in cases where the identity of a taxpayer is unknown. In cases involving a known taxpayer, the IRS may issue a summons to a third party to obtain information about the U.S. taxpayer, but must also notify the taxpayer who then has 20 days to petition a court to quash the summons to the third party. With a John Doe summons, however, IRS does not have the taxpayer's name and does not know where to send the taxpayer notice, so the statute substitutes a procedure in which the IRS must instead apply to a court for advance permission to serve the summons on the third party. To obtain approval of the summons, the IRS must show the court, in public filings to be resolved in open court, that: (1) the summons relates to a particular person or ascertainable class of persons, (2) there is a reasonable basis for concluding that there is a tax compliance issue involving that person or class of persons, and (3) the information sought is not readily available from other sources. In recent years, the IRS has used John Doe summonses to try to obtain information about taxpayers operating in offshore secrecy jurisdictions. For example, as indicated earlier, the IRS obtained court approval to serve a John Doe summons on the Swiss bank, UBS, to obtain the names of an estimated 19,000 U.S. clients who opened UBS accounts in Switzerland without disclosing those accounts to the IRS. This is a landmark effort to try to overcome Swiss secrecy laws. In earlier years, the IRS obtained court approval to issue John Doe summonses to credit card associations, credit card processors, and credit card merchants, to collect information about taxpayers using credit cards issued by offshore banks. This information has led to many successful cases in

which the IRS identified funds hidden offshore and recovered unpaid taxes.

Currently, however, use of the John Doe summons process is time consuming and expensive. For each John Doe summons involving an offshore secrecy jurisdiction, the IRS has had to establish in court that the involvement of accounts and transactions in offshore secrecy jurisdictions meant there was a significant likelihood of tax compliance problems. To relieve the IRS of the need to make this same proof over and over in court after court, the bill would provide that, in any John Doe summons proceeding involving a class defined in terms of accounts or transactions in an offshore secrecy jurisdiction, the court may presume that the case raises tax compliance issues. This presumption would then eliminate the need for the IRS to repeatedly establish in court the obvious fact that accounts, entities, and transactions involving offshore secrecy jurisdictions raise tax compliance issues.

Second, for a smaller subset of John Doe cases, where the only records sought by the IRS are offshore bank account records held by a U.S. financial institution where that offshore bank has an account, the bill would relieve the IRS of the obligation to get prior court approval to serve the summons. Again, the justification is that offshore bank records are highly likely to involve accounts that raise tax compliance issues so no prior court approval should be required. Even in this instance, however, if a U.S. financial institution were to decline to produce the requested records, the IRS would have to obtain a court order to enforce the summons.

Finally, the bill would streamline the John Doe summons approval process in large "project" investigations where the IRS anticipates issuing multiple summonses to definable classes of third parties, such as banks or credit card associations, to obtain information related to particular taxpayers. Right now, for each summons issued in connection with a project, the IRS has to obtain the approval of a court, often having to repeatedly establish the same facts before multiple judges in multiple courts. This repetitive exercise wastes IRS, Justice Department, and court resources, and fragments oversight of the overall IRS investigative effort.

To streamline this process and strengthen court oversight of IRS use of John Doe summons, the bill would authorize the IRS to present an investigative project, as a whole, to a single judge to obtain approval for issuing multiple summonses related to that project. In such cases, the court would retain jurisdiction over the case after approval is granted, to exercise ongoing oversight of IRS issuance of summonses under the project. To further strengthen court oversight, the IRS would be required to file a publicly

available report with the court on at least an annual basis describing the summonses issued under the project. The court would retain authority to restrict the use of further summonses at any point during the project. To evaluate the effectiveness of this approach, the bill would also direct the Government Accountability Office to report on the use of the provision after five years.

Section 205 - FBAR Investigations and Suspicious Activity Reports

Section 205 of the bill would make several changes to Title 31 of the U.S. Code needed to reflect the IRS' new responsibility for enforcing the Foreign Bank Account Report (FBAR) requirements and to clarify the right of access to Suspicious Activity Reports by IRS civil enforcement authorities.

