The great American tax haven: why the super-rich love South Dakota

The long read

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Illustration: Guardian Design

It’s known for being the home of Mount Rushmore – and not much else. But thanks to its relish for deregulation, the state is fast becoming the most profitable place for the mega-wealthy to park their billions.

By Oliver Bullough

Main image: Illustration: Guardian Design

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Late last year, as the Chinese government prepared to enact tough new tax rules, the billionaire Sun Hongbin quietly transferred $4.5bn worth of shares in his Chinese real estate firm to a company on a street corner in Sioux Falls, South Dakota, one of the least populated and least known states in the US. Sioux Falls is a pleasant city of 180,000 people, situated where the Big Sioux River tumbles off a red granite cliff. It has some decent bars downtown, and a charming array of sculptures dotting the streets, but there doesn't seem to be much to attract a Chinese multi-billionaire. It's a town that even few Americans have been to.

The money of the world's mega-wealthy, though, is heading there in ever-larger volumes. In the past decade, hundreds of billions of dollars have poured out of traditional offshore jurisdictions such as Switzerland and Jersey, and into a small number of American states: Delaware, Nevada, Wyoming – and, above all, South Dakota. "To some, South Dakota is a 'fly-over' state," the chief justice of the state's supreme court said in a speech to the legislature in January. "While many people may find a way to 'fly over' South Dakota, somehow their dollars find a way to land here."

The great American tax haven: why the super-rich love South Dakota – podcast

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Super-rich people choose between jurisdictions in the same way that middle-class people choose between ISAs: they want the best security, the best income and the lowest costs. That is why so many super-rich people are choosing South Dakota, which has created the most potent force-field money can buy – a South Dakotan trust. If an ordinary person puts money in the bank, the government taxes what little interest it earns. Even if that money is protected from taxes by an ISA, you can still lose it through divorce or legal proceedings. A South Dakotan trust changes all that: it protects assets from claims from ex-spouses, disgruntled business partners, creditors, litigious clients and pretty much anyone else. It won't protect you from criminal prosecution, but it does prevent information on your assets from leaking out in a way that might spark interest from the police. And it shields your wealth from the government, since South Dakota has no income tax, no inheritance tax and no capital gains tax.

A decade ago, South Dakotan trust companies held $57.3bn in assets. By the end of 2020, that total will have risen to $355.2bn. Those hundreds of billions of dollars are being regulated by a state with a population smaller than Norfolk, a part-time legislature heavily lobbied by trust lawyers, and an administration committed to welcoming as much of the world's money as it can. US politicians like to boast that their country is the best place in the world to get rich, but South Dakota has become something else: the best place in the world to *stay* rich.

At the heart of South Dakota's business success is a crucial but overlooked fact: globalisation is incomplete. In our modern financial system, money travels where its owners like, but laws are still made at a local level. So money inevitably flows to the places where governments offer the lowest taxes and the highest security. Anyone who can afford the legal fees to profit from this mismatch is able to keep wealth that the rest of us would lose, which helps to explain why – all over the world – the rich have become so much richer and the rest of us have not.

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In recent years, countries outside the US have been cracking down on offshore wealth. But according to an official in a traditional tax haven, who has watched as wealth has fled that country's coffers for the US, the protections offered by states such as South Dakota are undermining global attempts to control tax dodging, kleptocracy and money-laundering. "One of the core issues in fighting a guerrilla war is that if the guerrillas have a safe harbour, you can't win," the official told me. "Well, the US is giving financial criminals a safe harbour, and a really effective safe harbour – far more effective than anything they ever had in Jersey or the Bahamas or wherever."

Those of us who cannot vote in South Dakota elections have little hope of changing its laws. But if we don't do something to correct the imbalance between global wealth and local legislation, we risk entrenching today's inequality and creating a new breed of global aristocrat, unaccountable to anyone and getting richer all the time – with grave consequences for the long-term health of liberal democracy.

South Dakota is west of Minnesota, east of Wyoming, and has a population of 880,000 people. Politically, its voters enthusiastically embrace the Republicans' message of self-reliance, low taxes and family values. Donald Trump won more than 60% of the vote there in 2016, and the GOP has held a super-majority in the state's House of Representatives since the 70s, allowing the party to mould South Dakota in its image for two generations.

