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OPENING STATEMENT BY SENATOR JOHN McCAIN AT PSI HEARING ON BASKET OPTIONS

Washington, D.C. **–** U.S. Senator John McCain (R-AZ) today delivered the following opening statement at the Permanent Subcommittee on Investigations (PSI) hearing, "Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits."

More information on the Subcommittee's investigation is available here.

"Thank you, Mr. Chairman. Today's hearing sheds light on how Renaissance Technologies was able to avoid paying more than $6 billion in taxes by disguising its day-to-day stock trades as long term investments. To accomplish that, Renaissance set-up a quote 'basket option,' which is an artificial structure – not available to ordinary consumers – that allowed Renaissance to legally classify its short-term trading profits as long-term capital gains, subjecting those gains to a substantially lower tax rate.

"Renaissance profited from this tax treatment by insisting on the fiction that it didn't really own the stocks it traded – that the banks that Renaissance dealt with, did. But, the fact is that Renaissance did all the trading, maintained full control over the account, bore all the real risk, and reaped all of the profits. This setup allowed Renaissance to claim that profits from its day-to-day trades were actually long-term investments, thereby avoiding payment of billions in taxes.

"In reaction to Renaissance's use of this structure, the IRS opened an investigation and, today, is in the process of litigating the legal issues. It's not the Subcommittee's place to weigh in on those proceedings and determine whether the behavior in question was illegal. But, this basket-option practice – available to hedge funds but inaccessible to the average investor – needs to be fully examined and addressed.

"The biggest reason why it should be examined is the tremendous amount of taxes Renaissance was able to avoid paying by using this structure. In the course of its investigation, the Subcommittee learned that between the years 2000 and 2014, Renaissance exercised 60 long-term basket options with Deutsche Bank and Barclays, earning in the neighborhood of $34 billion in pre-tax profits and potentially avoiding over $6 billion in taxes.

"Meanwhile, Deutsche Bank and Barclays happily took part in the basket options because they made hundreds of millions of dollars in fees from these transactions, while incurring no actual risk. That is, until the IRS started to investigate. To protect themselves, Deutsche Bank in 2010 and Barclays in 2012 decided to only offer Renaissance options lasting less than one year so that all the profits from the options would have to be considered short-term capital gains.

“Large trading firms will always try to stay one step ahead of the game when it comes to pushing the envelope on the tax code to minimize paying taxes. And, regulators will inevitably struggle to detect and stop new schemes as they arise. It is, therefore, critical that regulators use the resources they have in an efficient manner to target the most likely offenders. So, whatever practical impediments currently disable the IRS from auditing large partnerships that use these sorts of tax structures, should be eased or eliminated. Doing so would allow the IRS to audit companies based on a careful assessment of the likelihood that a given company is engaging in activities that warrant an audit. This would differ from the current practice which focuses on the corporate form selected by that company, which has led to corporations being disproportionately audited.

“One thing is clear: Americans are tired of seeing Wall Street firms playing by a set of rules other than those that apply to ordinary citizens. Even as consumers worried about losing their savings in the 2008 financial crisis, Renaissance remained enormously profitable throughout by, among other things, utilizing the tax-avoidance structure detailed in today’s hearing. When ordinary citizens make short-term trades, they get taxed at the short-term rate. When financial firms like Renaissance make short-term trades, they shouldn’t be treated any differently. The perception that Wall Street self-deals or plays by its own rules engenders a deep-seeded distrust and cynicism among Americans that is neither desirable nor healthy for the nation.
I want to thank the witnesses for appearing before the Subcommittee today and I look forward to their testimony.

“Thank you, Mr. Chairman.”

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