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How Western States Help The Wealthy Avoid Taxes, Creditors

By **Daniel Pascucci** (July 16, 2021, 6:19 PM EDT)

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Recent weeks have brought a flurry of news highlighting complex structures the ultra-wealthy use to hold assets. As attention shifts from calls for taxation of wealth to an emerging spotlight on vehicles available to shield assets from tax collectors and creditors, the growing allure of several states as asset havens is gaining recognition, and highlights the need for creditors and claimants to consider robust U.S. enforcement strategies in any asset-recovery effort.

The Most Robust Tax and Privacy Shelter Is not Offshore

On June 8, ProPublica ran an extensive expose analyzing leaked tax data of the nation's wealthiest taxpayers.[1]

ProPublica's computation that the top 25 pay single-digit and lower tax rates on their wealth growth triggered an avalanche of media and lawmaker reactions ranging from calls for tax reform[2] to alarm over invasion of the privacy rights of the wealthy taxpayers whose information was leaked.[3]

Despite calls to the contrary, reforming tax laws will, at best, only reach assets taxpayers disclose and declare. But, as the initial ripple effects of the leak subside, attention is turning to the complex industry built around corporate and trust structures that enable the ultra-wealthy to move assets off their personal balance sheets while retaining the privileges of ownership.

On June 22, building on the ProPublica expose, Rolling Stone detailed the layered structures and mechanisms available to the ultra-wealthy.[4] Billionaires will often vest legal ownership of vast assets in shell companies owned by nominee shareholders, or in private trusts of which they are beneficiaries — all part of complex structures to remove assets from their legal estates.

Perhaps more eye-opening than the existence of shell companies and private trust mechanisms is their location. For decades, American taxpayers took comfort in seeing such mechanisms as offshore — the trappings of Swiss banks and protective corporate laws of small island nations. The renewed spotlight emanating from the ProPublica leak, however, is cracking that comforting veneer and exposing the U.S. as the unrivaled secrecy haven of choice for affluent Americans and foreigners.

According to the financial secrecy index of the Tax Justice Network, which ranks jurisdictions based on financial secrecy and scale of offshore activities, the U.S. has surpassed jurisdictions like Switzerland, Hong Kong, Singapore and the British Virgin Islands and, as of 2020, now ranks second only to the Cayman Islands on financial secrecy.[5]

In particular, several states — most notably, South Dakota, Wyoming, Nevada, Alaska and Delaware — have built robust and growing industries dedicated to assisting billionaires looking to move assets out of their names while retaining use and enjoyment.

How the West Was Lost

The past few decades have witnessed what is often referred to as a race to the bottom, with states like South Dakota, Wyoming, Alaska, Nevada and Delaware actively vying to attract deposits, trusts and shell companies of affluent depositors looking for safe havens in which to protect assets behind veils of secrecy.

The race started with changes to the rule against perpetuities — an unwieldy vestige of English common law that is a frequent bane of first-year property law students, the mere mention of which can trigger anxiety in practicing lawyers. But the rule serves the important purpose of untethering property from the control of the long departed.

Without the rule against perpetuities, a modern developer might be blocked from building a park in Virginia because Thomas Jefferson bequeathed that the land for the sole purpose of tobacco farming. Under the rule, the intentions of the departed are generally limited to a period extending 21 years past the life of someone alive when the interest is created.

It may seem universal in the U.S. that property is not restricted by the wills and trusts of long-gone ancestors, but the South Dakota Legislature set off a major tremor in that assumption in 1983 when it abolished the rule.[6] This change paved the way for creation of the now-notorious South Dakota dynasty trust — a planning device that allows wealthy families to control assets for generations without taxable transfers — and kicked off a race to the bottom among several states vying for the inflow of capital into fledgling wealth defense industries.

Other states would follow, with Alaska and Delaware abolishing their rules against perpetuities in clear efforts to compete with South Dakota,[7] but South Dakota quickly moved to solidify its premier haven status by enacting a wide range of trust law features explicitly catering to wealth defense.

These laws include provisions allowing trusts with no beneficiary other than the settlor of the trust, granting immunity from creditor claims after two years, and, most importantly, establishing broad privacy protections.