Outsiders tend to know South Dakota for two things: Mount Rushmore, which is carved with the faces of four US presidents; and Laura Ingalls Wilder, who moved to the state as a girl and wrote the Little House on the Prairie series of children's books. But its biggest impact on the world comes from a lesser-known fact: it was ground zero for the earthquake of financial deregulation that has rocked the world's economy.

The story does not begin with trusts, but with credit cards, and with Governor William "Wild Bill" Janklow, a US marine and son of a Nuremberg prosecutor, who became governor in 1979 and led South Dakota for a total of 16 years. He died almost eight years ago, leaving behind an apparently bottomless store of anecdotes: about how he once brought a rifle to the scene of a hostage crisis; how his car got blown off the road when he was rushing to the scene of a tornado.

In the late 70s, South Dakota's economy was mired in deep depression, and Janklow was prepared to do almost anything to bring in a bit of business. He sensed an opportunity in undercutting the regulations imposed by other states. At the time, national interest rates were set unusually high by the Federal Reserve, meaning that credit card companies were having to pay more to borrow funds than they could earn by lending them out, and were therefore losing money every time someone bought something. Citibank had invested heavily in credit cards, and was therefore at significant risk of going bankrupt.

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William 'Wild Bill' Janklow, the former governor of South Dakota in 1988. Photograph: Per Breiehagen/Life Images Collection via Getty Images

The bank was searching for a way to escape this bind, and found it in Janklow. "We were in the poorhouse when Citibank called us," the governor recalled in a later interview. "They were in bigger problems than we were. We could make it last. They couldn't make it last. I was slowly bleeding to death; they were gushing to death."

At the bank's suggestion, in 1981, the governor abolished laws that at the time – in South Dakota, as in every other state in the union – set an upper limit to the interest rates lenders could charge. These "anti-usury" rules were a legacy of the New Deal era. They protected consumers from loan sharks, but they also prevented Citibank making a profit from credit cards. So, when Citibank promised Janklow 400 jobs if he abolished them, he had the necessary law passed in a single day. "The economy was, at that time, dead," Janklow remembered. "I was desperately looking for an opportunity for jobs for South Dakotans."

When Citibank based its credit card business in Sioux Falls, it could charge borrowers any interest rate it liked, and credit cards could become profitable. Thanks to Janklow, Citibank and other major companies came to South Dakota to dodge the restrictions imposed by the other 49 states. And so followed the explosion in consumer finance that has transformed the US and the world. Thanks to Janklow, South Dakota has a financial services industry, and the US has a trillion-dollar credit card debt.

Fresh from having freed wealthy corporations from onerous regulations, Janklow looked around for a way to free wealthy individuals too, and thus came to the decision that would eventually turn South Dakota into a Switzerland for the 21st century. He decided to deregulate trusts.

Trusts are ancient and complex financial instruments that are used to own assets, such as real estate or company stock. Unlike a person, a trust is immortal, which was an attractive prospect for English aristocrats of the Middle Ages who wished to make sure their property remained in their families for ever, and would be secure from any confiscation by the crown. This caused a problem, however. More and more property risked being locked up in trusts, subject to the wishes of long-dead people, which no one could alter. So, in the 17th century, judges fought back by creating the "rule against perpetuities", which limited the duration of trusts to around a century, and prevented aristocratic families turning their local areas into mini-kingdoms.

That weakened aristocratic families, opened up the British economy, allowed new businessmen to elbow aside the entrenched powers in a way that did not happen elsewhere in Europe, and helped give the world the industrial revolution. “It’s a paradoxical point, but it wasn’t a bad thing when the scion of some family from out in the counties came down to London and pissed away his fortune. It was redistribution of wealth,” said Eric Kades, a law professor at William & Mary Law School in Virginia, who has studied trusts.

English emigrants took the rule to North America with them, and the dynamic recycling of wealth became even more frenetic in the land of the free. Then Governor Janklow came along. In 1983, he abolished the rule against perpetuities and, from that moment on, property placed in trust in South Dakota would stay there for ever. A rule created by English judges after centuries of consideration was erased by a law of just 19 words. Aristocracy was back in the game.

