Lewis, C. & Allison, B. (2002). ***The cheating of America: How tax avoidance and evasion by the super rich are costing the country billions – and what you can do about it.*** **New York: Perennial Press.**

Introduction

Moved by nostalgia for television of the 1980s, several hundred thousand people flock to the Southfork Ranch each year. About twenty miles northeast of downtown Dallas, Texas, the 220-acre ranch is the home of the famed series *Dallas,* which ran for twelve years and was once the world's most popular prime-time serial. With reruns of the series shown in ninety-six countries and translated into forty-three languages and dialects, the ranch has a worldwide pull.

Although indoor scenes were shot on California sound stages, the four-columned, two-story mansion is the highlight of the tour. Its twelve rooms have been decorated to reflect the show's characters, from Lucy's Yellow Rose of Texas-themed bedroom to the luxurious Jock Ewing living room to the elegant dining room reminiscent of the scenes of many a dysfunctional family dinner. With special permission— and about $3,500—a family or small group can spend the night in the mansion. The Dallas Cowboys cheerleaders enjoy this privilege—and the accompanying Texas-sized dinner and breakfast—at their yearly slumber party.

At Southfork's visitors center, guests dine on barbecued beef sandwiches and tortilla soup at Miss Ellie's Deli. They trace the Ewing family tree in the Dallas Legends: Fact to Fantasy exhibit, which houses five galleries of *Dallas* paraphernalia, including Lucy's Victorian-style wedding dress, J.R.'s white Stetson, and the pearl-handled Colt revolver used to shoot the villainous oil baron in the season-ending cliffhanger of 1980. In the middle of the Western gift shop, which peddles cowboy hats, fine jewelry, and expensive clothing, is Jock Ewing's 1978 Lincoln Continental.

The ranch also has a 63,000-square-foot event and conference center that holds various-sized ballrooms and an atrium with Victorian lampposts and Texas-shaped floor tiles. Southfork hosts 1,300 events annually and can accommodate such varied functions as political rallies, private rodeos, and wedding receptions. And recently, the ranch's owners discussed adding a 150- to 200-room resort hotel.

Southfork is one of twenty-three domestic properties owned by Forever Resorts. The Phoenix, Arizona-based company's list of holdings includes, among others, Signal Mountain Lodge at Grand Teton National Park and luxury houseboat rental operations on Lake Meade and Lake of the Ozarks.

Forever Resorts is owned by Rex Maughan, a onetime real estate entrepreneur. Having held several conferences at Southfork and having witnessed the continued enchantment with *Dallas* around the world, Maughan jumped at the opportunity to add the fabled ranch to his Forever Resorts holdings, shelling out $2.6 million for it at a 1992 auction. In addition to his other resort properties, Maughan owns a series of cattle ranches in Arizona and a ten-acre estate, complete with a 16,700-square-foot home, in Paradise Valley.

But Rex Maughan didn't make his fortune in real estate or resorts. Instead, this son of an Idaho cattle rancher hit it big by selling, of all things, aloe vera. His company, Forever Living Products International, is a multilevel marketing operation whose bestselling product is a drinkable aloe gel that looks like pineapple juice and, to hear some tell it, tastes like turpentine. Because of its specially patented stabilization process, the company claims, the gel retains its nutrients and active ingredients. High in vitamins, minerals, and amino acids, it has been touted as a treatment for everything from arthritis to ulcers. However, after being reprimanded by the

Texas attorney general's office in 1992 for advertised claims that aloe gel could control diabetes, the company has taken its miracle-treatment spiels down a notch.

Forever Living Products' line of aloe goods also includes soap, tooth gel, shampoo, laundry detergent, and cosmetics. Although less popular than its aloe merchandise, the company also pushes about fifty bee products, from honey to bee pollen tablets. While the tablets are said to provide stamina and energy, doctors say that they're dangerous, even deadly, to those allergic to them.

Despite concerns and doubts about his products' actual health benefits, Maughan's business has made him a very wealthy man. In 1998, Forever Living Products had sales of over $1 billion, thanks to .more than 5.5 million distributors in sixty-five countries. Maughan not only owns the distribution company, Forever Living Products, but also the production company, Aloe Vera of America, and even the aloe vera plantations from which the gel is harvested in Texas, Mexico, and the Dominican Republic. In 1997 and 1998, he was included as a member of the *Forbes* 400, a yearly listing of the wealthiest Americans. His estimated net worth in 1998: $525 million.