Today, the South Dakota dynasty trust has become a widely embraced vehicle for foreign and domestic depositors to conceal their ownership of assets. Property deposited into such a trust is, technically and by law, no longer in the depositor's name, and information connecting it back to the depositor is shielded behind robust privacy laws.[8] This mechanism not only frees the depositor from reporting gains of trust assets to tax authorities, but places a challenging roadblock in the path of creditors.

A small U.S. company could do business with a billionaire comfortable in the observation that the billionaire ostensibly owns extensive assets around the country and can back his or her promises. But if the deal goes sideways and the company is forced to litigate, it may well find that, on paper, the billionaire lacks attachable assets to satisfy losses. Instead, the unwitting creditor's path to recovery may require it to penetrate South Dakota laws that were written to tuck wealth away safely in an impenetrable trust.

While South Dakota pioneered the dynasty trust, other states honed their own tools to peddle to the wealth defense industry. Nevada, Wyoming and Delaware quickly emerged as destinations for the creation of shell companies and shelf companies.

Shell companies allow for the designation of nominee shareholders who publicly own the company while the real owner remains hidden but maintains control through irrevocable proxy agreements. Shelf companies can be acquired already aged to provide a veneer of stability and continuity.

The competition between these states became acute. A 2006 hearing before the U.S. Senate Committee on Homeland Security and Governmental Affairs studied the national security risks that domestic shell companies were creating. Evidence presented at the hearing included excerpts from a Wyoming formation service provider, explicitly advertising the advantages of Wyoming's corporate laws over Nevada's, including leads like "No information collected to be shared with IRS," "Nominee officers are legal" and "Wyoming draws little attention."[9]

The combination of these vehicles provides affluent Americans and foreigners options for secreting their assets out of reach of tax collectors and creditors, and the competition for these deposits remains fierce today.

As law professors Michael Heller and James Salzman recently wrote, South Dakota "has quietly made itself into the world's leading money haven, crushing former go-to shelters such as Switzerland and the Cayman Islands," while fending off competition from Nevada, Alaska, Delaware and other states "with annual giveaways: new 'asset protection' and 'decanting' tools ... while making wealth transfer taxes optional and ensuring ever-stricter secrecy."[10]

For a creditor seeking to enforce a judgment or claim against a wealthy debtor, the availability of these robust mechanisms can be a source of significant frustration.

Enforcement against parties willing to move assets to evade execution is challenging in the best of circumstances. Add in the support of state legislatures courting the wealthy with creative privacy safeguards and codified mechanisms to allow depositors to move assets out of their names, and creditors need deep resources and extensive staying power to press through layers of obstacles. In most cases, the creditor never gets past the first obstacle — learning what and who is behind the veil of secrecy created by these mechanisms.

The Federal Role in Enabling Haven States

The secrecy culture embedded in these states may seem at odds with decades of federal legislation to increase transparency in banking and asset ownership. For example, the U.S. enacted the Foreign Account Tax Compliance Act in 2010 and aggressively negotiated with foreign financial institutions to secure FATCA agreements around the world aimed at providing the Internal Revenue Service visibility into overseas holdings of U.S. taxpayers.

More recently, the Biden administration issued its national security study memorandum, outlining steps to crack down on tax havens and corrupt schemes that conceal true ownership by accelerating the creation of a beneficial ownership registry requiring shell companies to disclose true owners.[11] The beneficial ownership registry coincides with recent decisions by Cyprus, Ghana and Kenya to finalize such registries.

Between the call for banking transparency and the disclosure of beneficial owners, it would seem that the U.S. federal scheme is built to eradicate secrecy mechanisms, and trust havens and shell company jurisdictions are endangered species globally. It would seem.

Unfortunately, the U.S. has a long history of turning a blind eye to domestic deposits, and the current environment is not well poised to change this trend. While the U.S. Department of State and the IRS secured extensive assent to FATCA agreements among foreign financial institutions around the world, the U.S. has failed to provide the promised reciprocity to partner countries and even refused to accede to the common reporting standard embraced by most G-20 nations.

Similarly, the White House national security study memo is honed on foreign corruption with no attention to disclosure of beneficial ownership in states like Delaware, Wyoming and Nevada. The memo "directs departments and agencies to work with like-minded international partners," and invokes a full spectrum of international treaties and foreign-focused acts to build on, but is remarkably silent on U.S. havens.