Under present law, a person controlling a foreign financial account with over \$10,000 is required to check a box on his or her income tax return and, under Title 31, also file an FBAR form with the IRS. Treasury's Financial Crimes Enforcement Network (FinCEN), which normally enforces Title 31 provisions, recently delegated to the IRS the responsibility for investigating FBAR violations and assessing FBAR penalties. Because the FBAR enforcement jurisdiction derives from Title 31, however, and most of the information available to the IRS is tax return information, IRS routinely encounters difficulties in using available tax information to fulfill its new role as FBAR enforcer. The tax disclosure law permits the use of tax information only for the administration of the internal revenue laws or "related statutes." This rule is presently understood to require the IRS to determine, at a managerial level and on a case by case basis, that the Title 31 FBAR law is a "related statute." Not only does this necessitate repetitive determinations in every FBAR case investigated by the IRS before each agent can look at the potential non-filer's income tax return, but it prevents the use by IRS of bulk data on foreign accounts received from tax treaty partners to compare to FBAR filing records to find non-filers.

One of the stated purposes for the FBAR filing requirement is that such reports "have a high degree of usefulness in . . . tax . . . investigations or proceedings." 31 U.S.C 5311. If one of the reasons for requiring taxpayers to file FBARs is to use the information for tax purposes, and if IRS is to be charged with FBAR enforcement because of the FBARs' connection to taxes, common sense dictates that the FBAR statute should be considered a related statute for tax disclosure purposes, and the bill changes the related statute rule to say that.

The second change made by Section 205 is a technical amendment to the wording of the

penalty provision. Currently the penalty is determined in part by the balance in the foreign bank account at the time of the "violation." The violation is interpreted to have occurred on the due date of the FBAR return, which is June 30 of the year following the year to which the report relates. The statute's use of this specific June 30th date can lead to strange results if money is withdrawn from the foreign account after the reporting period closed but before the return due date. To eliminate this unintended problem, the bill would instead gauge the penalty by using the highest balance in the account during the reporting period.

The third part of section 205 relates to Suspicious Activity Reports, which financial institutions are required to file with FinCEN whenever they encounter suspicious transactions. FinCEN is required to share this information with law enforcement, but currently does not permit IRS civil investigators access to the information. However, if the information that is gathered and transmitted to Treasury by the financial institutions at great expense is to be effectively utilized, its use should not be limited to the relatively small number of criminal investigators, who can barely scratch the surface of the large number of reports. In addition, sharing the information with civil tax investigators would not increase the risk of disclosure, because they operate under the same tough disclosure rules as the criminal investigators. In some cases, IRS civil agents are now issuing an IRS summons to a financial institution to get access, for a production fee, to the very same information the financial institution has already filed with Treasury in a SAR. The bill changes those anomalous results by making it clear that "law enforcement" includes civil tax law enforcement.

Overall, Titles I and II of our bill include a host of innovative measures to strengthen the ability of federal regulators to combat offshore tax haven abuses. We believe these new tools merit Congressional attention and enactment this year if we are going to begin to make a serious dent in the \$100 billion in annual lost tax revenue from offshore tax abuses that forces honest taxpayers to shoulder a greater tax burden than they would otherwise have to bear.

Until now, I've been talking about what the bill would do combat offshore tax abuses. Now I want to turn to what the bill would do to combat abusive tax shelters and their promoters who use both domestic and offshore means to achieve their ends.

Abusive Tax Shelters

Abusive tax shelters are complicated transactions promoted to provide tax benefits

unintended by the tax code. They are very different from legitimate tax shelters, such as deducting the interest paid on a home mortgage or Congressionally approved tax deductions for building affordable housing. Some abusive tax shelters involve complicated domestic transactions; others make use of offshore shenanigans. All abusive tax shelters are marked by one characteristic: there is no real economic or business rationale other than tax avoidance. As Judge Learned Hand wrote in *Gregory v. Helvering*, they are "entered upon for no other motive but to escape taxation."

Abusive tax shelters are usually tough to prosecute. Crimes such as terrorism, murder, and fraud produce instant recognition of the immorality involved. Abusive tax shelters, by contrast, are often "MEGOs," meaning "My Eyes Glaze Over." Those who cook up these concoctions count on their complexity to escape scrutiny and public ire. But regardless of how complicated or eye-glazing, the hawking of abusive tax shelters by tax professionals like accountants, bankers, investment advisers, and lawyers to thousands of people like late-night, cut-rate T.V. bargains is scandalous, and we need to stop it.