Maughan claims that his success is due to the fact that he offers his distributors a larger cut of the profits than other multilevel marketing companies and that he rewards them with bonuses for high sales or recruiting salespeople. In a 1995 interview with *Success* magazine, he said, "My father always told me that if I wanted to dance, I had to pay the fiddler."

And dance he has. But apparently, paying the fiddler does not include fulfilling his obligations to the Internal Revenue Service.

When Maughan expands his business to a new country, he establishes a local company there. That company, in turn, kicks back royalties to his U.S. company, and then to him, at which time federal taxes should be paid on the income. However, Maughan, who had a fair knowledge of the tax system from his business school years at Arizona State and subsequent work in accounting, sought to lighten his tax burden on these royalties.

In 1994, the IRS issued a Notice of Deficiency to Maughan and his wife, Ruth, charging that they had understated their income for the years 1987 to 1990 and that they owed in excess of $4.7 million in taxes and penalties. Maughan's company, Selective Art, Inc.—aka Forever Living Products—received a similar notice for tax years 1987 to 1990, claiming the company owed over $4 million in taxes and penalties.

The story begins nearly a decade earlier, in 1985, when Forever Living Products sold global distributorship rights (excluding Canada, the United States, and Europe) to a nonresident United Kingdom company for $50,000—a price much lower than the actual value. Five days later, the distributorship rights were transferred to a different nonresident UK company. This company, in turn, licensed the rights to a Netherlands corporation called Batrax Rotterdam B.V. These transactions affected three of Forever Living Products' entities: Forever Living Products Japan, Forever Living Products Asia (Hong Kong), and Forever Living Products Australia PTY Limited.

Since Batrax held the distributorship rights, it received royalty payments from the Japan, Hong Kong, and Australia companies when their sales rose. However, instead of keeping the royalties, Batrax transferred them to International Marketing Company Limited, London (IMC London), the second nonresident UK corporation to receive Forever Living Products' distributorship rights. From there, the money was in turn sent to Swiss bank accounts under the IMC London name. Eventually, the royalty payments ended up in a pair of discretionary trusts, the Stratton Trust and the Peacon Trust, in the Channel Islands. The beneficiaries of the trusts were listed as charitable or educational entities in the Island of Jersey.

But the trusts made distributions to only one person: Rex Maughan. By directing royalty payments from the three Forever Living Products entities through foreign corporations and into the offshore trusts, Maughan and his company were able to avoid paying U.S. taxes on millions of dollars of income.

In reality, Batrax, International Marketing Company, and the other companies that were purported to hold distributorship rights and royalty payments are nothing more than sham corporations. None has any full-time employees, officers, production facilities, manufacturing expertise, experience in direct or multilevel marketing, or experience with the distribution of aloe vera products. And all but Batrax are owned, directly or indirectly, by a Swiss attorney named Dr. Richard Wengle and controlled by Maughan. Wengle, who was hired by Maughan in 1985 to set up the Batrax transaction, maintains active and inactive corporations, trusts, and other entities to use in his clients' business transactions. All told, Wengle used fourteen such companies—"shelf" corporations, as they're known—to set up the funneling of Forever Living Products' royalty payments.

As for the Channel Island trusts, they were also set up by Wengle, and the Swiss attorney was listed as the "protector" of the Peacon Trust. Although he did not hold that position for the Stratton Trust, Wengle nonetheless ensured that Maughan would reap its benefits. The deeds of the trusts were written with the understanding that their protector's requests would be granted, and the designated protector of the Stratton Trust was a man named Rjay Lloyd. Lloyd holds various positions at Forever Living Products, including director, assistant secretary, general counsel, and distributor. And in addition to being an accountant and an attorney specializing in taxation, Lloyd is also Rex Maughan's close childhood friend.