This foreign focus is hardly new. For decades, the U.S. has scrutinized overseas deposits of its taxpayers while inviting and fostering the inflow of trillions of dollars into secrecy mechanisms. In 1984, provisions in the Deficit Reduction Act changing taxation of foreign investments in the U.S. caused Time magazine to declare: "Suddenly America has become the largest and possibly the most alluring tax haven in the world."[12]

In 2001, when the U.S. enacted the qualified intermediary regime, a precursor to FATCA, it created a mechanism to obtain banking data on foreign deposits, but carefully ensured that only domestic taxpayer information would be passed to the IRS because receipt of foreign-depositor information could trigger reciprocity obligations to foreign governments.

The White House focus on foreign corruption in the national security study memo seems to be consistent with this long-standing trend, and any hope for a legislative or executive solution should be measured.

Recovering Secret Assets in the U.S.

Only time will tell whether the renewed attention on domestic secrecy havens will create stronger enforcement mechanisms for creditors seeking to recover against evasive debtors with deep resources hidden in the U.S. Unfortunately, hoping for a legislative path to greater transparency into haven states has proven futile for decades, and the considerable economic value of foreign deposits does not create a climate where significant reform is likely.

Until these fundamental drivers change, hope for increased transparency is better placed in the courts. Ironically, the aggressive reach of U.S. law enforcement, launching overseas investigations often enabled by FATCA disclosures, has played a major role in invoking the jurisdiction of U.S. district courts to enforce subpoenas and other investigation tools around the globe.

As the courts have wrestled with decisions evaluating their jurisdictional reach to issue global orders, they have resoundingly come down on the side of expanding jurisdiction.[13] The result is a robust body of law empowering U.S. district courts with the implicit authority to order the turnover of documents and information virtually worldwide.

The coinciding dynamics of the enhanced and expanding investigative reach of the federal courts, and the robust privacy shields offered by Western states, presents an emerging battleground. As the asset recovery practice catches up to the emergence of the U.S. West as a premier privacy haven, it is only a matter of time before the courts start crafting a body of case law addressing the rights of federal litigants to discover the real owners behind South Dakota trusts and Wyoming shell corporations.

When the unstoppable force of federal court discovery meets the immovable object of revenue-driven state privacy laws, who will yield first?

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[1] Jesse Eisinger, Jeff Ernsthausen and Paul Kiel, The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax, ProPublica (June 8, 2021).

[2] Maureen Tkacik, US Billionaires don't pay tax, and our politicians don't seem bothered, The Guardian (June 24, 2021).

[3] Letter from Senators Mitch McConnell, Charles Grassley and Mike Crapo to Attorney General Merrick Garland and FBI Director Christopher Wray (June 11, 2021) available at: https://www.finance.senate.gov/imo/media/doc/letter_to_ag_fbi.pdf.

[4] Andy Kroll, Inside the Shadowy Industry Where the Uber-Rich Pay Millions to Hide Trillions, Rolling Stone (June 22, 2021).

[5] https://fsi.taxjustice.net/en/introduction/fsi-results.

[6] S.D. Codified Laws § 43-5-8 ("Rule against perpetuities not in force. The common-law rule against perpetuities is not in force in this state.").

[7] While many states have moved away from the common law rule, most still impose a form of replacement limitation employing a different mechanism to limit the ability to control property movement after death.U.

[8] S.D. Codified Laws § 21-22-28.

[9] Failure to Identify Company Owners Impedes Law Enforcement, U. S. Senate Committee Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, 109-845, 109th Congress, Second Session (November 14, 2006).

[10] Michael Heller and James Salzman, Opinion: America's ultra-wealthy have pulled off a brilliant heist

— in South Dakota, Washington Post (March 19, 2021). Heller and Salzman are professors at Columbia and UCLA law schools, respectively.

[11] FACT SHEET: Establishing the Fight Against Corruption as a Core U.S. National Security Interest, The White House (June 3, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-establishing-the-fight-against-corruption-as-a-core-u-s-national-security-interest/.

[12] Charles P. Alexander, America the Tax Haven, Time magazine (August 13, 1984).

[13] See e.g., Republic of Argentina v. NML Capital Ltd., 573 U.S. 134 (2014) (holding that, in judgment enforcement actions, creditor's broad right to discovery overcomes sovereign immunity of debtor nation).