My Subcommittee has spent years examining the design, sale, and implementation of abusive tax shelters. Our first hearing on this topic in recent years was held in January 2002, when the Subcommittee examined an abusive tax shelter purchased by Enron. In November 2003, the Subcommittee held two days of hearings and released a staff report that pulled back the curtain on how even some respected accounting firms, banks, investment advisers, and law firms had become engines pushing the design and sale of abusive tax shelters to corporations and individuals across this country. In February 2005, the Subcommittee issued a bipartisan report that provided further details on the role these professional firms played in the proliferation of these abusive shelters. Our Subcommittee report was endorsed by the full Committee on Homeland Security and Governmental Affairs in April 2005.

In 2006, the Subcommittee released a staff report entitled, "Tax Haven Abuses: The Enablers, the Tools, and Secrecy," which disclosed how financial and legal professionals designed and sold yet another abusive tax shelter known as the POINT Strategy, which depended on secrecy laws and practices in the Isle of Man to conceal the phantom nature of securities trades that lay at the center of this tax shelter transaction. Most recently, in 2008, the Subcommittee released a staff report and held a hearing on how financial firms have designed and sold complex financial transactions, referred to as dividend enhancement transactions, to help offshore hedge funds and others escape payment of U. S. taxes on U.S. stock dividends.

The Subcommittee investigations have found that many abusive tax shelters are not dreamed up by the taxpayers who use them. Instead, most are devised by tax professionals, such as accountants, bankers, investment advisors, and lawyers, who then sell the tax shelter to clients for a fee. In fact, as our 2003 investigation widened, we found a large number of tax advisors cooking up one complex scheme after another, packaging them up as generic "tax products" with boiler-plate legal and tax opinion letters, and then undertaking elaborate marketing schemes to peddle these products to literally thousands of persons across the country. In return, these tax shelter promoters were getting hundreds of millions of dollars in fees, while diverting billions of dollars in tax revenues from the U.S. Treasury each year.

For example, one shelter investigated by the Subcommittee and featured in the 2003 hearings has since become part of an IRS effort to settle cases involving a set of abusive tax shelters known as "Son of Boss." Following our hearing, more than 1,200 taxpayers admitted wrongdoing and agreed to pay back taxes, interest and penalties totaling more than \$3.7 billion. That's billions of dollars the IRS has collected on just one type of tax shelter, demonstrating both the depth of the problem and the potential for progress. The POINT shelter featured in our 2006 hearing involved another \$300 million in tax loss on transactions conducted by just six taxpayers. The offshore dividend tax scams we examined in 2008 meant additional billions of dollars in unpaid taxes over a ten year period.

Titles III and IV of the bill we are introducing today contain a number of measures to curb abusive tax shelters. First, they would strengthen the penalties imposed on those who aid or abet tax evasion. Second, they would prohibit the issuance of tax shelter patents. Several provisions would deter bank participation in abusive tax shelter activities by requiring regulators to develop new examination procedures to detect and stop such activities. Others would end outdated communication barriers between the IRS and other enforcement agencies such as the SEC, bank regulators, and the Public Company Accounting Oversight Board, to allow the exchange of information relating to tax evasion cases. The bill also provides for increased disclosure of tax shelter information to Congress.

In addition, the bill would simplify and clarify an existing prohibition on the payment of fees linked to tax benefits; and authorize Treasury to issue tougher standards for tax shelter opinion letters. Finally, the bill would codify and strengthen the economic substance doctrine, which eliminates tax benefits for transactions that have no real business purpose apart from avoiding taxes.

Let me be more specific about these key provisions to curb abusive tax shelters.

Sections 301 and 302 - Strengthening Tax Shelter Penalties

Title III of the bill strengthens two very important penalties that the IRS can use in its fight against the professionals who make complex abusive shelters possible. Three years ago, the penalty for promoting an abusive tax shelter, as set forth in Section 6700 of the tax code, was the lesser of \$1,000 or 100 percent of the promoter's gross income derived from the prohibited activity. That meant in most cases the maximum fine was just \$1,000.