An IRS audit uncovered the tax avoidance scheme that allowed the Maughans and Forever Living Products to continue to reap sizable royalties from their foreign entities tax free. However, as often happens in large tax cases, the parties settled out of court. The Maughans got off paying $840,000 of the $4,736,538 they were assessed in the 1994 Notice of Deficiency—a mere 18 cents on the dollar. Maughan's company, Forever Living Products, fared even better: It paid only $500,000 of the $4,045,002 assessed by the IRS, or 12 cents on the dollar. Maughan, who vigorously disputed all of the service's claims, maintained he did nothing wrong, or even unethical. He certainly did nothing illegal—there is no law against lowering one's tax burden through legal means.

In fact, many millionaires, like Maughan, are able to avoid paying their fair share of income taxes by funneling their assets through shelf corporations, bogus trusts, and other financial devices which tax attorneys and crafty accountants create and exploit. They are able to engineer their finances so that they owe very little in taxes—sometimes none at all—while nonetheless reaping huge profits.

In 1998, Charles O. Rossotti, the commissioner of the Internal Revenue Service, testified before the Senate Finance Committee that non-compliance with the Internal Revenue Code—tax avoidance and tax evasion—costs each taxpayer more than $1,600 a year. Put simply, because some don't pay what they should, others must make up the difference. Some wealthy individuals and corporations are making the rest of us pay their share of the bill for our civilized society, to paraphrase the Oliver Wendell Holmes Jr. line that the IRS has engraved in stone.

From the beginning, the argument over taxation in the United States has been one over fairness—whether between classes, regions, or industries. From its earliest days as a nation, the United States has struggled with tax avoidance and evasion. Strapped with debts from the Revolutionary War—started in part by the colonists' revolt against unfair British taxes—the first Congress passed excise taxes on luxury items. Tobacco and snuff, refined sugar, carriages, property sold at auctions, various legal documents, and distilled spirits were covered by the tax, passed in 1794. Thus began the Whiskey Rebellion, when poor farmers in western Pennsylvania, who were dependent on selling distilled spirits for their meager incomes, revolted. Not only did they refuse to pay the tax, they also tarred and feathered the sheriffs who tried to collect it. President Washington deployed federal troops to quell the rebellion and enforce the tax.

America's first experience with an income tax came in 1861, when the Union needed extra revenue to fight the Civil War. At the beginning of the conflict, Congress increased tariffs and excise taxes and borrowed money to fund the war effort. But tariffs and excise taxes were consumption-oriented and regressive, and placed an increasingly heavy burden on the wallets of the country's lower-income citizens. The search for a fairer system of raising revenue led Congress to implement the income tax in 1861. Like those in later years, the Civil War income tax was based on the individual's ability to pay, imposing a 3 percent tax on any annual income over $800.

The Internal Revenue Act of 1862 was a more progressive measure that exempted the first $600 in income and imposed a 3 percent rate of taxation on income between $600 and $10,000 and a 5 percent rate on income over $10,000. The tax form of 1863 explained that the $600 exemption was "the amount fixed by law as an estimated computation for the expenses of maintaining a family."

Taxes were withheld from corporations' dividends and government employees' salaries. As the cost of the war grew, the income tax rates were increased, and the number of tax brackets expanded. In praise of the progressiveness of the income tax, Thaddeus Stevens, a Republican representative from Pennsylvania, said, "The food of the poor is untaxed; and no one will be affected by the provisions of this bill whose living depends solely on his manual labor."

After the war, the government's revenue needs decreased dramatically, and most taxes were repealed, including the income tax in 1872. Taxes on liquor and tobacco were the main source of government revenue by 1868 and made up nearly 90 percent of government income from then until 1913, when the income tax became a permanent feature of American life.

On February 25, 1913, four years after it was proposed by Congress, the Sixteenth Amendment to the Constitution was adopted. It states, "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Sereno Payne, a Republican representative from New York, introduced the amendment in the House. He was under no illusions about the potential for well-heeled taxpayers to avoid paying the tax. "I believe it is the most easily concealed of any tax that can be laid, the most difficult of enforcement, and the hardest to collect," he said on the House floor in 1909. "[lit is, in a word, a tax upon the income of honest men and an exemption, to a greater or lesser extent, of the income of rascals."

Congress began exempting the incomes of rascals with the passage of the Tariff Act of October 3, 1913. As predicted by Sereno Payne, over the years, collecting it would prove difficult.

With the entry of the United States into World War I, the tax laws were revised and expanded to generate revenue to fund the military effort. By 1918, there were fifty-five income brackets, a maximum individual tax rate of 77 percent, and a corporate rate of 12 percent. Still, 95 percent of the population paid no income tax.

