

# **URGENT MESSAGE TO U.S. President, Congress & Constituents**

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The Uglan House in Grand Cayman is used as the address for 12,748 companies.

By David Evans

◀ On a January afternoon in George Town, the capital of the Cayman Islands, the sun beats down on three cruise ships anchored at Hog Sty Bay. Along the waterfront on Church Street stands a green-trimmed, white, five-story office building called Ugland House. From the outside, there's no way to see it's the official address of 12,748 companies. Ugland and other office buildings in George Town are home to subsidiaries of more than 150 U.S. corporations, including Coca-Cola Co., Intel Corp. and 10 more of the 30 companies in the Dow Jones Industrial Average.

Parmalat Finanziaria SpA, the Italian food company that collapsed in December after telling investors it had lied about its finances, used three Cayman subsidiaries to misrepresent assets, according to Italian prosecutors. Enron Corp., the Houston-based energy company that went bankrupt in December 2001, used 441 Cayman affiliates to help hide \$2.9 billion in losses, U.S. Senate investigators say.

Scores of the biggest U.S. companies use havens like the tax-free Cayman Islands, a British crown colony 150 miles southwest of Cuba, to escape billions of dollars in U.S. taxes, says Senator Byron Dorgan, a Democrat from North Dakota.

Twenty-four of the 100 largest contractors with the U.S. federal government—including Altria Group Inc., Oracle Corp. and Procter & Gamble Co.—have subsidiaries in the Caymans, according to a March report by the General Accounting Office, Congress's investigative arm. Those 24 companies received a total of \$35 billion from the U.S. government in 2001, the GAO found. "They are shortchanging our country even as they profit from it," says Dorgan, 62, the top Democrat on the Competition, Foreign Commerce and Infrastructure Subcommittee of the Committee on Commerce, Science and Transportation.

Oracle spokeswoman Deborah Lilienthal says the database software maker's Cayman subsidiary owns a minority share of a foreign company she declined to disclose. Procter & Gamble spokesman Douglas Shelton says the household goods maker's Cayman subsidiary is an inactive holding company. "We're currently exploring dissolution of that entity so it doesn't raise questions in people's minds," he says. Altria spokesman Tim Kellogg says the food and cigarette maker's Cayman subsidiary is a holding company.

The 100 U.S. contractors own 464 subsidiaries in offshore tax havens, according to the GAO report. The offshore subsidiaries often serve the sole purpose of allowing companies to avoid paying U.S. taxes, says Senator Carl Levin, 68, a Democrat from Michigan. "Many are little more than a post office box set up to allow corporations to move profits to the low- or no-tax havens rather than reporting that income to the United States," he says.

J.P. Morgan Chase & Co. estimated in a June study that \$650 billion of profit earned abroad by U.S. companies over decades had never been taxed by the U.S. That's up from a cumulative total of \$500 billion cited by J.P. Morgan in a study a year ago. In 2001, almost half of the money U.S. companies earned outside the

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That costs the  
U.S. billions  
in lost taxes.

# THE \$150 BILLION SHELL GAME

U.S.—47 percent—was accounted for in offshore tax havens such as the Cayman Islands, which has no corporate income tax, says Martin Sullivan, 45, a former U.S. Treasury Department economist, citing Commerce Department data. As a result, companies didn't have to pay the 35 percent U.S. corporate income tax.

The tax haven units held only 12.6 percent of the companies' foreign plants and equipment and 9 percent of their foreign employees, says Sullivan, who now writes a column for *Tax Notes*, a weekly journal. In other words, U.S. companies were avoiding not only U.S. taxes but taxes in other countries where they made and sold products, Levin says. "When \$250 billion of the \$880 billion in foreign bank deposits within U.S. banks is attributed to the Cayman Islands, to connect the dots you've got to ask questions about the extent of tax dodging in that country and other tax havens," Levin says. Sullivan says his research shows the Caymans are being used for U.S. tax avoidance.

David James, vice president of research at James Investment Research Inc., which manages \$650 million, says he has mixed feelings about companies that use the Cayman Islands to avoid U.S. taxes. "As an American, I hate to see it happen," he says. "As an economist, I see it as a sign U.S. taxes are too high. As a shareholder, I favor lowering taxes to boost the bottom line. If they can move to Mars and reduce taxes further, that would be fine."

James Investment, based in Beavercreek, Ohio, holds 24,000 shares of Seagate Technology Inc., the world's largest computer disk drive maker. Seagate, based in Scotts Valley, California, incorporated in the Cayman Islands in 2000. The company reduced its taxes in fiscal 2003 to an effective rate of 2.9 percent, or \$19 million on profit of \$660 million, according to its 2003 annual report. Seagate's taxes included foreign taxes paid of \$40 million and a U.S. tax credit of \$21 million, according to the report.



U.S. Senator **Byron Dorgan** says too many companies abuse accounting rules to avoid taxes.

Spokesman Guy Cantwell says about 69 percent of the company's revenue comes from outside the U.S.

Coca-Cola, the world's largest soft-drink maker, manufactures syrup in two Irish plants owned by Coke's Cayman-based subsidiary, Atlantic Industries. Coke, based in Atlanta, saved \$500 million in U.S. taxes last year by earning 63 percent of its income through foreign subsidiaries, according to its 2003 annual report. Coke used the Cayman subsidiary to sell syrup to customers in 75 countries and avoid paying U.S. taxes on earnings from more than \$1 billion in revenue last year, according to a person familiar with Coke's finances. Coke spokesman Ben Deutsch says the company doesn't comment on tax strategies for competitive reasons.

"When companies, including great companies like Coca-Cola, decide they want to minimize their participation in the payment of taxes for that which we enjoy in this country, it bothers me," Dorgan says.

Intel, the world's biggest computer chip maker, uses a Cayman subsidiary to run plants in Ireland, which has a 12.5 percent corporate income tax. Intel, using its offshore units, avoided \$792.6

million in U.S. taxes from 2001 to 2003, according to SEC filings. Asked why Intel, based in Santa Clara, California, has a Cayman subsidiary, spokesman Chuck Mulloy says, "I can only assume it's for tax purposes." He adds, "Unless we absolutely need it onshore, we'll keep it offshore to avoid paying a 35 percent tax." Intel Chief Executive Officer Craig Barrett declines to comment, Mulloy says.

Intel is part of a group of U.S. companies called the Homeland Investment Coalition that supports Congressional proposals to allow the billions of dollars in overseas profits to be repatriated for one year in exchange for paying a 5.25 percent tax.

The coalition, which has hired PricewaterhouseCoopers

## 'We have to get on top of corporate accounting and manipulation of corporate books for the sole purpose of reducing taxes,' Senator Charles Grassley says.

Seagate incorporated in the Caymans to reduce its taxes, spokesman Brian Ziel says. "The competitive benefits relate both to taxes saved on certain income earned outside of the United States and the ability to efficiently deploy assets around the globe to remain competitive," he says.

Other U.S.-based corporations incorporated in the Caymans include Fresh Del Monte Produce Inc., the world's third-largest banana producer, which is actually headquartered in Coral Gables, Florida, and Transocean Inc., a drilling company with an \$8.2 billion market value, which is actually based in Houston. Del Monte spokeswoman Dana Weinstein declined to comment. Transocean wrote in a 1999 SEC filing that it had incorporated in the Caymans to lower its taxes.

LLP to lobby the U.S. Congress, presents the proposal as an idea that would benefit both the companies and the country's economy. It says the repatriated money would be used to create jobs, fund pension plans and pay off debt. Few of these dollars would ever be brought back to the U.S. and taxed if the one-time tax break isn't approved, the coalition said in an April 28, 2003, letter to Congress. J.P. Morgan estimates \$425 billion would be repatriated. That would result in \$22.3 billion in U.S. tax revenue, using the proposed 5.25 percent tax rate. That figure represents 17 percent of the \$132 billion in U.S. corporate tax revenue in fiscal 2003, according to the Congressional Budget Office.

Forty-five percent of U.S. corporations with revenue exceeding \$50 million or assets of more than \$250 million paid no federal income tax in 2000, according to the GAO study. That has increased each year since 1996, when it was 33 percent, a GAO study found.

"There's no reliable data on how many offshore subsidiaries serve as tax dodges versus valid business outlets," Levin says. "But recent research does show that U.S. businesses are reporting more and more of their profits in tax havens while paying less and less in U.S. taxes."