Many abusive tax shelters sell for \$100,000 or \$250,000 apiece. Our investigation uncovered some tax shelters that were sold for as much as \$2 million or even \$5 million apiece, as well as instances in which the same cookie-cutter tax opinion letter was sold to 100 or even 200 clients. There are huge profits to be made in this business, and a \$1,000 fine is laughable. The Senate acknowledged that in 2004, when it adopted the Levin-Coleman amendment to the JOBS Act, S. 1637, raising the Section 6700 penalty on abusive tax shelter promoters to 100 percent of the fees earned by the promoter from the abusive shelter. A 100 percent penalty would have ensured that the abusive tax shelter hucksters would not get to keep a single penny of their ill-gotten gains. That figure, however, was cut in half in the conference report, setting the penalty at 50 percent of the fees earned and allowing the promoters of abusive shelters to keep half of their illicit profits.

While a 50 percent penalty is an obvious improvement over \$1,000, this penalty still is inadequate and makes no sense. Why should anyone who pushes an illegal tax shelter that robs our Treasury of needed revenues get to keep half of their ill-gotten gains? What deterrent effect is created by a penalty that allows promoters to keep half of their fees if caught, and of course, all of their fees if they are not caught?

Effective penalties should make sure that the peddler of an abusive tax shelter is deprived of every penny of profit earned from selling or implementing the shelter and then is fined on top of that. Section 301 of this bill would do just that by increasing the penalty on tax shelter promoters to an amount equal to up to 150 percent of the promoters' gross income from the prohibited activity.

A second penalty provision in the bill addresses what our investigations have found to be

a key problem: the knowing assistance of accounting firms, law firms, investment firms, banks, and others to help taxpayers understate their taxes. In addition to those who meet the definition of "promoters" of abusive shelters, there are many other types of professional firms that aid and abet the use of abusive tax shelters and enable taxpayers to carry out the abusive tax schemes. For example, law firms are often asked to write "opinion letters" to help taxpayers head off IRS questioning and fines that they might otherwise confront for using an abusive shelter. Currently, under Section 6701 of the tax code, these aiders and abettors face a maximum penalty of only \$1,000, or \$10,000 if the offender is a corporation. This penalty, too, is a joke. When law firms are getting \$50,000 for each of these cookie-cutter opinion letters, it provides no deterrent whatsoever. A \$1,000 fine is like a jaywalking ticket for robbing a bank.

Section 302 of the bill would strengthen Section 6701 of the tax code by subjecting aiders and abettors to a maximum fine up to 150 percent of the aider and abettor's gross income from the prohibited activity. This penalty would apply to all aiders and abettors, not just tax return preparers.

Again, the Senate has recognized the need to toughen this critical penalty. In the 2004 JOBS Act, Senator Coleman and I successfully increased this fine to 100 percent of the gross income derived from the prohibited activity. Unfortunately, the conference report completely omitted this change, allowing many aiders and abettors to continue to profit without penalty from their wrongdoing.

If further justification for toughening these penalties is needed, one document uncovered by our investigation shows the cold calculation engaged in by a tax advisor facing low fines. A senior tax professional at accounting giant KPMG compared possible tax shelter fees with possible tax shelter penalties if the firm were caught promoting an illegal tax shelter. This senior tax professional wrote the following: "[O]ur average deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000." He then recommended the obvious: going forward with sales of the abusive tax shelter on a cost-benefit basis.

Section 303 - Prohibition on Tax Shelter Patents

Section 303 of our bill addresses the growing problem of tax shelter patents, which has the potential for significantly increasing abusive tax shelter activities.

In 1998, a federal appeals court ruled for the first time that business methods can be

patented and, since then, various tax practitioners have filed applications to patent a variety of tax strategies. The U.S. Patent Office has apparently issued over 70 tax strategy patents to date, up from 49 in 2007, and with many more on the way. These patents were issued by patent officers who, by statute, have a background in science and technology, not tax law, and know little to nothing about abusive tax shelters.

Issuing these types of patents raises multiple public policy concerns. Patents issued for aggressive tax strategies, for example, may enable unscrupulous promoters to claim the patent represents an official endorsement of the strategy and evidence that it would withstand IRS challenge. Patents could be issued for blatantly illegal tax shelters, yet remain in place for years, producing revenue for the wrongdoers while the IRS battles the promoters in court. Patents for tax shelters found to be illegal by a court would nevertheless remain in place, creating confusion among users and possibly producing illicit income for the patent holder.