With the beginning of the Great Depression, individual and corporate incomes—and subsequently income tax revenues—declined sharply. Congress again raised the tax rates and lowered exemptions in order to raise government revenues. By 1932, corporate rates had increased to 13.75 percent. Individual rates doubled. Nevertheless, the richest Americans still found ways to avoid their income taxes.

In 1933, average Americans were shocked to learn that all twenty partners of J. P. Morgan & Company, the giant Wall Street banking firm, had paid no income taxes the previous two years. Newspapers of the day trumpeted the disclosure as tax evasion by the firm's partners, although they had broken no law. They had merely taken advantage of loopholes in the laws to avoid their taxes. J. Pierpont Morgan Jr., the son of the firm's founder and his successor at its helm, later remarked, "Congress should know how to levy taxes, and if it doesn't know how to collect them, then a man is a fool to pay the taxes. If stupid mistakes are made, it is up to Congress to rectify them and not for us taxpayers to do so."

The distinction between avoidance and evasion may have been lost on the public, but Congress understood the difference, and began tinkering with the tax laws to prevent the wealthy from paying nothing to the federal treasury. By 1936, the maximum individual tax rate had jumped to 79 percent. A number of other taxes were implemented as well, including taxes on capital stock and dividend receipts. The Social Security Act of 1935 imposed a wage tax—half paid by employers, half by employees—for a system of federally funded retirement benefits.

The wealthy, meanwhile, were finding new ways to opt out of the New Deal. Alfred P. Sloan Jr., the chief executive officer of General Motors and one of the highest-paid executives in the country, set up a personal holding company called the Rene Corporation. The company owned his 235-foot yacht, the *Rene.* Sloan, whose annual income totaled $2.9 million in 1936, wrote off the costs of maintaining his yacht—about $150,000 a year—to lower his taxes.

Other well-heeled individuals established personal holding companies in offshore locales like the Bahamas and Panama—countries that, unlike the United States, had no personal or corporate income taxes. The offshore companies accumulated tax-free wealth for America's millionaires. After holding hearings on the issue, Congress added foreign personal holding company provisions to the tax laws in 1937. U.S. shareholders had to pay taxes on their share of income that accumulated in Caribbean and Central American corporations. Although these provisions have been revised many times over the years, offshore tax havens continue to do a thriving business sheltering the income of affluent Americans.

All the changes made the tax system ever more complicated. In 1938, President Franklin Delano Roosevelt sent a letter to the commissioner of internal revenue along with his 1937 tax return explaining his problems in determining the amount of tax he owed: "As this is a problem in higher mathematics," he wrote, "may I ask that the Bureau let me know the amount of the balance due?"

Higher math wasn't the only problem. The tax laws had never been gathered together. In 1939, Congress ordered that the tax rules contained in the Statutes at Large be codified, and the first permanent tax code—later renamed the Internal Revenue Code of 1939—was born.

When Pearl Harbor was bombed on December 7, 1941, the country was shaken out of the doldrums of the Depression. The twin threats of Nazi Germany and imperial Japan demanded an all-out effort from the American people. Congress cut exemptions for individual and married filers nearly in half, dramatically expanding the reach of the income tax; the number of taxpayers grew from 4 million to 43 million from 1939 to 1945. In the span of five years, from 1940 to 1944, rates were raised from 4 percent to 19 percent at the bottom tax bracket, while the top bracket increased to 88 percent. Because of the increased tax rates, it was difficult for taxpayers to come up with a lump sum once a year to pay their taxes. Withholding tax from paychecks, first instituted during the Civil War, was rein traduced.

In 1953, the Bureau of Internal Revenue changed its name to the Internal Revenue Service, following an internal reorganization. The tax code was reorganized once again and clarified in the Internal Revenue Code of 1954. And in 1959, the IRS earned the distinction of becoming the world's largest accounting, collection, and forms-processing organization.

With numerous revisions and expansions over time, the tax code has become riddled with special provisions, called tax shelters, that allow the well-heeled to forgo—or at least drastically reduce—their tax obligations. By abusing these tax shelters, tax attorneys have been able to create complex investment schemes that have saved the wealthy thousands, or even millions, of dollars in taxes.