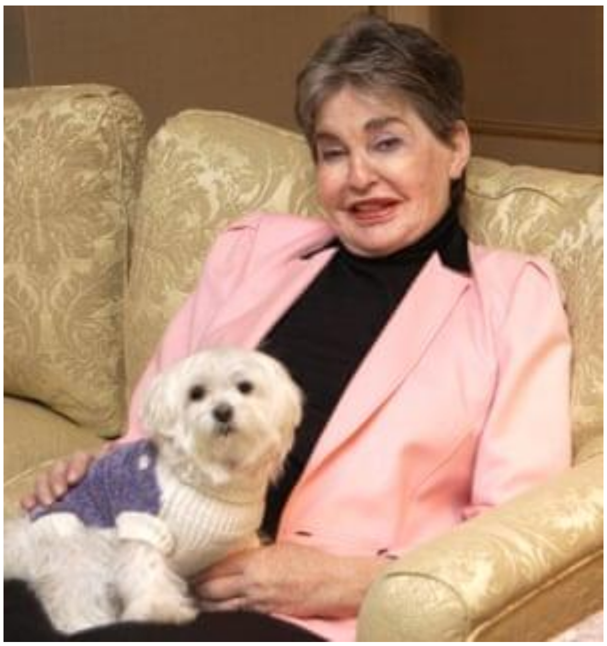
In allowing trusts to last for ever, South Dakota did something genuinely revolutionary, but sadly almost everyone I contacted – from current governor Kristi Noem to state representatives to members of the South Dakotan Trust Association – refused to talk about it. For an answer to the question of what exactly prompted the state to ditch the rule against perpetuities, I was eventually directed to Bret Afdahl, the director of the state administration’s Division of Banking, who wanted the question in writing. A week later, back came a one-word response: “unknown”.

Initially, South Dakota’s so-called “dynasty trusts” were advertised for their ability to dodge inheritance tax, thus allowing wealthy people to cement their family’s long-term control over property in the way English aristocrats had always wanted to. It also gave plenty of employment to lawyers and accountants.

“It’s a clean industry, there are no smokestacks, we don’t have to mine anything out of the earth or anything, and they’re generally good paying jobs,” said Tom Simmons, an expert on trust law at the University of South Dakota, when we chatted over coffee in central Sioux Falls. Alongside his academic work, Simmons is a member of South Dakota’s trust taskforce, which exists to maintain the competitiveness of the state’s trust industry. “Janklow was truly a genius in seeing this would be economic development with a very low cost to the government,” he said. (By “the government”, he of course means that of South Dakota, not that of the nation, other states or indeed other countries, which all lose out on the taxes that South Dakota helps people avoid.)

As the 1990s progressed, and more money came to Sioux Falls, South Dakota became a victim of its success, however, since other states – such as Alaska and Delaware – abolished the rule against perpetuities, too, thus negating South Dakota’s competitive advantage. But, having started the race to the bottom, Janklow was damned if any other state was going to beat him there. So, in 1997, he created the trust taskforce to make sure South Dakota was going as fast as it could. The taskforce’s job was to seek out legal innovations created in other jurisdictions, whether offshore or in the US, and make them work in South Dakota.

Thanks to the taskforce, South Dakota now gives its clients tricks to protect their wealth that would have been impossible 30 years ago. In most jurisdictions, trusts have to benefit someone other than the benefactor – your children, say, or your favourite charity – but in South Dakota, clients can create a trust for the benefit of themselves (indeed, Sun Hongbin is a beneficiary of his own trust). Once two years have passed, the trust is immune from any creditor claiming a share of the assets it contains, no matter the nature of their claim. A South Dakotan trust is secret, too. Court documents relating to it are kept private for ever, to prevent knowledge of its existence from leaking out. (It also has the useful side effect of making it all but impossible for journalists to find out who is using South Dakotan trusts, or what legal challenges to them have been filed.)



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Leona Helmsley with her dog, Trouble. Photograph: Jennifer Graylock/AP

This barrage of innovations has allowed lawyers to create structures with complex names – the South Dakota Foreign Grantor Trust, the Self-Settled Asset Protection Trust, etc – which have done two simple things: they have kept the state ahead of the competition; and they have made South Dakota's property protections extraordinarily strong. "The smart people want privacy," explained Harvey Bezozi, a Florida financial adviser and tax expert who blogs under the name Your Financial Wizard. "South Dakota offers the best privacy and asset protection laws in the country, and possibly in the world, for the wealthy to protect their assets. They've done a pretty good job in making themselves unique; a real boutique place where the people in the know will eventually gravitate to."