Another set of policy concerns relates to the patenting of more routine tax strategies. If a single tax practitioner is the first to discover an advantage granted by the law and secures a patent for it, that person could then effectively charge a toll for all other taxpayers to use the same strategy, even though as a matter of public policy all persons ought to be able to take advantage of the law to minimize their taxes. Companies could even patent a legal method to minimize their taxes and then refuse to license that patent to their competitors in order to prevent them from lowering their operating costs. Tax patents could be used to hinder productivity and competition rather than foster it.

The primary rationale for granting patents is to encourage innovation, which is normally perceived to be a sufficient public benefit to justify granting a temporary monopoly to the patent holder. In the tax arena, however, there has historically been ample incentive for innovation in the form of the tax savings alone. The last thing we need is a further incentive for aggressive tax shelters. That's why Section 303 would prohibit the patenting of any "tax planning invention" that is "designed to reduce, minimize, determine, avoid or defer ... tax liability." The wording of this section has been updated since the Stop Tax Haven Abuse Act of 2007, to reflect the bipartisan consensus that was reached on this provision in S. 2369, a Baucus-Grassley-Levin bill to bar tax patents, introduced but not acted upon in the 110th Congress.

Section 304 - Fees Contingent upon Obtaining Tax Benefits

Another finding of the Subcommittee investigations is that some tax practitioners are

circumventing current state and federal constraints on charging tax service fees that are dependent on the amount of promised tax benefits. Traditionally, accounting firms charged flat fees or hourly fees for their tax services. In the 1990s, however, they began charging "value added" fees based on, in the words of one accounting firm's manual, "the value of the services provided, as opposed to the time required to perform the services." In addition, some firms began charging "contingent fees" that were calculated according to the size of the paper "loss" that could be produced for a client and used to offset the client's other taxable income – the greater the so-called loss, the greater the fee.

In response, many states prohibited accounting firms from charging contingent fees for tax work to avoid creating incentives for these firms to devise ways to shelter substantial sums. The SEC and the American Institute of Certified Public Accountants also issued rules restricting contingent fees, allowing them in only limited circumstances. Recently, the Public Company Accounting Oversight Board issued a similar rule prohibiting public accounting firms from charging contingent fees for tax services provided to the public companies they audit. Each of these federal, state, and professional ethics rules seeks to limit the use of contingent fees under certain, limited circumstances.

The Subcommittee investigation found that tax shelter fees, which are typically substantial and sometimes exceed \$1 million, are often linked to the amount of a taxpayer's projected paper losses which can be used to shelter income from taxation. For example, in four tax shelters examined by the Subcommittee in 2003, documents show that the fees were equal to a percentage of the paper loss to be generated by the transaction. In one case, the fees were typically set at 7 percent of the transaction's generated "tax loss" that clients could use to reduce other taxable income. In another, the fee was only 3.5 percent of the loss, but the losses were large enough to generate a fee of over \$53 million on a single transaction. In other words, the greater the loss that could be concocted for the taxpayer or "investor," the greater the profit for the tax promoter. Think about that -- greater the loss, the greater the profit. How's that for turning capitalism on its head!

In addition, evidence indicated that, in at least one instance, a tax advisor was willing to deliberately manipulate the way it handled certain tax products to circumvent contingent fee prohibitions. An internal document at an accounting firm related to a specific tax shelter, for example, identified the states that prohibited contingent fees. Then, rather than prohibit the tax shelter transactions in those states or require an alternative fee structure, the memorandum directed the firm's tax professionals to make sure the engagement letter was signed, the engagement was managed, and the bulk of services

was performed "in a jurisdiction that does not prohibit contingency fees."

Right now, the prohibitions on contingent fees are complex and must be evaluated in the context of a patchwork of federal, state, and professional ethics rules. Section 304 of the bill would establish a single enforceable rule, applicable nationwide, that would prohibit tax practitioners from charging fees calculated according to a projected or actual amount of tax savings or paper losses.