Cutting rates for the wealthy in the Tax Reform Act of 1986, for example, did not reduce their evasion any more than it did in the 1920s. In 1998, IRS Commissioner Rossotti testified to the Senate Finance Committee that taxpayer noncompliance costs the federal government $195 billion a year. The actual figure is probably much higher, since the commissioner's estimate is based on forward projections of survey data gathered in 1988.

Those numbers do not even include the usual games corporations play, such as incorporating offshore. For example, for years the largest, essentially American cruise lines have avoided American taxes simply by incorporating outside the United States. Royal Caribbean, for instance, is incorporated in Liberia; Carnival Cruise Lines is incorporated in Panama. Both companies thus have eluded paying hundreds of millions of dollars in U.S. taxes.

In March 2000, the *New York Times* reported that half a dozen U.S. insurance companies no longer pay income taxes because they moved their corporate headquarters to Bermuda (which has no corporate income tax) or they were acquired by a Bermuda insurer. Treasury officials estimated that if all U.S. property and casualty insurers did this, they could avoid $7 billion in U.S. taxes annually. By moving their headquarters to Bermuda, these insurance companies can place their considerable investment income on the Bermuda books—beyond the reach of the Internal Revenue Service—and keep the unprofitable part of the company on the United States ledgers. According to a 1993 study of 200 U.S. corporations by four economists, "the average multinational firm with subsidiaries in more than five regions uses income shifting to reduce its taxes to 51.6 percent of what they would otherwise be."

Along these lines, federal authorities have noticed a striking divergence between the actual taxable income companies have reported to their shareholders and to the IRS. In 2000, for example, it was estimated that less than 70 percent of profit reported by corporations to shareholders was reported to the IRS as taxable; in 1990, the number was 91 percent. In fact, for 1995, the most recent year for which federal data are available, for the nation's largest corporations with assets of $250 million or more, 1,279 out of 7,537, or 17 percent, reported no net income to the IRS and therefore paid no taxes.

Tax avoidance by corporations has been increasing in other ways: corporate tax shelters. In recent years, well-known companies, including Colgate-Palmolive, Compaq Computer, and United Parcel Service have been involved in schemes that allowed them, collectively, to avoid billions of dollars in taxes via tax shams. According to a Treasury Department analysis, "Corporate tax shelters breed disrespect for the tax system—both by the people who participate in the tax shelter and by others who perceive unfairness. . . . These tax-engineered transactions may cause a 'race to the bottom.' If unabated, this could have long-term consequences to our voluntary tax system far more important than the short-term revenue loss we are experiencing."

Forbes magazine and others have estimated conservatively that corporate tax shelters cost the U.S. Treasury at least $10 billion each year, and that number is increasing significantly. In terms of tax law enforcement, Treasury Secretary Lawrence H. Summers declared in 2000 that, "Corporate tax shelters are our No. 1 problem."

For a number of reasons and in a variety of ways, then, U.S. companies generally are paying *fewer* corporate income taxes today. For example, taxes paid by corporations on profits reported to the IRS dropped from 26 percent to 20 percent between 1990 and 1997. By comparison, in 1997, 15 percent of Americans' income went to the IRS, an increase from 13 percent in 1990.

In other words, the federal tax burden resides more and more with individual citizens. In 1997, corporations spent $60 billion less in income taxes than they would have paid in 1990, at the same rate. Meanwhile, individual taxpayers paid $80 billion more in annual income taxes between 1990 and 1997.

Unlike the nation's corporations and wealthy elite, the "little people" cannot afford to move to the Bahamas or hire expensive accountants and lawyers to hide their money in clever tax shelters and other tax avoidance schemes. This disparity is what two-time Pulitzer Prize-winning investigative reporters Donald Barlett and James Steele have referred to as "the two-tax, two-class society." At the high end, there were 998 families and individuals with incomes of $200,000 or more who paid no income tax in 1995, for an effective tax rate of zero. And 9,188 families and individuals in that income stratosphere who *did* pay their taxes, paid them at an effective tax rate of under 7 percent. Another 17,959 wealthy filers in that income bracket paid less than 12 percent of their income in taxes. Most individuals and families with incomes over $200,000, it is reassuring to note, actually paid their taxes without avoidance jujitsu: there were 1,271,510 taxable returns, reporting $639.4 billion in combined adjusted gross income, paying nearly $182.5 billion in total income tax, for an effective rate of 28.5 percent.