Among those in the know were the lawyers of Leona Helmsley, the legendarily mean hotel heiress, who coined the phrase "only the little people pay taxes". When Helmsley died in 2007, she left $12m in trust for the care of her dog, a maltese called Trouble. Trouble dined on crab cakes and kobe beef, and the trust provided her with $8,000 a year for grooming and $100,000 for security guards, who protected her against kidnappings, as well as against reprisals from the people that she bit. When a New York court – not entirely unreasonably – decided to restrain this expenditure, trustees moved the trust to South Dakota, which had crafted “purpose trusts” with just such a client in mind. Other states impose limits on how a purpose trust can care for a pet, on the principle that perhaps there are better things to do with millions of dollars than groom a dog, but South Dakota takes no chances. The client is always right.

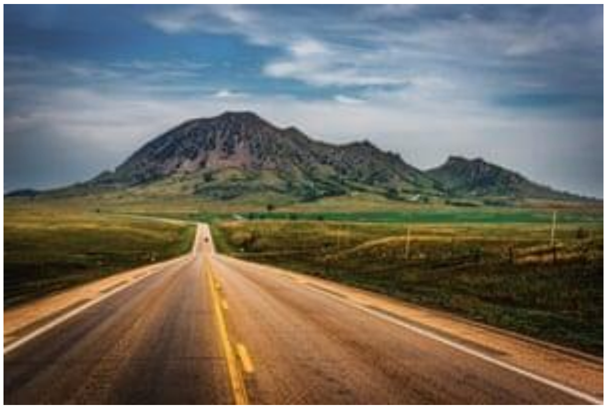
Despite all its legal innovating, South Dakota struggled for decades to compete with offshore financial centres for big international clients – Middle Eastern petro-sheikhs perhaps, or billionaires from emerging markets. The reason was simple: sometimes the owners’ claim to their assets was a little questionable, and sometimes their business practices were a little sharp. Why would any of them put their assets in the US, where they might become vulnerable to American law enforcement, when they could instead put them in a tax haven where enforcement was more … negotiable?

That calculation changed in 2010, in the aftermath of the great financial crisis. Many American voters blamed bankers for costing so many people their jobs and homes. When a whistleblower exposed how his Swiss employer, the banking giant UBS, had hidden billions of dollars for its wealthy clients, the conclusion was explosive: banks were not just exploiting poor people, they were helping rich people dodge taxes, too.

Congress responded with the Foreign Account Tax Compliance Act (Fatca), forcing foreign financial institutions to tell the US government about any American-owned assets on their books. Department of Justice investigations were savage: UBS paid a $780m fine, and its rival Credit Suisse paid $2.6bn, while Wegelin, Switzerland’s oldest bank, collapsed altogether under the strain. The amount of US-owned money in the country plunged, with Credit Suisse losing 85% of its American customers.

The rest of the world, inspired by this example, created a global agreement called the Common Reporting Standard (CRS). Under CRS, countries agreed to exchange information on the assets of each other’s citizens kept in each other’s banks. The tax-evading appeal of places like Jersey, the Bahamas and Liechtenstein evaporated almost immediately, since you could no longer hide your wealth there.

How was a rich person to protect his wealth from the government in this scary new transparent world? Fortunately, there was a loophole. CRS had been created by lots of countries together, and they all committed to telling each other their financial secrets. But the US was not part of CRS, and its own system – Fatca – only gathers information from foreign countries; it does not send information back to them. This loophole was unintentional, but vast: keep your money in Switzerland, and the world knows about it; put it in the US and, if you were clever about it, no one need ever find out. The US was on its way to becoming a truly world-class tax haven.



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The Black Mountain Hills of South Dakota. Photograph: Posnov/Getty Images

The Tax Justice Network (TJN) still ranks Switzerland as the most pernicious tax haven in the world in its Financial Secrecy Index, but the US is now in second place and climbing fast, having overtaken the Cayman Islands, Hong Kong and Luxembourg since Fatca was introduced. “While the United States has pioneered powerful ways to defend itself against foreign tax havens, it has not seriously addressed its own role in attracting illicit financial flows and supporting tax evasion,” said the TJN in the report accompanying the 2018 index. In just three years, the amount of money held via secretive structures in the US had increased by 14%, the TJN said. That is the money pouring into Sioux Falls, and into the South Dakota Trust Company.