Section 305 - Deterring Financial Institution Participation in Abusive Tax Shelter Activities

The bill would also help fight abusive tax shelters that are disguised as complex investment opportunities and use financing or securities transactions provided by financial institutions. In reality, tax shelter schemes lack the economic risks and rewards associated with a true investment. These phony transactions instead often rely on the temporary use of significant amounts of money in low risk schemes mischaracterized as real investments. The financing or securities transactions called for by these schemes are often supplied by a bank, securities firm, or other financial institution.

Currently the tax code prohibits financial institutions from providing products or services that aid or abet tax evasion or that promote or implement abusive tax shelters. The agencies that oversee these financial institutions on a daily basis, however, are experts in banking and securities law and generally lack the expertise to spot tax issues. Section 305 would crack down on financial institutions' illegal tax shelter activities by requiring federal bank regulators and the SEC to work with the IRS to develop examination techniques to detect such abusive activities and put an end to them.

These examination techniques would be used regularly, preferably in combination with routine regulatory examinations, and the regulators would report potential violations to the IRS. The agencies would also be required to prepare joint reports to Congress in 2010 and 2013 on preventing the participation of financial institutions in tax evasion or tax shelter activities.

Section 306 - Ending Communication Barriers between Enforcement Agencies

During hearings before the Permanent Subcommittee on Investigations on tax shelters in November 2003, IRS Commissioner Mark Everson testified that his agency was barred by Section 6103 of the tax code from communicating information to other federal agencies that would assist those agencies in their law enforcement duties. He pointed out that the

IRS was barred from providing tax return information to the SEC, federal bank regulators, and the Public Company Accounting Oversight Board (PCAOB) -- even, for example, when that information might assist the SEC in evaluating whether an abusive tax shelter resulted in deceptive accounting in a public company's financial statements, might help the Federal Reserve determine whether a bank selling tax products to its clients had violated the law against promoting abusive tax shelters, or help the PCAOB judge whether an accounting firm had impaired its independence by selling tax shelters to its audit clients.

Another example demonstrates how harmful these information barriers are to legitimate law enforcement efforts. In 2004, the IRS offered a settlement initiative to companies and corporate executives who participated in an abusive tax shelter involving the transfer of stock options to family-controlled entities. Over a hundred corporations and executives responded with admissions of wrongdoing. In addition to tax violations, their misconduct may be linked to securities law violations and improprieties by corporate auditors or banks, but the IRS has informed the Subcommittee that it is currently barred by law from sharing the names of the wrongdoers with the SEC, banking regulators, or PCAOB. The same is true for the offshore dividend tax shelters exposed in the Subcommittee's 2008 hearing. The IRS knows who the offending banks and investment firms are that designed and sold questionable dividend enhancement transactions to offshore hedge funds and others, but it is barred by Section 6103 of the tax code from providing detailed information or documents to the SEC or banking regulators who oversee the relevant financial institutions.

These communication barriers are outdated, inefficient, and ill-suited to stopping the torrent of tax shelter abuses now affecting or being promoted by so many public companies, banks, investment firms, and accounting firms. To address this problem, Section 306 of this bill would authorize the Treasury Secretary, with appropriate privacy safeguards, to disclose to the SEC, federal banking agencies, and the PCAOB, upon request, tax return information related to abusive tax shelters, inappropriate tax avoidance, or tax evasion. The agencies could then use this information only for law enforcement purposes, such as preventing accounting firms, investment firms, or banks from promoting abusive tax shelters, or detecting accounting fraud in the financial statements of public companies.

Section 307 - Increased Disclosure of Tax Shelter Information to Congress

The bill would also provide for increased disclosure of tax shelter information to Congress.

Section 307 would make it clear that companies providing tax return preparation services to taxpayers cannot refuse to comply with a Congressional document subpoena by citing Section 7216, which prohibits tax return preparers from disclosing taxpayer information to third parties. Several accounting and law firms raised this claim in response to document subpoenas issued by the Permanent Subcommittee on Investigations, contending they were barred by the nondisclosure provision in Section 7216 from producing documents related to the sale of abusive tax shelters to clients for a fee.