Some of the research Levin refers to is by economist Sullivan, who analyzed Commerce Department data and found that profits for Cayman subsidiaries of U.S. companies are soaring. They earned \$5.1 billion in 2001, up from \$300 million in 1993, he found. Revenue for the Cayman units rose to \$12.5 billion from \$2 billion, while their assets increased to \$141.8 billion from \$9 billion eight years earlier, Sullivan found.

Companies focusing on tax avoidance by shifting income to tax havens don't impress all investors, says Lynn Yturri, who oversees \$500 million at Columbus, Ohio-based Banc One Investment Advisors, which manages more than \$150 billion. "Conservative tax strategies are what investors are looking for, not gimmicks," he says. "Investors are going to discount the stock of companies that don't pay their fair share of taxes." Yturri cites Stanley Works, the largest U.S. maker of hand tools, which in August 2002 abandoned plans to change its legal address to the tax-free island of Bermuda from New Britain, Connecticut. Stanley shares have risen 25 percent since that decision.

Presidential candidates John Kerry, a Democratic senator from Massachusetts, and Republican President George W. Bush disagree about how much tax U.S. corporations should pay the U.S. Kerry, 60, says he would require U.S. corporations to pay U.S. taxes on all exported products regardless of where they're made or sold. "American companies should pay taxes on their profits in the same way whether they earn them in Bangalore or Buffalo," says Kerry aide Jason Furman, 33,

who was a staff economist on President Bill Clinton's Council of Economic Advisers.

Kerry would also allow a one-time tax bonus for U.S. companies: If they bring previous foreign earnings into the U.S., corporations could pay a 10 percent tax rate on that money rather than the current 35 percent. In the future, he would use the new taxes on foreign income to help lower the U.S. tax rate to 33.25 percent—minus credits for taxes paid to other countries.

**P**resident Bush, 57, unlike Kerry, doesn't want U.S. companies' foreign subsidiaries to pay U.S. taxes if they already pay foreign taxes, says Tara Bradshaw, a U.S. Treasury Department spokeswoman. Bush opposes a tax break for repatriated profit because it would be unfair to U.S. companies that already paid the full 35 percent tax rate, she says. Imposing income taxes on foreign subsidiaries of U.S. companies would place them at a disadvantage with competitors that don't pay U.S. taxes, she says. "This would be a serious blow to U.S. businesses seeking to compete in the global marketplace."

A practice called transfer pricing may be the key to how U.S.

corporations avoid taxes in the U.S. and other countries, Dorgan says. The accounting practice lets companies buy and sell products and services with their own offshore subsidiaries and set prices themselves. Companies abuse transfer pricing by shifting profits overseas to avoid U.S. taxes, Dorgan says. They set artificially high prices for imports and artificially low prices on exports, he says.

In a March report on financial crime and international law enforcement, the U.S. State Department cited examples of transfer pricing abuses, without naming companies. It said one company claimed to import dish towels from Pakistan for \$153.72 each; another reported it had imported briefs and panties from Hungary for \$739.25 a dozen; a third claimed it had paid \$4,896 a unit for metal tweezers imported from Japan. The report also cited a company claiming to export toilet bowls to Hong Kong for \$1.75 each. The State Department report called those prices absurd and ridiculous.

The fabricated high prices of imports let companies report artificially high expenses in IRS tax filings. The exaggerated low prices of exports allow companies to report smaller profits to the IRS. "Criminal individuals, corporations and other enterprises engage in abnormal international trade

pricing that transfers value and/or reduces U.S. tax liability," the State Department report said.

Transfer pricing abuses by corporations cost the U.S. Treasury \$53 billion a year, according to Professor John Zdanowicz of Florida International University in Miami. He says tracking a product used in transfer pricing transactions between U.S. companies and their subsidiaries in the Caymans

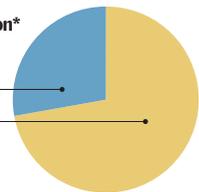


**Imbalance** The Caymans account for more than a quarter of U.S. foreign deposits.

Total foreign deposits in U.S. banks: \$880 billion\*

Cayman Islands: 27.8%

Rest of the world: 72.1%



\*As of February. Figures do not add up to 100 due to rounding. Source: U.S. Treasury

and elsewhere is difficult. "Where it really comes from and where it's really going, nobody knows, because of the secrecy," he says. The \$53 billion in lost U.S. taxes results from more than \$150 billion of profit from improper transfer pricing, Zdanowicz says. "It's a \$150 billion shell game," he says. Zdanowicz and Simon Pak, now at Penn State University in Great Valley, Pennsylvania, were granted \$2 million by Congress in

Monetary Authority. That's more deposits than there are in New York City, says Manhattan District Attorney Robert Morgenthau. The Cayman Islands are about one-third the size of New York City. "While some of this money may be there for legitimate purposes, much of it has been put there to avoid taxes and responsible regulation in this country," Morgenthau, 84, says.

The Caymans and its financial services industry profit from U.S. corporate accounts even while the Caymans collect no taxes. Cayman banks and related companies provide more than 10 percent of the islands' jobs, according to the government. The Caymans are home to about 200 licensed mutual fund administrators, who manage fund offices in the Caymans, more than 3,000 hedge funds, the Cayman Islands

Stock Exchange and offices of the four largest international accounting firms.

In the Cayman Islands, the names of company officers, directors and owners are, by law, secret. The Caymans are home to about 40,000 residents and an equal number of foreign-owned companies. The only public information available from the government's General Registry is a company's local address and date of incorporation. That information can be obtained for \$18 through a personal visit to the agency's public information counter on North Church Street, across the road from the harbor in George Town.

U.S. citizens are required to pay U.S. income tax on their earnings above \$80,000 around the world, even if they live and bank in the Cayman Islands. If they don't pay U.S. taxes, they can be prosecuted for criminal tax evasion. More than 20 U.S. citizens have been convicted of tax evasion since 1996 after hiding money from the IRS in Guardian Bank in the Cayman Islands. John Mathewson, 76, the owner of the bank and a U.S. citizen, pleaded guilty to money laundering in August 1997. As part of a plea agreement with U.S. prosecutors,

he turned over the names of more than 1,000 U.S. citizens suspected of using his bank to evade U.S. income taxes.

The rules are different for U.S.-based multinational corporations; they don't have to pay any U.S. taxes on profits earned from sales by their Cayman subsidiaries unless the money is brought back to the U.S. Under U.S. law, U.S. companies can use Cayman subsidiaries and transfer pricing rules to shift sales and profits from other countries, thus reducing their overall tax burden.

Four companies alone have accumulated a combined total of more than \$75 billion in earnings untaxed by the U.S.: Hewlett-Packard Co., Merck & Co., Pfizer Inc. and Coca-Cola, according to their most-recent annual reports. Pfizer spokesman Paul Fitzhenry

## 'I'd like to see just a small dose of patriotism with some of these companies,' Senator Byron Dorgan says.

2001 to do a more complete study of transfer pricing abuses. The economists' earlier study was cited in the March State Department report. The professors say they expect to complete their research this year.

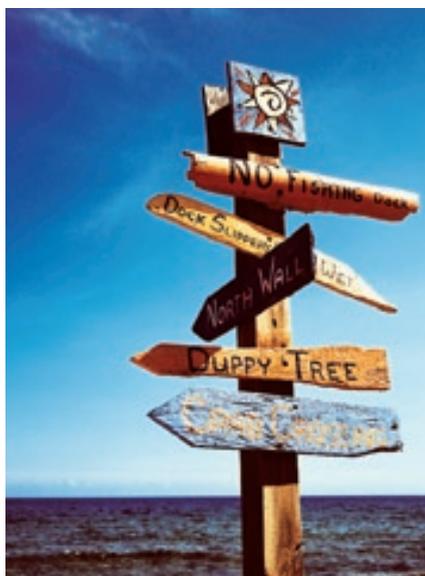
"We have to get on top of corporate accounting and manipulation of corporate books for the sole purpose of reducing taxes," says U.S. Senator Charles Grassley, 70, a Republican from Iowa and chairman of the Senate Finance Committee. "It's not any different than going overseas to set up a shell corporation. That is a shell game."

As long as U.S. companies are permitted to use loosely defined transfer pricing rules, massive tax evasion will continue, Dorgan says. "The IRS is staggering around in a fog here," Dorgan says. "They don't have a ghost of a chance of addressing these issues. And the growth in avoided taxes is scandalous."

Companies trading with their own foreign subsidiaries accounted for 46 percent of the \$1.33 trillion in goods imported to the U.S. in 2001 and 31 percent of the \$731 billion in exports that year, according to Commerce Department data. Under IRS rules in place since 1991, companies can negotiate with the IRS to determine transfer prices. Companies and the IRS sign contracts called Advance Pricing Agreements, which, like tax returns, are confidential.