“The easy takeaway is that people are trying to hide. But wanting to be private, to be confidential, there’s nothing illegal about that,” said Matthew Tobin, the managing director of the South Dakota Trust Company (SDTC), where Sun Hongbin parked his $4.5bn fortune. We were sitting in SDTC’s conference room, which was decorated with a large map of Switzerland, as if it were a hunting trophy.

Tobin added that many foreign clients had wealth in another jurisdiction, and worried that information about it could be reported to their home country, thanks to CRS. “That could put them at risk. They could be at risk of losing their wealth, it could be taken from them. There’s kidnapping, ransom, hostages. There is risk in a lot of parts of the world,” he explained. “People are saying: ‘OK, if the laws are the same, but I can have the stability of the US economy, the US government, and maintain my privacy, I might as well go to the US.’” According to the figures on its website, SDTC now manages trusts holding $65bn and acts as an agent for trusts containing a further $82bn, all of them tax-free, all of them therefore growing more quickly than assets held elsewhere.

When I spoke to the official from one of the traditional tax havens, who asked not to be identified, for fear of wrecking what was left of the jurisdiction’s financial services industry, he was furious about what the US was doing. “One of the bitter aspects of this, and it’s something we haven’t said in public, is the sheer racism of the global anti-money laundering management effort,” he said. “You will notice that the states that are benefiting from this in America are the whitest states in the country. They’ve ended up beating the shit out of a load of black and Hispanic places, and stuffing all the money in South Dakota. How does that help?”

I put those comments to a South Dakotan trust lawyer who agreed to speak to me as long as I didn't identify them. The lawyer was sympathetic to the offshore official's argument, but said this is how the world is now, and everyone is just going to have to get used to it. It is, after all, not just South Dakota and its trust companies that are sucking in the world's money. Banks in Florida and Texas are welcoming cash from Venezuela and Mexico, realtors in Los Angeles are selling property to Chinese potentates, and New York lawyers are arranging these transactions for anyone that wants them to. Perhaps under previous administrations, there might have been some appetite for aligning the US with global norms, but under Trump, it's never going to happen.

"You can look at South Dakota and its trust industry, but if you really want to look at CRS, look at the amount of foreign money that is flowing into US banks, not just into trusts," the lawyer said. "The US has decided at very high levels that it is benefiting significantly from not being a member of CRS. That issue is much larger than trusts, and I don't see that changing, I really don't."

We have no idea yet what this means in the long term, because the revolution in trust law that began in South Dakota and spread throughout the US is only a generation old. But the implications are ominous.

Here is an example from one academic paper on South Dakotan trusts: after 200 years, $1m placed in trust and growing tax-free at an annual rate of 6% will have become $136bn. After 300 years, it will have grown to $50.4tn. That is more than twice the current size of the US economy, and this trust will last for ever, assuming that society doesn't collapse altogether under the weight of this ever-swelling leach.

If the richest members of society are able to pass on their wealth tax-free to their heirs, in perpetuity, then they will keep getting richer than those of us who can't. In fact, the tax rate for everyone else will probably have to rise, to make up for the shortfall caused by the wealthiest members of societies opting out, which will just make the problem worse. Eric Kades, the law professor at William & Mary Law School, thinks that South Dakota's decision to abolish the rule against perpetuities for the short term benefit of its economy will prove to have been a long-term catastrophe. "In 50 or 100 years, it will turn out to have been an absolute disaster," said Kades. "Now we're going to have a bunch of wealthy families, and no one will be able to piss away that wealth, it will stay in the family for ever. This just locks in advantage."

So far, most of the discussion of this development in wealth management has been confined to specialist publications, where academic authors have found themselves making arguments you do not usually find in discussions of legal constructs as abstruse as trusts. South Dakota, they argue, has struck at the very foundation of liberal democracy. "It does seem unfair for some people to have access to 'property plus', usable wealth with extra protection built in beyond that which regular property owners have," noted the Harvard Law Review back in 2003, in an understated summation of the academic consensus that South Dakota has unleashed something disastrous.

And if some people have access to privileged property, where does that leave the equality before the law that is central to how society is supposed to function? Another academic, writing in the trade publication Tax Notes two decades ago, put that unfairness in context: “Perpetual trusts can (and will) facilitate enormous wealth and power for dynastic families. In the process, we leave to future generations some serious issues about the nature of our country’s democracy.”

