United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs

Carl Levin, Chairman
Norm Coleman, Ranking Minority Member

EMBARGOED TO 10:00 P.M.
Wednesday, September 10, 2008

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To 10 P.M., WEDNESDAY, SEPTEMBER 10, 2008

Permanent Subcommittee on Investigations Issues Report on Major Banks Helping Non-U.S. Clients Dodge U.S. Dividend Taxes

WASHINGTON -- At a Thursday hearing entitled ***Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends***, the Senate Permanent Subcommittee on Investigations will examine how some financial institutions have designed, marketed, and implemented transactions to enable foreign taxpayers, including offshore hedge funds, to dodge millions of dollars of taxes on U.S. stock dividends each year. The hearing, which follows a year-long bipartisan investigation, is part of a series of Subcommittee hearings on offshore tax abuse, which costs the United States an estimated $100 billion in tax revenues every year. Subcommittee Chairman Sen. Carl Levin (D-Mich.) and Ranking Minority Member Norm Coleman (R-Minn.) will release a 77-page joint staff report detailing the findings of the investigation in conjunction with the hearing.

“Financial gimmicks are being used to help foreign investors dodge U.S. taxes on U.S. dividend taxes, and it is an open secret among insiders that they can get away with it,” said Levin. “Major financial institutions have devised complex financial structures to enable their offshore clients to dodge U.S. dividend taxes. Over the last ten years, dividend tax abuse has cost the U.S. treasury and honest taxpayers billions of dollars in lost revenue. We need legislation to take these abusive tax avoidance gimmicks off the market, and we need to end the silence and inaction of the Treasury and IRS in the face of rampant dividend tax dodging.”

“The Subcommittee’s bipartisan investigation leaves no doubt that some institutions have taken advantage of ambiguities in U.S. tax law and pushed the tax-avoidance envelope too aggressively,” said Coleman. “The findings are compelling and we must reevaluate the wisdom and effectiveness of the tax regime governing these complex structures, some of which are designed solely to avoid taxes. A swaps transaction with no business purpose other than the avoidance of taxes is just a bridge too far. It’s especially troubling that the IRS has failed to address many of these problems for so long; in short, it appears that the IRS dropped the ball on preventing many of these egregious schemes. Most importantly, these tax-avoidance schemes that are being used by a privileged few force millions of honest American taxpayers to shoulder a disproportionate share of the tax base, to dig deeper to maintain investment in crucial areas like healthcare, homeland security, and education. Honest American taxpayers are the victims here.”

Hearing witnesses will include representatives of financial institutions, hedge funds, a tax expert, and the Commissioner of the Internal Revenue Service.

Foreigners who invest in the United States are exempt from many U.S. taxes – they don't pay taxes on interest earned on money deposited in a U.S. bank, nor do they pay taxes on capital gains – but if they invest in a U.S. company and the stock pays a dividend, U.S. law requires the foreign investor to pay a tax on the dividend. Dividends sent abroad are supposed to be taxed at a rate of 30% in most countries, and 15% in countries having a tax treaty with the United States. In reality, however, many non-U.S. stockholders never pay the dividend taxes they owe. The Subcommittee found that part of the reason is that U.S. financial institutions are helping non-U.S. clients escape paying the U.S. taxes they owe.

The Subcommittee began its investigation into offshore dividend tax abuse in September 2007. It issued more than a dozen subpoenas, conducted numerous interviews, and reviewed hundreds of thousands of pages of documents. To illustrate the scope and nature of the problem, the Subcommittee developed six case histories involving Lehman Brothers, Morgan Stanley, Deutsche Bank, UBS, Merrill Lynch, and Citigroup. Each developed and marketed dividend-dodging products, involving primarily stock swaps or loans, which were described as offering "dividend enhancement," "yield enhancement," or "dividend uplift."

The Subcommittee also interviewed managers of offshore hedge funds that used these products, including Angelo Gordon, Goldman Sachs Asset Management, Highbridge, Maverick, Moore Capital, and funds managed by the financial institutions listed above. The investigation found that many of these offshore hedge funds functioned as shell entities controlled by U.S. professionals who facilitated their participation in dividend-dodging transactions.

"It adds insult to injury when so-called 'offshore' hedge funds turn out to have a shell operation offshore and their real headquarters are in the United States with U.S. personnel advising them on how to dodge U.S. taxes," said Levin.

The investigation found: (1) for over ten years, some U.S. financial institutions have been structuring abusive transactions aimed at enabling their non-U.S. clients to dodge U.S. taxes on stock dividends; (2) offshore hedge funds are frequent participants in abusive dividend tax transactions, and their U.S. general partners or investment managers frequently facilitated their participation; (3) over the last ten years, offshore dividend tax abuses have resulted in billions of dollars in lost U.S. tax revenues; and (4) the Department of Treasury and IRS have failed to take effective action to stop offshore dividend tax abuses, and their inaction has encouraged the spread of offshore dividend tax abuse.

The investigation also disclosed 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, used dividend enhancement products at multiple firms to escape dividend taxes from 2000 to 2007, totaling nearly $95 million. Citigroup told the IRS that it had failed to withhold dividend taxes on a limited set of swap transactions from 2003 to 2005, and voluntarily paid those taxes which totaled $24 million.

In the report, the Subcommittee Majority staff recommends the following:

(1) **End Offshore Dividend Tax Abuse.** Congress should end offshore dividend tax abuse by enacting legislation to make it clear that non-U.S. persons cannot avoid U.S. dividend taxes by using a swap or stock loan to disguise dividend payments. This legislation should end the abuse by eliminating the different tax rules for U.S. stock dividends, dividend equivalent payments, and dividend substitute payments, and making them all equally taxable as dividends.

(2) **Take Enforcement Action.** The IRS should complete its review of dividend-related transactions and take civil enforcement action against taxpayers and U.S. financial institutions that knowingly participated in abusive transactions aimed at dodging U.S. taxes on stock dividends.

(3) **Strengthen Regulation on Equity Swaps.** To stop misuse of equity swap transactions to dodge U.S. dividend taxes, the IRS should issue a new regulation to make dividend equivalent payments under equity swap transactions taxable to the same extent as U.S. stock dividends.

(4) **Strengthen Stock Loan Regulation.** To stop misuse of stock loan transactions to dodge U.S. dividend taxes, the IRS should immediately meet its 1997 commitment to issue a new regulation on the tax treatment of substitute dividend payments between foreign parties to make clear that inserting an offshore entity into a stock loan transaction does not eliminate U.S. tax withholding obligations.

The Minority staff participated in and supports the investigation and concurs in the report's findings and analysis, but takes no position on the recommendations pending further review.

Since 2001, PSI has held a series of hearings on offshore tax abuses. Past hearings include a 2006 hearing, "Tax Haven Abuses: The Enablers, the Tools, and Secrecy," that looked at how offshore industry professionals aid U.S. tax evasion; and a July 2008 hearing, "Tax Haven Banks and U.S. Tax Compliance" shows how Swiss and Liechtenstein banks have helped U.S. clients hide assets from tax authorities. Details about PSI's work on tax shelter and tax haven abuses can be found on the Subcommittee's website.