"Transparency ought to be the name of the game," Grassley says. "There's got to be some check upon bureaucrats making decisions that lack oversight and the insight into public accounting. Obviously, it's not something that's very good the way it is."

The Caymans provide near-total financial secrecy for companies, banks and accounts. There are more than 500 banks and trust companies with deposits of more than \$1 trillion in the Cayman Islands, according to the Cayman



The Cayman Islands have about 40,000 residents and the same number of companies.

declined to comment. Merck spokesman Tony Polhoros says the company's decisions are in the best interests of U.S. employees and investors. "The earnings retained by our international subsidiaries include profits reinvested to expand our global sales," he says. Hewlett-Packard spokesman Brian Humphries declined to comment.

Atlantic Industries, the Cayman-based subsidiary of Coca-Cola that operates two factories in Ireland, exports more than \$1 billion of its syrup annually, according to John Whelan, CEO of the Irish Exporters Association. Atlantic's profit, which isn't made public, is taxed in Ireland and not at all in the Caymans or the U.S.

## ***Cayman Contracts With Terrorist States***

On April 13, 2003, President George W. Bush accused Syria of having weapons of mass destruction. "We believe there are chemical weapons in Syria," he said on the South Lawn of the White House. Secretary of Defense Donald Rumsfeld, appearing on CBS's *Face the Nation* the same day, said busloads of Syrians were sent to Iraq to kill Americans. "Reasonable people don't want to be associated with a state that's on a terrorist list," Rumsfeld said. "Who in the world would want to invest in Syria?"

Six weeks later, on May 31, Devon Energy Corp., an Oklahoma City-based oil and gas producer, entered a partnership with the Syrian government to spend \$17 million to search for oil in Syria, according to company filings with the U.S. Securities and Exchange Commission. Theodore Katoutouf, then U.S. ambassador to Syria, attended the contract signing in Damascus. Devon channeled the business through a Cayman Islands subsidiary.

Devon's work in Syria didn't mark the first time a U.S. company won a contract through a Cayman subsidiary in what the U.S.

called a terrorist state. A Halliburton Co. subsidiary sold \$33.6 million in products and services to Iran in 2001, according to filings with the SEC. Vice President Dick Cheney was chief executive officer of Houston-based Halliburton, an energy services and engineering company, from 1995 to 2000.

Iran is blacklisted by the U.S. as a terrorist state, which means U.S. companies are forbidden from accepting contracts from Iran. The Halliburton unit that won the contract in Iran was incorporated in the Cayman Islands and therefore wasn't subject to U.S. law, Halliburton says.

"All of Halliburton's business is clearly permissible under applicable U.S. laws and regulations," says Wendy Hall, a Halliburton spokeswoman. "If Congress decides to change the laws and provisions, Halliburton will, of course, comply."

Cheney spokesman Kevin Kellems says that before he was vice president, Cheney usually opposed economic sanctions. "He believed they were rarely effective and they often discriminated against American companies," he says.

In February, the U.S. Senate Finance Committee, chaired by Republican Charles Grassley, sent a letter to the Treasury Department asking if Halliburton was being investigated for violating U.S. sanctions. The committee also wrote letters to ConocoPhillips and General Electric Co. asking about their revenue from terrorist states, including Iran and Syria.

"If these companies are going through the backdoor to invest in terrorist nations, Congress must take action to immediately close, lock and seal those doors," said Senator Max Baucus, 62, of Montana, the senior Democrat on the committee.

The Finance Committee didn't challenge Devon's contract with Syria. Congress and President Bush put restrictions on U.S. companies working in Syria—such as barring exports from the U.S. to Syria, except for food and medicine—without banning them from working in that country.

"We entered Syria with the support of the U.S. government," says Brian Jennings, 43, Devon's chief financial officer. Jennings says that by using a Cayman subsidiary in Syria, the

company can finance that operation with profit earned in China without first paying U.S. taxes on it.

Halliburton is the 30th-largest military contractor, with fiscal 2001 federal contracts of \$534.2 million, according to a March study by the General Accounting Office, the auditing arm of Congress. Halliburton has 13 subsidiaries in the Caymans, two in Liechtenstein and two in Panama.

General Electric, the world's largest company by market value, has sold locomotives in Syria; in Iran, it sold medical equipment, provided oil and gas services and contracted to build hydroelectric generators, according to the Senate Finance Committee. ConocoPhillips, the largest U.S. oil refiner, runs a gas processing plant in Syria, the committee said. "We comply strictly with U.S. law in sales to Iran," says GE spokesman Gary Sheffer. "If Congress decides to change the law, we'll comply."

ConocoPhillips spokesman Sam Falcona says the company talks with U.S. officials to keep up with the rules. "We are in full compliance with the letter and spirit of U.S. laws," he says.

DAVID EVANS

Coke's Cayman subsidiary exports soft-drink concentrate to 75 countries on four continents, including China, Japan and Russia, according to Coke's annual report. By declaring its intent never to repatriate \$8.2 billion of foreign profit to the U.S., Coke has avoided paying any U.S. taxes on it. Instead, the company reinvests the profit overseas through such units as the Cayman subsidiary, according to its annual report.

Atlantic Industries' investments include partial ownership of two of the world's largest independent Coca-Cola bottlers: Athens-based Coca-Cola Hellenic Bottling Co., which operates in 26 countries—including Greece, Italy, Nigeria and Russia—according to its annual report, and Mexico City-based Coca-Cola Femsa SA, which operates in eight Latin American nations—including Argentina, Brazil and Mexico—according to its annual report. The profit from those investments isn't taxed in the U.S. because Atlantic is based in the Caymans, and the money isn't returned to the U.S.

With the offshore tax savings and other tax breaks such as losses on Latin American investments, the company's effective U.S. tax rate was reduced to 20.9 percent for 2003, according to its annual report. Coke's tax savings came as the company's board of directors—which includes Warren Buffett, 73, the world's second-richest person—told shareholders in its annual report that it had scaled back work in high-tax nations, firing a total of 3,700 employees in the U.S. and Germany last year. Buffett declines to comment, his assistant Debbie Bosanek says.

Buffett's Berkshire Hathaway Inc., an insurance and investment company, has no Cayman subsidiaries. Berkshire paid \$3.8 billion in U.S. taxes in 2003, or 32 percent of its earnings,

## 'As an American, I hate to see it happen,' says one fund manager. 'As a shareholder, I favor lowering taxes.'

SEC filings show. In his annual letter to shareholders in March, Buffett said the Bush administration was wrong to let U.S. companies play accounting games with the tax code and avoid U.S. taxes. "Today, many large corporations—run by CEOs whose fiddle-playing talents make your chairman look like he is all thumbs—pay nothing close to the stated federal tax rate of 35 percent," Buffett wrote.

Berkshire Hathaway, Coca-Cola's largest shareholder, owns 200 million shares, or 8.2 percent, of Coke, valued at about \$10 billion.

Citigroup Inc. says in SEC filings that it would have to pay \$1.8 billion in U.S. taxes if it brought back \$5.8 billion it keeps offshore. Oracle says it would have to pay \$691 million

**Tax relief** Pfizer has amassed almost \$40 billion in offshore profits.



Source: Company SEC filings

in taxes if it brought home \$3.1 billion that escaped U.S. taxes abroad. Other companies, such as Apple Computer Inc., drugmaker Schering-Plough Corp. and Intel, say they can't figure out how much they would owe.

Intel runs its largest microchip manufacturing site outside the U.S. in Leixlip, Ireland, on a former stud farm. The \$5.5 billion plant is owned by Cayman subsidiary Intel Ireland, spokesman Mulloy says. The 360-acre site has 4,700 employees. Mulloy says 70 percent of Intel's sales are made outside the U.S. He

says the company is legally keeping its tax bill as low as it can. Intel had accumulated \$7 billion in overseas earnings not taxed by the U.S. as of Dec. 31, 2003, SEC filings show. Mulloy says Intel's foreign earnings never taxed by the U.S. helped pay for the Ireland plant's construction. "Generally, we try to use the cash we generate offshore for offshore purposes," he says. By investing offshore earnings outside the U.S., Intel can legally avoid paying U.S. taxes.

Intel's then vice president of tax, licensing and customs, Robert Perlman, 60, told the U.S. Senate Finance Committee in March 1999 that Intel would have been better off incorporating in the Cayman Islands when it was founded in 1968. "Our tax code competitively disadvantages multinationals simply because the parent is a U.S. corporation," Perlman testified.