The issue is not whether America's wealthiest citizens generally pay their taxes today. They do. What most intrigues us is the extraordinary extent today of naked greed and betrayal. In *The Cheating of America,* we investigate the people and companies who have benefited most from our society and our way of life and then chosen to thumb their noses at the rest of us, by paying little or no taxes. As mentioned earlier, nothing rubs the American psyche raw more than the specter of the rich ducking taxes at the expense of the poor and middle class.

For example, of those families and individuals with incomes between $30,000 and $40,000, some 2,700,965 filed returns whose effective tax rate was between 12 percent and 15 percent. More than 4.5 million tax returns were filed by the upper income bracket of the working poor—those earning between $15,000 and $20,000—who paid between 7 percent and 10 percent of their incomes in taxes. But some 45,000 returns were filed by individuals making $100,000 or more a year, who paid less than 7 percent of their earnings into the federal treasury.

To add insult to injury, wealthy families and individuals are audited less frequently today than in the past. According to a 1996 General Accounting Office (GAO) report, IRS annual audit rates—although generally higher for higher-income individuals—have "decreased since fiscal year 1988 for the highest-income individuals, while increasing in the past two years for the lowest-income individuals." In fiscal years 1994 and 1995, Americans earning less than $25,000 saw their audit rates double. In the meantime, audit rates dropped to one-fourth of what they had been in fiscal year 1988 for those making more than $100,000.

Those GAO findings were bolstered in 1999, when it was widely reported that the IRS audited 1.36 percent of all income tax returns filed by people earning less than $25,000 a year in 1998, but audited only 1.15 percent of returns filed by taxpayers who made $100,000 or more. Since 1988, audit rates have increased by almost a third for the poor, from 1.03 percent to 1.36 percent, and dropped 90 percent for the most affluent, from 11.4 percent to 1.15 percent of tax returns. According to an exhaustive analysis of IRS audit and enforcement actions by a Syracuse University research organization, the Transac-tional Records Access Clearinghouse, the audit rate for the largest U.S. corporations also dramatically decreased in 1999. For corporations with more than $250 million in assets, 34.5 percent were audited, down from 54.6 percent in 1992.

Why would the IRS focus so much of its audit and tax enforcement energy on the poorest of this country when many corporations and wealthy individuals are hiding *billions* of dollars from the United States each year? IRS officials—who supplied the massive government data to the Syracuse researchers—attributed the rise in audit rates for the working poor to congressional and White House pressure put on the IRS to closely monitor misuse of the Earned Income Tax Credit program. Begun in the 1970s and designed to help low income families, the program was criticized in 1995 by former Speaker of the House Newt Gingrich and the Republican Congress, who wanted to downsize it. The Clinton administration, meanwhile, responded with calls to increase IRS scrutiny of program fraud and abuse. All of that heat resulted in greater audit scrutiny of those tax returns claiming earned income tax credits—i.e., the poor—which has distorted the overall IRS audit rate picture.

Meanwhile, no one in government seems terribly concerned about the sharp drop in large corporate audits. In fact, the broader, more fascinating question is: What has happened to the IRS? The overall percentage of individual taxpayer and corporation audits has been decreasing for years. Perhaps that is because while the number of IRS staff has stayed the same since 1983, the total number of tax returns has increased by a third. The number of annual IRS property seizures to pay back taxes has fallen to 161 from 10,000 a decade ago. In 1999, there were only 722 tax-related criminal prosecutions in the United States, half the number in 1981.

Given all the evidence of IRS audit and enforcement reticence when it comes to the rich, it is hardly surprising that the American people today are suspicious and disgruntled about the fairness of their taxes. According to the Gallup polling organization, fully two-thirds of the public believes that "upper-income" Americans pay too little in taxes.

It is interesting today that not only do most Americans think the current tax system unfairly favors the rich, they *also* have historically significant distrust of politicians at all levels. In the 1996 and 1998 elections, the United States had the lowest voter turnout in half a century; 100 million Americans do not participate in our democracy.

