Newsweek

Vanguard Whistleblower Could Get Billions in Tax Dodge Complaint

Article published on December 3, 2015
By Davis Cay Johnson

If you are among the 20 million Americans saving for retirement through Vanguard, you may be in for an expensive shock. The nation's largest mutual fund company is under fire for not taking more of your money. That sounds ridiculous, but based on arcane provisions of the endlessly complex U.S. tax code, the Pennsylvania-based company may soon be forced to pay a staggering amount of back taxes because of the famously low fees it charges to manage your nest egg.

Two years ago, David Danon, a former Vanguard tax lawyer who is now a whistleblower no one would ever confuse with Erin Brockovich, filed formal complaints with the Internal Revenue Service and many state taxing agencies claiming that Vanguard's low fees are an illegal tax dodge. He argues that Vanguard should have charged investors an extra $19.8 billion in investment fees this year alone and owes almost $35 billion in taxes, interest and penalties since 2007. Under a 2006 law, a tax whistleblower may collect 15 to 30 percent of what the IRS collects, which means Danon could be heading for a payday of up to $10 billion.

Vanguard insists it does not owe any corporate income taxes, but Danon just collected a $117,000 whistleblower bounty from Texas, which suggests the company paid that state at least $2.3 million in taxes based on his information, because the reward rate is 5 percent. Texas audited Vanguard four times last year, finding taxes owed in each case, public records show without revealing the amounts. In November, the California Franchise Tax Board sent Danon an email saying his complaint against Vanguard warranted assigning criminal investigators. Vanguard could be on the hook for about $750 million there.

If Danon wins in other courts—and tax law seems to be on his side—people investing through Vanguard would accumulate much less money in their accounts because higher fees would cut into their investment gains. One of the most widely read tax scholars in America, professor Reuven Avi-Yonah of the University of Michigan Law School, says the case against Vanguard is clear-cut.

"The IRS will win in court if it challenges Vanguard's" policy of not earning profits, he tells Newsweek.

There is a double whammy here for Vanguard's customers: Raising fees to cover those taxes could require quadrupling its average fee, according to Avi-Yonah, who is working with Danon on this issue. Increasing Vanguard's average annual fee of $2 per $1,000 invested to the industry average would mean a fee of $8.20. If the stock market goes up by 5 percent, or $50 for every $1,000 invested with Vanguard, the amount investors keep after fees would drop

Board	Mtg Date	Item #
DC	01.19.15	3d

from $48 to less than $42. Over time, that smaller return takes a larger and larger bite from investors because there is less money to reinvest.

The paradox behind this dispute is that federal tax law assumes for-profit corporations like Vanguard Group Inc. earn a profit. But by design, the Vanguard Group does not earn any profits, even though every other major mutual fund company does. Congress has carved out 29 exceptions to taxing corporate profits under Section 501(c) of the tax code—it authorizes tax-exempt electric power cooperatives and even small nonprofit insurance companies—but there is no exception authorizing a company investing mutual fund money to operate without profits.

And why would a company do that? Most mutual funds are sold by an investment company created to make a profit by managing investors' money. These companies buy and sell stocks and bonds, keep records and do other work. They charge investors annual fees to cover their costs and generate a hefty profit. Industry records indicate that more than 30 cents out of each dollar in mutual fund fees goes for profits. That's extraordinarily profitable—the 100,000 or so largest companies in America typically keep as profit less than 7 cents out of each dollar they collect from customers.

Vanguard Group does not take a profit from the mutual funds it manages because of its unique structure. The Vanguard Group is not an independent company; it is owned by all the investors in Vanguard mutual funds, and one board of directors oversees both. Vanguard Group founder Jack Bogle has said his motive in creating the Vanguard mutual funds was to maximize returns to investors through lower costs, not to maximize profits for the managers of those funds. Charging yourself a profit makes no sense, Bogle explained long ago.

Bogle also says the profit motive creates a conflict of interest between the investment company managers, who want to make as much as they can, and the mutual fund investors, who want to keep as much of their investment gains as they can. He maintains that eliminating the profit motive eliminates that conflict. It can also eliminate a huge tax bill, as Danon argues.

Making a profit matters because of a widely used tax dodge involving related companies, known as transfer pricing. Consider a company that manufactures shoes in Asia at a cost of $2 a pair. While the shoes are on a ship crossing the Pacific, the company's manufacturing subsidiary in Asia transfers ownership of the shoes to a sister company in the Cayman Islands that exists only on paper. The Caymans subsidiary pays $52 for the shoes, then resells the shoes to American retailers for $60, producing gross profit of $58. (And you pay $120 at the register.) Of the $58 gross profit, $50 was taken in the Caymans, where no tax is imposed. Edward Kleinbard, who for years was a prominent designer of tax shelters before he began exposing such techniques, says the goal of such maneuvers is earning "stateless income," so-called because no government taxes the profit.

To limit such ploys, Congress requires that internal company transactions be at arm's length. That means charging for all goods and services at close to what an independent company would demand.

But in Vanguard's case, there are no profits hidden offshore. Instead, investors keep more of what the market generates and, when they withdraw their money, pay higher taxes only because they have earned more money.

Danon's lawyer for his whistleblower claims, Stephen Sorensen, argues that under Section 482 of the tax code, "you are not allowed to offer services internally at cost except for a few truly administrative things." The Vanguard setup, he says, "clearly does not qualify."

Sorensen acknowledges that "this is not the prototypical Section 482 case," in which tax havens are used to hide profits offshore, because Vanguard seeks no profits.

Sorensen and others say Congress could resolve Danon's complaint in several ways and allow Vanguard to stick with its low fees. One would be to add a line to Section 482 explicitly exempting from tax any mutual fund investment management company owned by the mutual funds it serves. That would surely set off a huge lobbying blitz by other mutual funds, which would surely like to see Vanguard forced to raise its fees and diminish its huge competitive advantage.

Another solution would be to add a 30th exemption to the list of nonprofit activities allowed in the tax code.

If Congress bails out Vanguard with either of those moves, it could add a requirement that Vanguard disclose how much it pays its executives and money managers, perhaps all those making $1 million or more. "Nobody has any idea what anyone at Vanguard makes," Sorensen says. "They can pay themselves whatever they want because it's kind of a black box without any disclosures, and no one [who invests through them] cares because Vanguard's fees are so low."

Even with those low fees, those managers' pay could be significant since the Vanguard Group manages more than $3 trillion, a fifth of all American mutual fund assets. Given how much Congress has expanded disclosures of executive pay at both nonprofits and publicly traded companies, requiring such disclosures for mutual fund companies is likely to enjoy broad political support.

Or Congress could do nothing and see if the IRS smacks Vanguard with a $35 billion tax bill. That would make for a lot of unhappy Vanguard investors, but for all those competing companies charging higher fees, the news would be glad tidings of great joy.