Dorgan says that perspective is unpatriotic. "Well, maybe he should just change the language and say if we can find ways to not support our country and our government through the paying of taxes, our company would like to do it," Dorgan says. "I'd like to see just a small dose of patriotism with some of these companies because they do well as American companies, they're protected by our military, they access all our transportation, our education facilities and so on. They want all the benefits of American citizenship except that of paying taxes."

Parmalat, Italy's largest dairy company, filed for bankruptcy in December after saying one of its Cayman subsidiaries didn't actually have \$4.9 billion Parmalat had previously told investors it did. Parmalat used the Cayman shell companies to create billions of dollars of nonexistent assets, Parmalat said in December. They included Epicurum, a hedge fund that supposedly held an investment from Parmalat valued at more than \$600 million. In fact, the fund existed on paper only and was worthless, Italian prosecutors say. Also Based at Uglad House was Bonlat Financing Corp. Parmalat said it had falsely told investors that subsidiary possessed billions of dollars of certificates of deposit at Bank of America.

Enron, the world's largest energy trader until 2001, set up 441 companies in the Cayman Islands as part of a massive accounting fraud, according to Senate investigators. Former CEO Jeffrey Skilling was charged with federal criminal fraud

and is awaiting trial. Former Chief Financial Officer Andrew Fastow pleaded guilty in federal court to securities fraud in January and was sentenced to 10 years in prison.

Cindy Scotland, executive director of the Cayman Monetary Authority, the independent agency charged with policing financial institutions on the island, says the Caymans have stiffened regulations in the past three years. The government enacted tough anti-money laundering laws that include possible jail terms for lawyers and accountants who don't report money laundering, created an independent monetary authority to oversee financial institutions, mandated licensing for securities dealers and required more identity and background information from anyone opening a bank account, she says. Financial scams, such as those by Parmalat, rarely originate on the island, she says. "None of that fraud was actually created here," Scotland says. She says no jurisdiction could ever entirely prevent fraud.

Even so, the Caymans have agreed to provide information only upon request of U.S. authorities. Strict Cayman secrecy laws remain in place, says Reuven Avi-Yonah, professor of international tax law at the University of Michigan Law School in Ann Arbor. "The likelihood U.S. officials would know what to ask for is very low," he says.

Maples and Calder, the largest law firm on the island, is headquartered in Ugland House. Law books on a shelf in the boardroom include the five-volume set *Money Laundering, Asset Forfeiture and International Financial Crimes* by Fletcher Baldwin Jr. (Oceana Publications, 1993). Litigation partner Andrew Jones, 54, says the firm set up five Parmalat-related entities at the law firm's address.

**A**s for U.S. tax revenue, fraud isn't the culprit; abuse of the laws is, says Douglas Shackelford, a business professor at the University of North Carolina in Chapel Hill. U.S. multinational corporations will continue to legally stash profits overseas, out of the IRS's grasp, unless the U.S. changes the rules of the international tax game, he says.

"As long as there's a Cayman Islands, there'll always be some guys who'll give you secret banks and no taxes," Shackelford, 45, says. "They're the leak in the bucket."

Until the U.S. removes incentive for companies to shift income to low-tax or no-tax places, companies like Coca-Cola and Intel will have little reason to change their strategies. ▶

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**BLOOMBERG TOOLS**

## A Closer Look at Offshore Subsidiaries

Twelve of the 30 companies in the Dow Jones Industrial Average have subsidiaries in the Cayman Islands, according to filings with the U.S. Securities and Exchange Commission. Type `INDU <Index> MEMB <Go>` for a list of the index's members, including their percentages of weight in the index, numbers of shares in the index and last price quotes. Click on a ticker, such as `KO UN` for Coca-Cola Co., and select `DES` from the pop-up menu for a description of the company. Type `RELS <Go>` for a menu of related securities, as shown below, and then type `3 <Go>` for a listing of some major subsidiaries.

In addition to the Dow members, 24 of the 100 largest contractors with the U.S. federal government have subsidiaries in the Caymans, according to the General Accounting Office, the auditing arm of Congress. Type `USLE <Go>` and click on General Accounting Office to access the GAO's Web site for information on its reports and other publications. Type `ITAX <Go>` for

a menu of Web sites related to U.S. income taxes, including the U.S. Internal Revenue Service and U.S. Department of Treasury sites.

Company filings with the SEC show that in addition to gaining tax benefits, incorporating in the Caymans can help a company avoid U.S. securities laws intended to protect investors. To access filings for a specific company, type the ticker followed by `<Equity> CF <Go>`. For example, type `FDP US <Equity> CF <Go>` to list Fresh Del Monte Produce's filings.

MARY K. WOOD

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For Immediate Release  
April 18, 2007

Contact: Carol Guthrie  
202-224-4515

**Hearing Statement of Senator Max Baucus (D-Mont.)  
Regarding the Administration's Plan for Reducing the Tax Gap**

Forty-five years ago, President Kennedy challenged the nation. He said:

"I believe that this nation should commit itself to achieving the goal, before this decade is out, of landing a man on the moon and returning him safely to the Earth."

President Kennedy acknowledged the difficulty of the task. But he also saw the risks of failing to act. He said:

"[W]hile we cannot guarantee that we shall one day be first, we can guarantee that any failure to make this effort will make us last."

Today, we discuss goals for improving compliance with the tax law. Improving tax compliance might also be a difficult task. But it is not rocket science.

In 2005, the rate of voluntary tax compliance was 85 percent. But in 2006, it dropped to 83.7 percent. That's a drop of more than a full percentage point on one year. Each percentage point drop in the rate amounts to a \$25 billion increase in the annual tax gap.

Since 2001, the Government has failed to collect more than \$2 trillion in legally-owed taxes.

The American people have a right to expect that their government will have a goal and a credible plan to reduce this tax gap. And it is the Treasury's job to fix it. Yet the administration does not appear to take the job seriously.

In February 2006, I asked Secretary Snow for a tax gap plan within 30 days. When he left office, five months later, we still had not received one. He left behind a few proposals that would raise \$3.5 billion over 10 years, barely a dent in a tax gap that will lose \$3.5 trillion over 10 years.

On June 13, 2006, I asked IRS Commissioner Everson for a "reasonable, but aggressive" plan to reduce the tax gap. He agreed to provide a plan. But he has not delivered one.

On June 27, 2006, I asked Mr. Paulson for a plan. He did not commit to provide one.

On July 13, 2006, I asked Mr. Solomon for a plan. He, too, did not commit to provide a plan.

Only after I held up Mr. Solomon's nomination did Treasury agree to come up with something. And what we received was an outline for a strategy. That outline was utterly inadequate. It merely rehashed ideas that were already floating around Washington. It contained no specific goals.

The Treasury promised to provide a more detailed outline, following the release of the administration's fiscal year 2008 budget plan.

In February, however, the administration's budget included 16 tax compliance proposals that would raise just \$29 billion over 10 years.

Finance Committee staff is working closely with Treasury officials to develop these proposals. But a few worthy ideas do not rise to the level of a plan. And a penny on every dollar of the tax gap is simply not enough.

The budget says that the Treasury and the IRS, quote, "continue to consider additional approaches to reducing the tax gap." For two and a half months, this committee has been waiting to hear what they are.

Some complain that improving tax compliance will burden taxpayers and decrease their rights. But what about the rights of honest, hard-working taxpayers who do pay the taxes that they owe? What about the additional tax burden on honest taxpayers when the dishonest are allowed to skate by?

I know that there is no magic solution to the tax gap. But that doesn't mean there is no solution to the tax gap.

Increasing our nation's rate of voluntary tax compliance is going to take some ingenuity. It will take some elbow grease. It is going to require a multi-faceted approach. It will require addressing services, enforcement, and technology.

The administration needs a plan. It needs a concrete plan. It needs a plan with goals, benchmarks and timetables.

Secretary Paulson was a successful investment banker. Any banker would ask for a comprehensive business plan before approving a loan.

And every time that the Secretary of the Treasury travels overseas, the Department has a destination, an itinerary, and a precise timetable. For that, it has a plan.

That's why it astounds me that the Treasury does not have a comprehensive, credible plan for the tax gap.

I will not wait any longer. I am going to set the goal for you, today.

I am setting a goal of 90 percent voluntary compliance by the year 2017. That is six percentage points higher than today's rate. This is a realistic goal. It is achievable, within 10 years. When it is reached, collections of taxes legally owed will increase by at least \$150 billion each year.