The accounting and law firms maintained this position despite an analysis provided by the Senate legal counsel showing that the nondisclosure provision was never intended to create a privilege or to override a Senate subpoena, as demonstrated in federal regulations interpreting the provision. This bill would codify the existing regulations interpreting Section 7216 and make it clear that Congressional document subpoenas must be honored. Section 307 would also ensure Congress has access to information about decisions by Treasury related to an organization's tax exempt status. A 2003 decision by the D.C. Circuit Court of Appeals, *Tax Analysts v. IRS*, struck down certain IRS regulations and held that the IRS must disclose letters denying or revoking an organization's tax exempt status. The IRS has been reluctant to disclose such information, not only to the public, but also to Congress, including in response to requests by the Subcommittee.

For example, in 2005, the IRS revoked the tax exempt status of four credit counseling firms, and, despite the *Tax Analysts* case, claimed that it could not disclose to the Subcommittee the names of the four firms or the reasons for revoking their tax exemption. Our bill would make it clear that, upon receipt of a request from a Congressional committee or subcommittee, the IRS must disclose documents, other than a tax return, related to the agency's determination to grant, deny, revoke or restore an organization's exemption from taxation.

Section 308 - Tax Shelter Opinion Letters

As part of Circular 230, the Treasury Department has issued standards for tax practitioners who provide opinion letters on the tax implications of potential tax shelters. Section 308 of the bill would provide express statutory authority for these and even clearer regulations.

The public has traditionally relied on tax opinion letters to obtain informed and trustworthy advice about whether a tax-motivated transaction meets the requirements of the law. The Permanent Subcommittee on Investigations has found that, in too many

cases, tax opinion letters no longer contain disinterested and reliable tax advice, even when issued by supposedly reputable accounting or law firms. Instead, some tax opinion letters have become marketing tools used by tax shelter promoters and their allies to sell clients on their latest tax products. In many of these cases, financial interests and biases were concealed, unreasonable factual assumptions were used to justify dubious legal conclusions, and taxpayers were misled about the risk that the proposed transaction would later be designated an illegal tax shelter. Reforms are essential to address these abuses and restore the integrity of tax opinion letters.

The Treasury Department recently adopted standards that address a number of the abuses affecting tax shelter opinion letters; however, the standards could be stronger yet. Our bill would authorize Treasury to issue standards addressing a wider spectrum of tax shelter opinion letter problems, including: preventing concealed collaboration among supposedly independent letter writers; avoiding conflicts of interest that would impair auditor independence; ensuring appropriate fee charges; preventing practitioners and firms from aiding and abetting the understatement of tax liability by clients; and banning the promotion of potentially abusive tax shelters. By addressing each of these areas, a beefed-up Circular 230 could help reduce the ongoing abusive practices related to tax shelter opinion letters.

Title IV - Economic Substance

Finally, Title IV of the bill incorporates a Baucus-Grassley proposal which would strengthen legal prohibitions against abusive tax shelters by codifying in federal tax statutes for the first time what is known as the economic substance doctrine. This anti-tax abuse doctrine was fashioned by federal courts evaluating transactions that appeared to have little or no business purpose or economic substance apart from tax avoidance. It has become a powerful analytical tool used by courts to invalidate abusive tax shelters. At the same time, because there is no statute underlying this doctrine and the courts have developed and applied it differently in different judicial districts, the existing case law has many ambiguities and conflicting interpretations.

This language was developed under the leadership of Senators Baucus and Grassley, the Chairman and Ranking Member of the Finance Committee. The Senate has voted on multiple occasions to enact the economic substance doctrine into law, but House conferees have rejected it each time. Since no tax shelter legislation would be complete without addressing this issue, Title IV of this comprehensive bill proposes once more to include the economic substance doctrine in the tax code.

Conclusion

The eyes of some people may glaze over when tax shelters and tax havens are discussed, but unscrupulous taxpayers and tax professionals see illicit dollar signs. Our commitment to crack down on their tax abuses must be as strong as their determination to get away with ripping off America and American taxpayers.

Our bill provides powerful tools to end offshore tax haven and tax shelter abuses. Offshore tax abuses alone contribute nearly \$100 billion to the \$345 billion annual tax gap, which represents taxes owed but not paid. With the financial crisis facing our country today and the long list of expenses we're incurring to try to end that crisis, it is past time for taxes owing to the people's Treasury to be collected. And it is long past time for Congress to stop tax cheats from shifting their taxes onto the shoulders of honest Americans.

I am optimistic that under the leadership of the new Obama Administration and with the support of the Senate Finance Committee that we can finally tackle this massive problem.