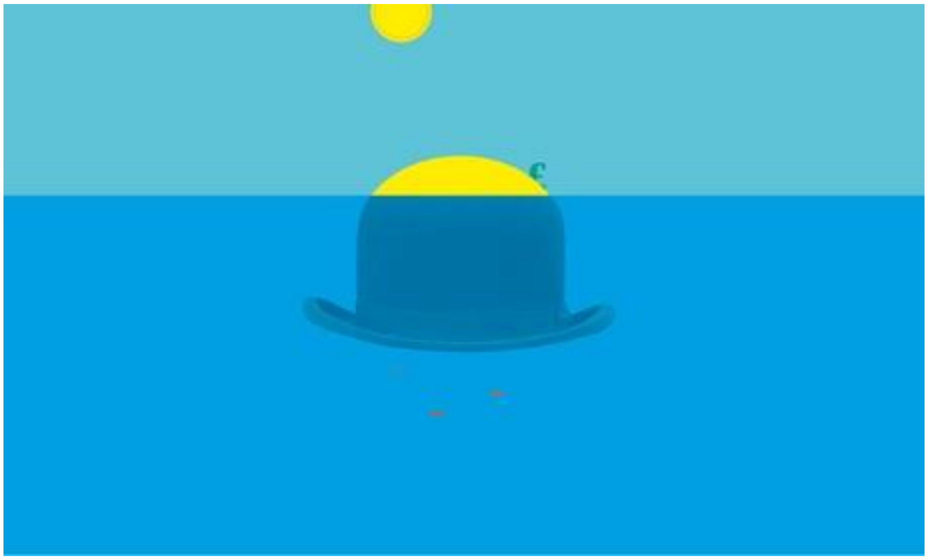
With Washington unconcerned by what is happening, and the rest of the world incapable of doing anything about it, is there any prospect of anyone in South Dakota moving to repair the damage? The short answer is that it is too late. Two-dozen other states now have perpetual trusts too, so the money would just move elsewhere if South Dakota tried to tighten its rules. The longer answer is that South Dakotan politics appears to have been so comprehensively captured by the trust industry that there is no prospect of anything happening anyway.

The state legislature is elected every even-numbered year, and meets for two months each spring. It last updated the law governing trusts in 2018, and brought in Terry Prendergast, a trust lawyer, to explain the significance of the changes. “People should be allowed to do with their property what they desire to do,” Prendergast explained. “Our entire regulatory scheme reflects that positive attitude and attracts people from around the world to look at South Dakota as a shining example of what trust law can become.”

There were a few questions from the representatives, but they were quickly shut down by Mike Stevens, a Republican lawyer, and chairman of the state’s judiciary committee. “No more questions. I didn’t understand perpetuities in law school, and I don’t want to understand it now,” he said, laughing.

Susan Wismer, one of just 10 Democrats among the House’s 70 members, attempted to prolong the discussion by raising concerns about how South Dakota was facilitating tax avoidance, driving inequality and damaging democracy. Her view was dismissed as “completely jaded and biased” by a trust lawyer sitting for the Republicans. It was a brief exchange, but it went to the heart of how tax havens work. There is no political traction in South Dakota for efforts to change its approach, since the state does so well out of it. The victims of its policies, who are all in places like California, New York, China or Russia, where the tax take is evaporating, have no vote.

Wismer is the only person I met in South Dakota who seemed to understand this. “Ever since I’ve been in the legislature, the trust taskforce has come to us with an updating bill, every year or every other year, and we just let it pass because none of us know what it is. They’re monster bills. As Democrats, we’re such a small caucus, we’re the ones who ought to be the natural opponents of this, but we don’t have the technical expertise and don’t really even understand what we’re doing,” she confessed, while we ate pancakes and drank coffee in a truck stop outside Sioux Falls. “We don’t have a clue what the consequences are to just regular people from what we’re doing.”



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That means legislators are nodding through bills that they do not understand, at the behest of an industry that is sucking in ever-greater volumes of money from all over the world. If this was happening on a Caribbean island, or a European micro-principality, it would not be surprising, but this is the US. Aren't ordinary South Dakotans concerned about what their state is enabling?

"The voters don't have a clue what this means. They've never seen a feudal society, they don't have a clue what they're enabling," Wismer said. "I don't think there are 100 people in this state who understand the ramifications of what we've done."

• This article was amended on 20 November 2019 because an earlier version misnamed the Foreign Account Tax Compliance Act as the Financial Assets Tax Compliance Act.

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