It is up to the Treasury Department to develop and present to this Committee a plan that will achieve this 90 percent compliance goal.

I invite the Secretary to appear before this Committee in 90 days — on July 18, 2007 — to deliver his plan, complete with benchmarks and timetables.

The dropping voluntary compliance rate threatens the integrity of our tax system. It undermines fairness. It weakens confidence in government. And it breeds disrespect for the law.

This nation should commit itself to achieving the goal, before a decade is out, of having at least nine out of 10 taxpayers comply with the tax law. While we cannot guarantee that we shall achieve this goal, we can guarantee the consequences of failure to make the effort.

Let us challenge more taxpayers to comply with the law. Let us challenge the Treasury Department to find ways to make it so. And let us together work to restore the integrity of our tax system.

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Opening Statement of Sen. Chuck Grassley  
Hearing, “Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals,  
Benchmarks and Timetables?”  
Wednesday, April 18, 2007

I commend the Chairman for holding today’s hearing on the tax gap. While the tax gap is an important issue, it is certainly not a new issue. We have had a tax gap problem in this administration, the previous administration and my guess is back to when we first had an income tax.

According to the GAO, the voluntary compliance rate has ranged from around 81 percent to 84 percent over the past three decades. In the Finance Committee, we take the tax gap very seriously, because it’s not fair to the vast majority of taxpayers who pay their taxes on time.

But while this Committee has its feet on the ground on this issue, I’m worried that some members have their head in the clouds when it comes to the tax gap. Some members view the tax gap as money in the pocket to spend on favorite proposals. Nothing could be further from the truth. Closing the tax gap is a difficult and grinding process.

We have had several hearings when I was Chairman to examine the size, sources, and solutions to the tax gap, and we have enacted many steps to reduce the tax gap, such as reducing abuse in charitable donations of cars and intellectual property; increased penalties and reporting requirements; expanding the IRS’ whistleblower program; and authorizing the private debt collection program.

But we need to do more. Dozens of factors contribute to the tax gap and dozens of solutions are needed to close it. I am completely in support of taking appropriate measures to close the tax gap – and I will work aggressively toward enacting legislative changes to help close it -- but these steps have to be done with care in order to be effective. There are no easy solutions. There seems to be a general consensus that potential solutions to the tax gap fall into four categories:

- (1) additional and more efficient enforcement by the IRS;
- (2) additional legislative or regulatory tools for the IRS, such as information reporting and withholding;
- (3) changes to our tax base – as well as Treasury regulations and IRS guidance – that reduce the complexity of our current system; and

(4) improved service by the IRS to taxpayers; and I would add a new one since our hearing last week:

(5) ensuring that paid tax preparers provide taxpayers honest and informed assistance in filing their taxes.

I would give my colleagues an observation from a poet, T.S. Eliot, who said, “It is impossible to design a system so perfect that no one needs to be good.” Mr. Chairman, I think that sentence captures part of the challenge with the tax gap. The term “good” here, as I apply it, has two meanings. One notion of “good” taxpayers is taxpayers who intend to comply with the system. The second notion of “good” is taxpayers with the knowledge to competently deal with our complex tax system. Those two groups of taxpayers represent 84 percent of the dollars due and owing. As the Treasury Department’s work shows, part of the tax gap problem arises from willful non-compliance. Part of the problem arises from unintended non-compliance – i.e., confusion or the current system’s unwieldy complexity.

Of the taxpayers who make up the 16 percent of noncompliance, some do so willingly. There may not be a “perfect” system that can catch every willful noncomplier. Another portion of that 16 percent of dollars that is not compliant are not willful in their noncompliance. And to add to the difficulty, you may often have a situation where a taxpayer is very compliant in one area of their return but either willfully or ignorantly noncompliant in another part of their return. So it’s important to remember that the 16 percent noncompliance rate doesn’t translate into 16 percent of taxpayers; it may represent a much larger group of taxpayers who are a mix of compliant and noncompliant. A tax system designed to perfection, viewing it solely from the standpoint of the “perfect” rate of compliance, could undermine the efforts of the good folks who do now comply or mostly comply. This balance is a key consideration for the tax-writing committees.

We’re accountable to the people who must deal with the changes to the tax system. We’re right to insist on a level playing field – that is, ensuring that complying taxpayers are not subsidizing non-compliant taxpayers. At the same time, we must make sure that the system is workable for the vast majority who do comply.

Lastly, I would only repeat a comment made by the Chairman, and echoed in the title of this hearing. I think it is important that we start getting measures for success in closing the tax gap. I know all the comments about uncertainties and difficulties but we will never get to a better place regarding the tax gap if we don’t have the focus of reasonable achievements and objectives. I commend the administration for its efforts in the budget for dealing with the tax gap – both in terms of IRS funding and changes in the tax law. I think they are meaningful steps. But just that, steps. I hope this hearing will provide a better picture of what goals these steps, and future steps, can lead to.



For Immediate Release  
May 3, 2007

Contact: Carol Guthrie  
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**Hearing Statement of Senator Max Baucus (D-Mont.)  
Regarding Offshore Tax Evasion**

In Ecclesiastes, the Preacher urged his listeners to trade overseas, for they would find a good return. He said:

“Cast your bread upon the waters, for after many days, you will find it again.”

World trade has certainly generated a good return. The world’s pension, insurance, and mutual fund business now totals at least \$46 trillion. The world’s stock market capitalization is more than \$40 trillion. And the world’s credit derivatives market amounts to more than \$250 trillion.

Foreigners now own about \$12 trillion of American stocks, bonds, and other assets. That includes \$2 trillion of Federal government debt.

Most of this international trade is a healthy exchange of goods and services. But as international trade becomes more complex, it is becoming more and more difficult to track transactions legally subject to taxation. As a result, offshore tax evasion has become a large and growing element of the tax gap, that share of taxes legally owed that is not paid.

For years, the Federal government has been concerned about U.S. taxpayers hiding behind the veil of foreign corporations. And today, the government has the added challenge of keeping up with \$1.5 trillion in some 8,000 hedge funds investing around the globe. The IRS is increasingly outgunned in its effort to enforce tax rules in the international economy.

Consider these offshore tax scams that have recently come to light:

Two brothers from Texas set up 58 separate trusts and shell corporations, sheltering tens of millions of dollars in assets on which they avoided paying taxes.

A car dealer from Illinois was charged with pretending to live in the Virgin Islands, just so that he could get a break on his taxes.

A former U.S. Attorney from North Carolina pleaded guilty to failing to disclose on his taxes that he had an offshore debit account.

And a dentist in California was sentenced to two years in prison for faking tax deductions and hiding money in an offshore bank account.

And these are just the scams that we know about. Common sense dictates that they are just the tip of the iceberg.

I am pleased that today we can kick off our work this Congress on international tax evasion. Today we will hear the results of a GAO investigation into a critical part of our offshore tax enforcement program.

GAO focuses on almost \$300 billion in funds that it has identified as being transferred out of the United States every year. And GAO considers the tax issues raised by those transfers.

The real amount transferred overseas is much higher. But this is a good start for our oversight agenda.

Frankly, one job for the Federal government is just to nail down the amount being transferred offshore. We need to learn what the total amount is. And after that, we need to learn much more about how much tax is being avoided.

Within the \$300 billion total, we are told that the IRS has no idea where \$19 billion ends up, once the funds are transferred overseas. This is troubling.

Today, we will hear the results of two GAO reports. The first deals with qualified intermediaries. Qualified intermediaries are foreign banks and other exchanges that process funds entering and leaving the U.S.

In a second report, the GAO explains that the IRS takes much longer to finish its examination of an offshore tax evasion case than a domestic case. But the return to the IRS from an offshore case is typically three times what is recovered from a domestic case. This is a sure sign that the volume of offshore tax evasion is huge.

And GAO gives us some recommendations to consider:

GAO recommends that Congress should consider extending the statute of limitations for complicated offshore tax evasion cases.

GAO recommends that qualified Intermediaries need to do a better job of identifying and tracking the money that they handle.

And GAO recommends that the IRS needs to do a better job of tracking information about foreign financial transactions.

*--1 more--*

I also want to welcome our witnesses from the Treasury Department, the University of Michigan law school, and the Organization of Economic Co-operation and Development. All three can comment on the GAO findings. And all our witnesses can help us to explore the broader issues related to offshore tax evasion.

This hearing can help us to begin thinking about how the international community will eventually structure its tax system. We've seen the outsourcing of jobs. But now we are risking the outsourcing of our revenue base.

We have to contend with tax havens. But now even our friends in Europe are busy lowering their corporate tax rates. We have also seen cases of American companies moving their intellectual property overseas, in order to pay lower tax rates.

The heart of the problem is that the Treasury, the IRS, and American institutions know far less than they should. With international trade increasingly flowing across national boundaries at the speed of light, it is becoming more and more difficult to make sure that we are collecting the taxes that are owed. And the honest American taxpayers who work hard, and do not have the ability to engage in offshore activity, are left holding the bill.

So today we will examine the effort to combat tax evasion. And in days to come, this Committee will ask where our tax system should fit, in the new global economy.

So let us do what we can to ensure that American businesses continue to find profit in trade upon the waters. But let us also make sure that U.S. tax enforcement is not lost at sea. And in not too many days, may we once again find the right balance.

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Hearing on Offshore Tax Evasion: Stashing Cash Overseas  
Statement of Senator Chuck Grassley, Ranking Member  
Thursday, May 3, 2007

I want to thank Chairman Baucus for calling this hearing on offshore tax evasion and the international tax gap. Like the rest of the tax gap, offshore tax evasion is not a new issue. But it is an issue of growing importance in our increasingly global economy, where investment flows without regard to national borders, but a nation's taxing jurisdiction, and as a matter of policy or in practical effect, is often limited by national borders.

The focus of this hearing is to examine the problem of U.S. income tax evasion by individual taxpayers who hide their assets and income in foreign bank accounts and foreign entities. Since 1913, our tax code has subjected U.S. citizens to income tax on their worldwide income. No matter what the internet purveyors of tax evasion say, this principle cannot be avoided by living on a yacht or putting passive assets and income offshore. The tax code has rules to prevent this, and reporting requirements to make the IRS aware of the foreign activities of U.S. taxpayers. Taxpayers who willingly violate these rules are guilty of tax fraud.

Our existing reporting requirements regarding foreign activities of U.S. taxpayers are largely a matter of self-reporting. As a result, information exchange with other jurisdictions is an important tool for the government. Our income tax treaties contain an article on information exchange designed to help the government obtain quality information to enforce our tax laws. In addition, administrations past and present have entered into over 20 tax information exchange agreements with jurisdictions that are often referred to as tax havens. An important part of the value of our information exchange network lies in its deterrent effect. Taxpayers who know the IRS can get access to tax information from foreign jurisdictions will think twice before willingly failing to satisfy their self-reporting requirements.

As we will hear today, the OECD encourages effective information exchange, and the United States has been a leader in the international community in this area. Offshore tax evasion isn't just a U.S. problem; it is an international problem. Sensible solutions to the offshore tax evasion problem should aim to improve on our tax information exchange network, and not put it at risk.

The problem of offshore evasion is not that our laws permit it. The problem is that there are

some taxpayers who are intent on cheating and hiding their income from the IRS. The IRS has been successful in catching many of these tax cheats, but more can be done. I look forward to hearing from today's witnesses, as we continue to evaluate the offshore tax evasion problem and sensible ways to solve it.



For Immediate Release  
September 26, 2007

Contact: Carol Guthrie  
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**Hearing Statement of Senator Max Baucus (D-Mont.)  
Regarding Offshore Tax Issues: Reinsurance and Hedge Funds**

Benjamin Franklin said: "In this world, nothing can be said to be certain, except death and taxes."

Today, we will examine how some folks are going far afield in this world to make their taxes far less certain.

We will look at how people go offshore to avoid taxation in three settings: Insurance, hedge funds, and personal compensation.

The first setting that we will examine today is insurance.

Insurance companies make a living by doing two things: They set premiums based on their prediction of the likelihood of events against which they insure. That's called "underwriting."

And they also make money by investing the premiums that they collect until they have to pay out claims. If they are good at these two jobs, they make a profit.

Customers buy insurance from insurance companies to guard against the risk of a fire, disaster, or some other calamity. In exchange for paying premiums, the customers shift some of their risk to the insurance companies.

Insurance companies also buy insurance. Property and casualty insurance companies pay premiums to "reinsurance" companies in exchange for shifting some of their risk to the reinsurance company.

Sometimes the reinsurance company is also the parent company of the property and casualty insurance company. In that case, the property and casualty insurance company shifts risk to the parent reinsurance company at something less than an arm's length transaction.

Here's where the tax avoidance comes in. Some parent insurance companies set up their headquarters in low tax jurisdictions, like Bermuda. Subsidiary property and casualty insurance companies shift risk to the Bermuda parent. Because of Bermuda's low tax burden, the Bermuda parent can get a greater after-tax return on their investment activities.

*--more--*

As a result, the subsidiary property and casualty insurance companies can charge lower premiums for their insurance. They get a competitive advantage over insurance companies doing business in jurisdictions that tax investments.

The second setting that we will examine today involves hedge funds.

Foundations and other nonprofits are some of the largest investors in hedge funds. The law requires nonprofit investors that invest directly in hedge fund partnerships to pay the unrealized business income tax, known as “UBIT.” The policy behind the law is that tax-exempt entities should not be able to have an unfair advantage over tax-paying entities doing the same thing.

To avoid UBIT, nonprofit investors sometimes invest in hedge funds through offshore entities incorporated in low or no tax jurisdictions, such as the Cayman Islands or Bermuda. These offshore entities are called “blockers.”

The third setting that we will examine today is the compensation of hedge fund managers.

Hedge fund managers receive fees from offshore blocker corporations used by nonprofits and foreign investors. Some hedge fund managers elect to defer their income. Deferring income means that you pay taxes later, which is the same as a significant tax savings.

In each of these three settings, people can argue that there are legitimate business reasons for the offshore transaction. And in each of these three settings, people can legitimately question whether someone is avoiding paying their taxes.

Today, we will see whether Ben Franklin was right about the certainty of taxes in this world. We will see whether there are parts of this world where people get away without paying taxes. And we’ll examine whether this is something — unlike death — that we can do something about.

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Opening Statement of Senator Chuck Grassley  
Hearing, Offshore Tax Issues: Reinsurance and Hedge Funds  
September 26, 2007

Thank you Chairman Baucus, for calling this hearing on selected international tax issues. This morning, we will examine three seemingly discrete issues: (1) offshore reinsurance; (2) the use of offshore “blocker” corporations by domestic tax-exempt organizations to make hedge fund investments; and (3) the practice of deferring compensation by U.S. hedge fund managers with respect to offshore hedge funds.

We are in an increasingly global economy. U.S. businesses face foreign competitors here at home and in foreign markets. Under our system of taxing active business income, U.S.-owned businesses are taxed on their worldwide income, but deferral for active income helps them compete in foreign markets. We tax foreign-owned businesses only on their income that is sufficiently connected to the U.S. Concern about competition in the U.S. market often focuses on rules to prevent foreign-owned businesses from inappropriately stripping their U.S. tax base. The earnings stripping rules provide one example.

Our international tax system can affect the competitiveness of U.S. businesses both here and abroad. The insurance industry, which we are examining today, illustrates this fact. To help U.S. insurers compete in foreign markets, the tax code allows them to defer U.S. tax on their active foreign insurance income. This rule expires after 2008, but it has broad bipartisan support. In U.S. markets, however, domestic insurers have revived the claim that our tax rules place them at a disadvantage relative to their foreign-based competitors. Our tax code has rules designed to address this issue, but if there is a problem, then, by definition, those rules would be inadequate.

The reinsurance business is primarily located in London, Germany, Switzerland, and Bermuda. But Bermuda has received the most attention. One industry publication refers to the Bermuda reinsurance model as a “better mouse trap” for insuring U.S. risks because of its tax efficiency. Proponents of change are not pushing for tax relief for themselves to level the playing field. Instead, they are pushing to change the way their foreign-based competitors are taxed.

But let’s not put the cart before the horse. Before we try to figure out how to solve a problem, we need to determine whether or not a problem exists and, if so, we need to define it. This hearing will help with this analysis.

The other two issues we'll be examining relate to offshore hedge funds. We've all seen the picture of the Uglan House in the Cayman Islands as the registered address for 12,748 companies. A good number of those companies are there because of hedge fund investment structures.

Speaking of tax efficient mouse traps, hedge funds are structured in a very tax-efficient manner. Each structural component serves a specific tax objective. U.S. taxable investors invest through a partnership, and the manager is compensated with a carried interest. For the investor, this serves the objective of permitting a de facto deduction for the manager's fee that would otherwise be limited. For the fund manager, it permits some conversion of ordinary income to capital gain and avoidance of Medicare tax.

On the other side of the structure, foreign and tax exempt investors, like pension plans and university endowments, invest in hedge funds through offshore "blocker" corporations, and the fund manager receives an incentive fee. By using this structure, the tax exempt investor avoids unrelated business taxable income, while the fund manager is able to defer tax on an unlimited portion of the incentive fee through a nonqualified deferred compensation arrangement.

This committee should analyze the underlying policy of the debt financing rules. I am concerned that tax exempt organizations are so easily able to plan around those rules with offshore structures. We should also examine these deferred compensation arrangements. We'll be looking at these issues at today's hearing. The principal purpose of this hearing is to examine offshore reinsurance and hedge fund issues. I look forward to hearing testimony on these issues. But first, we'll hear from Senator Dorgan, who will discuss his proposed legislation.

Testimony of U.S. Senator Byron Dorgan  
before the Senate Committee on Finance Hearing on Offshore Tax Issues

September 26, 2007

Mr. Chairman, I want to applaud you, Senator Grassley and other members of the Finance Committee for holding this series of hearings this year to grapple with complicated tax issues involving U.S. companies and their offshore affiliates and business activities.

The issue of American companies off-shoring good paying U.S. manufacturing jobs, and using overseas tax havens and other tax scams to avoid paying U.S. taxes they rightfully owe, has been around for many years. But today these companies are getting more scrutiny from federal policymakers and Internal Revenue Service (IRS) officials because of the size of their tax dodging and blatant manipulation of our tax laws.

The evidence suggests that we have a serious tax haven problem and it may now be costing the U.S. Treasury tens of billions of dollars every year. That's why I have authored legislation with Senator Levin, S. 396, which we believe will give the IRS new tools to combat offshore tax haven abuses and ensure that U.S. multinational companies pay their share of U.S. taxes.

**Curbing U.S. Corporate Offshore Tax Haven Abuses**

American taxpayers have a right to be angry when they read or hear news accounts about how corporate taxpayers are shirking their tax obligations by actively shifting their profits to foreign tax havens or using other inappropriate tax avoidance techniques.

A few years ago, this Committee passed legislation, which I supported and is now law, that addresses the troubling problem of corporate inversions that involved a couple dozen U.S. corporate expatriates that reincorporated their headquarters overseas. That behavior was a shameful, unpatriotic tax scam that was shut down by Congress.

However, that legislation hit just the tip of the iceberg. It did nothing to deal with the problem of U.S. companies setting up foreign tax-haven subsidiaries offshore to avoid their taxpaying responsibilities.

Around the time of the debate on corporate inversions, a *New York Times* story hit the nail on the head, suggesting that "instead of moving headquarters offshore, many companies are simply placing patents on drugs, ownership of corporate logos, techniques for manufacturing processes and other intangible assets in tax havens...The companies then charge their subsidiaries in higher-tax locales, including the U.S., for the use of these intellectual properties. This allows the companies to take profits in these havens and pay far less in taxes."

How pervasive is the tax-haven subsidiary problem? Several years ago, the Government Accountability Office (GAO), the investigative arm of Congress, issued a report that Senator Levin and I requested that sheds some light on the potential magnitude of this tax avoidance activity.

The GAO found that 59 out of the 100 largest publicly-traded federal contractors in 2001 -- with tens of billions of dollars of federal contracts in 2001-- had established hundreds of subsidiaries located in

offshore tax havens. According to the GAO, Exxon-Mobil Corporation, the 21<sup>st</sup> largest publicly traded federal contractor in 2001, had some 11 tax-haven subsidiaries in the Bahamas. The same report revealed that the Halliburton Company had 17 tax-haven subsidiaries, including 13 in the Cayman Islands, a country that has never imposed a corporate income tax, as well as two in Liechtenstein and two in Panama. It turned out that the now infamous Enron Corporation had 1,300 different foreign entities, including some 441 located in the Cayman Islands.

But the poster child for offshore tax haven abuses, in my opinion, is a five-story building located on Church Street in the Cayman Islands that thousands of companies call home. According to a very good investigative report published by David Evans with Bloomberg News in the summer of 2004, the Uglan House in Grand Cayman is used as the address for 12,748 companies. In case you haven't seen it, I have carried along a picture of the Uglan House.

A recent study suggests that nearly half of the money U.S. companies earn overseas is accounted for in tax havens like the Cayman Islands. A former Joint Committee on Taxation economist released a study with an extraordinary finding: U.S. multinational companies had moved hundreds of billions of dollars in profits to tax havens in 1999-2002, the latest years for which IRS data was available.

The legislation that Senator Levin and I authored would help the IRS stop these avoidance schemes. Specifically, our legislation denies tax benefits, namely tax deferral, to U.S. multinational companies that set up controlled foreign corporations in tax haven countries. This tracks the same general approach in legislation passed by the Congress and enacted into law that was designed to curb the problem of corporate inversions. Our bill builds upon the good work of your Committee by extending similar tax policy changes to cover this case.

Specifically, our legislation would treat U.S. controlled foreign subsidiaries that are set up in tax haven countries -- but are not engaged in a real and active business -- as domestic companies for U.S. tax purposes. In other words, we would simply treat these companies as if they never left the United States, which is essentially the case in these tax avoidance motivated transactions.

The bill's list of specific tax haven countries subjected to the new rule is based upon previous work by the Organization for Economic Cooperation and Development. However, our legislation does give the Secretary of the Treasury the ability to add or remove a foreign country from this list in appropriate cases. We also give businesses until December 31, 2008 to restructure their tax haven operations if they so choose.

As I mentioned, our legislation effectively ends the deferral tax benefit for U.S. companies that shift income to offshore, inactive tax haven subsidiaries. This means, for example, that:

- Any efforts by a U.S. company to move profits to the subsidiary through transfer pricing schemes will not work because the income earned by the subsidiary would still be immediately taxable by the United States.
- Likewise, any efforts to move otherwise active income earned by a U.S. company in a high-tax foreign country to a tax haven would cause the income to be immediately taxable by the United States.

- Under this bill, companies that try to move intangible assets – and the income they produce – to tax havens would be unsuccessful because that income would still be immediately taxable by the United States.

The Joint Tax Committee says this legislation will prevent these companies from draining nearly \$15 billion in revenues from the U.S. Treasury over the next decade.

But let me be very clear about one thing. This legislation, like other legislation I have been working on for many years that deals with runaway U.S. manufacturing plants, does not take a shotgun approach with respect to ending the U.S. deferral tax break. This proposal, and other proposals I have authored, would not repeal tax deferral in all cases.

In fact, the Dorgan-Levin tax haven legislation will not adversely impact U.S. companies with controlled foreign subsidiaries located in tax havens, if they are doing legitimate and substantial business. The legislation expressly exempts a U.S.-controlled foreign subsidiary from its tax rule change when almost all of its income is derived from the active conduct of a trade or business within a tax haven country.

It's grossly unfair to ask our Main Street businesses to operate at a competitive disadvantage to large multinational businesses simply because our tax authorities are unable to grapple with the growing offshore tax avoidance problem. It is also outrageous that tens of millions of working families, who pay their taxes on time every year, are shouldering the tax burden of large profitable U.S. multinational companies using these tax haven subsidiaries.

In a recent *International Tax Notes* article, "A Statutory Proposal for U.S. Transfer Pricing", Michael Durst, a former IRS official and now counsel to a prestigious law firm, suggests that, "based on extensive practice, that retaining the current [arm's length pricing] system is not a viable option" for dealing with current transfer pricing abuses and that "a revised, concededly more "formulary" system... would offer substantial relative advantages." I think he is dead right and I have advocated for a federal formulary apportionment system for multinational taxation for decades.

But until we move in that direction, my proposal with Senator Levin is a simple, straightforward way to deal with transfer pricing abuses in cases that involve U.S. companies parking profits in offshore tax havens.

### **End the Wrong-headed Tax Subsidy for Runaway Manufacturing Plants**

I have worked very hard with Senator Mikulski and a number of our colleagues to end the large ill-conceived federal tax break provided to U.S. companies that close down a U.S. manufacturing plant, fire its American workers and move those good-paying jobs to countries like China.

I have forced the U.S. Senate to vote on my proposal to end this tax subsidy four times since the early 1990s, but the majority in the Senate has said no. As a result, hardworking Americans whose jobs are cut and moved overseas are forced to help foot the bill of companies that move production offshore – a bill which the non-partisan Joint Tax Committee suggests will cost taxpayers \$15.5 billion over the next decade. We can no longer afford to ignore this matter. The federal debt is expected to hit \$9 trillion at the end of the year and continue climbing to over \$11 trillion in just five years.

Our proposal, S. 1284, would end the insidious tax subsidy in the tax code that rewards U.S. firms that move their production overseas and then turn around and import those products back to the United States for sale. When a U.S. company closes down a U.S. manufacturing plant, firing its American workers to move those good-paying jobs to China or other locations abroad, U.S. tax laws allow these firms to defer paying any U.S. income taxes on the earnings from those now foreign-manufactured products until those profits are returned, if ever, to this country. This tax break is not available to American companies that make the very same products here on American soil. So the U.S. company that decides to stay at home suffers a competitive disadvantage -- a disadvantage that our tax laws have helped to create. Multinational companies ought to pay the same taxes that domestic companies pay. At a minimum, U.S. companies that keep their jobs here should not be put at a competitive disadvantage by federal tax policy.

The notion that granting large tax breaks to companies that move their manufacturing operations offshore is good for this country is utter nonsense. Among other things, those who support this fiscal policy claim that shutting down U.S. manufacturing operations and moving them abroad will result in more U.S. jobs and increase our exports.

However, this assertion is not supported by the facts. According to the latest available data, the number of foreign manufacturing affiliates has grown from 7,420 to 8,490, up some 14 percent since 1993. From 1993 though 2004, U.S. companies moved one million manufacturing jobs offshore to their foreign affiliates.

Throughout this entire period, this perverse deferral break has been in effect. Has it resulted in new U.S. manufacturing jobs? No. We have lost some 3.1 million U.S. manufacturing jobs since 2000 alone. Has this misguided tax subsidy resulted in higher exports from U.S. companies to their foreign affiliates, as the proponents of this tax subsidy suggest? No. In fact, imports into the United States from the foreign subsidiaries of U.S. companies more than doubled from \$92 billion in 1993 to \$203 billion in 2004. And the balance of trade with foreign affiliates of U.S. firms plummeted to a \$72 billion deficit in 2004 as compared to \$3.4 billion in 1997.

I have described stories on the Senate floor about a number of American companies that have moved production overseas. These companies include: Huffly bicycles and Radio Flyer little red wagons moved to China; Samsonite went to Mexico and then China; Levi's are now made all over the world, everywhere except in the very country that invented them; Maytag now makes appliances in Mexico and Korea; and Fruit of the Loom moved to Mexico. This tax deferral break given to companies like Radio Flyer or formerly to Huffly bicycles is not available to American companies that make the very same products on U.S. main streets.

In a similar refrain, let me share with you something from a recent article that describes the problem relating to manufacturing jobs so well. This story was part of a recent Washington Post article regarding a small town in North Carolina.

“ ‘We didn’t see it coming,’ the furniture man grimly declared. Michael K. Fugan once ran Henredon Furniture Industries, which operated a plant in Spruce Pine, a former mining town in the rugged mountains in the western part of the state.

There the company made hand-carved wooden bedroom furniture, once employing more than 1,000 people. Many lacked high school diplomas and some were illiterate, yet the factory provided a way for these workers to support families and to acquire modest homes and cars.

It paid roughly \$14 an hour, plus health and pension benefits. Henredon's four-poster beds retailed for about \$5,000 in the early 1990s, Dugan recalled. A few years later, similar models started showing up from the Philippines for less than \$2,000. Now they can be found for \$799, produced by workers in southern China who earn as little as 40 cents an hour.

Henredon first trimmed its workforce. Three years ago, it shut down the plant, eliminating 350 positions...For 26 years, Phillip Wilson worked at Henredon as a master carver. Now, on most days, he wakes before dawn and drives to his new job – the 5:30 a.m. shift as a prison guard... his pay down 15 percent, forcing him into a second job at a used-appliance store to make ends meet.”

Still we run into stiff opposition from many U.S. multinational companies, their lobbyists and some policymakers who claim our proposal would impede the ability of U.S. firms to compete and grow in the global economy. That's hogwash. To hear the proponents of cutting corporate taxes, one might be lead to believe that somehow U.S. companies are struggling to compete in the international arena. But that is simply not the case.

My proposal with Senator Mikulski certainly does nothing to hinder U.S. multinationals that produce abroad from competing with foreign firms in foreign markets. The legislation we have introduced is carefully targeted; it ends the deferral tax break only where U.S. multinationals produce goods abroad, and, then ship those products back to the U.S. market.

Once again, I'd like to remind everyone that the tax experts with the Joint Committee on Taxation estimate that this pernicious tax break will cost U.S. taxpayers some \$15.5 billion over the next decade. It is no wonder that the powerful lobby for the largest U.S. multinational firms has fought to keep this tax loophole fully intact.

Given our exploding deficits and debt, I hope the Senate Finance Committee will pass this initiative to shut down this loophole. But if not, I will bring this proposal to the Senate floor with Senator Mikulski and others again and again until this wrong-headed tax subsidy is finally repealed.

I understand that some U.S. companies will still choose -- with or without this tax subsidy -- to dislocate thousands of workers in America in search of cheaper labor, lax regulation and greater profits abroad at whatever the cost. They will be free to do so. But at least U.S. taxpayers will not be asked to provide billions of dollars in tax subsidies for those who do.

### **End Tax Benefits for Abusive Foreign Cross-Border Leasing Transactions**

In S. 554, I authored a proposal that would put a death nail in the heart of abusive cross-border foreign leasing transactions. Specifically, this provision adjusts the effective date for the application of the JOBS Act of 2004's anti-leasing abuse prohibition. The loss limitation rules would apply to leases with foreign entities, regardless of when the lease was entered into.

This provision relates to one of the most scandalous tax abuses I can remember in recent years. A few years ago, PBS's Frontline program aired stories that uncovered massive tax shelter scheme dealing with cross-border leasing abuses, known as Lease-In/Lease-Out Transactions (LILOs), and later known as Sale-In/Lease-Out Transactions (SILOs). The stories discussed how city accountants in Germany and other European countries had generated large cash payments for selling or leasing their streetcars, water purification plants, sewage systems, town halls, rail systems and school buildings to large U.S.

corporations that artificially generated large rental or depreciation deductions to pay little or no U.S. taxes. This Committee is very familiar with this issue.

With Rev. Ruling 2002-69 and by regulation, the IRS challenged the rental and interest deductions generated by LILOs. This effectively put an end to the use of tax loss-creating LILO transactions. However, the industry regrouped and replaced LILOs with SILOs, and, then asserted that the IRS rulings did not cover these "unique and different" transactions.

One of the worst SILO cases I am aware of involves Wachovia Bank (formerly First Union Bank), which reportedly entered into a SILO transaction involving its purchase of sewer pipes in Bochum, Germany. Under the transaction, Bochum sold its underground sewer pipes to Wachovia for \$500 million. The city then immediately leased those pipes back, thus retaining use of its sewer system and repaying the lease over a period of many years with the proceeds from the "sale." In return, Bochum was immediately paid a \$20 million fee. Wachovia would eventually get its money back – absent the fee, and the Bank reportedly generated about \$175 million in tax savings coming primarily from depreciation deductions over time.

From the standpoint of the entities involved in these deals, there was little or no financial risk. When the deal was closed, the tax-exempt indifferent entity, say a foreign municipality, continued to use the property it "sold" but was leased back under the agreement and the U.S. taxpayer now gets the following tax benefits:

- 1.) Large depreciation deductions that are worth more than the "payments" made to "purchase" the property and the fee they pay to the tax indifferent party;
- 2.) Amortization of transaction costs (cost of setting up the deal) over the period of the deal; and
- 3.) Interest deductions for the loans the taxpayer used to "purchase" the property.

In 2004, Congress limited the tax benefit available in these transactions by allowing U.S. taxpayers to take tax breaks only up to the amount of income recognized on a year-by-year basis under the leasing agreement. However, there are some foreign leasing transactions entered into prior to March 12, 2004, where the lessee is a foreign tax exempt entity that is not affected by this law change. We should close this international tax scam completely. This means that large U.S. companies that already had completed foreign SILO transactions will siphon the Treasury General Fund – and therefore the American taxpayers – of an estimated \$4 billion over the next decade. That result can not be allowed to stand and I look forward to working with the Committee to finally pull the plug on these unbelievable tax scams.

In the words of Cologne's city accountant, "After all, the Americans should know themselves what they do with their money. If they subsidize this kind of transaction, we gratefully accept."

In conclusion, Mr. Chairman and members of the Committee, I look forward to working with you to stop those profitable U.S. multinational companies that benefit from our legal system, our national defense and other government protections, but do not believe they should contribute their fair share of taxes to keep this country strong.