There is an intriguing overlap between popular resentment over tax unfairness and disgust toward our elected officials who promulgate those tax laws and enable their enforcement. That visceral skepticism is well founded. Many of the wealthiest and most powerful people and corporations in America today not only have high-priced legal and accounting talent at their beck and call, they also are, of course, very well acquainted with Washington. They contribute billions of dollars to the two political parties and the political campaigns of the most important elected officials in our nation's capital. And they retain the best lobbyists money can buy. At the same time, 96 percent of the American people—Leona Helmsley's "little people"—do not contribute to *any* politician or party at the federal level. The maximum allowable contribution to an individual candidate, $1,000, comes from less than 0.1 percent of the American people.

So perhaps it is not surprising that Congress and a succession of presidents over the past few decades have accommodated the wishes of their most ardent financial sponsors. Since the 1970s, Republicans and Democrats have substantially reduced both the top income tax rate and the tax on capital gains. Over the years, Congress has repeatedly cut taxes for corporations and wealthy individuals, and it shows. In 1956, corporate income taxes accounted for 28 percent of all federal tax revenue. Today that number is down to 10 percent. And in the 2000 presidential campaign, the major party candidates—both millionaires themselves, incidentally—did not advocate tougher new laws to make the rich pay their fair share of taxes. George W. Bush and Albert Gore Jr. cumulatively raised nearly $100 million in campaign contributions from America's wealthiest interests in 1999.

At the Center for Public Integrity over the past five years, we have written extensively about how powerful, moneyed interests have been distorting our democracy, in such books as *The Buying of the President, The Buying of the Congress,* and *The Buying of the President 2000.* Now, with *The Cheating of America,* we investigate a different kind of distortion, which also causes enormous distrust and cynicism about the laws, the policies, and the people who govern us. What you are about to read is the result of an exhaustive, unprecedented investigation of U.S. tax records by a dozen researchers, writers, and editors. This book is not a systematic analysis of all the exemptions wealthy individuals and corporations take. Rather, it is a series of case studies, painstakingly assembled over the course of more than two years, that show how some affluent individuals have avoided paying their fair share of federal income tax. A few have done so through illegal means, but the vast majority of them have taken advantage of perfectly legal loopholes in the Internal Revenue Code to shield millions of dollars in income from the taxes that ordinary Americans have to pay.

In the course of preparing this book, we reviewed years of statistical data published by the Internal Revenue Service to determine which deductions and credits are most favored by wealthy individuals and corporations to reduce their tax burdens. We scoured records at the U.S. Tax Court, delving into the minutiae of tax disputes, while never losing sight of the larger story those documents revealed. We interviewed dozens of experts, tax attorneys, law enforcement officials, former IRS insiders, and ordinary Americans. We traveled across the country and to tax havens like the Bahamas and Belize to interview some of the wealthy individuals we've profiled.

Most of these people have broken no criminal law. Many of them are prominent citizens in their local communities, well regarded by their peers. Some have given sizable amounts to charitable endeavors. A few have endowed educational institutions.

What they have not done is pay the price for our civilized society.

All told, we chronicle the activities of dozens of memorable people and companies whose essential characteristics seem to be almost breathtaking chutzpah and attitude. Most of them have confounded the IRS over the years; the dirty little secret of this book actually is the stunning ease by which these tax finaglers can nimbly avoid or wear down federal authorities. To these wealthy individuals and companies, the annual tax bill seems to be more of a recommendation than an actual requirement—something to be worked out over time with the IRS, for pennies on each dollar owed.

The Cheating of America is not intended to be a book about the IRS. Nor is it intended to be a "how-to" manual for would-be tax scam artists. Nor is it intended to be a simplistic screed against wealth and people with money. Most Americans, even most millionaires, pay their taxes.

What interests us are the people and companies who have benefited and profited handsomely from the American economy and quality of life, but who have chosen to opt out of the system. At some point, they have decided to abandon their country, or at least minimize their contribution to it. And meanwhile, an entire tax avoidance industry has evolved to encourage it, proselytizing directly to the wealthy that the United States is headed unavoidably for the abyss. One proponent of the "coming apocalypse" is Jerome Schneider, who wrote in *The Complete Guide to Offshore Money Havens,* "You need to accept that the domestic scene is hopeless, and you need to create a financial escape route for yourself and those who depend on you. Stop beating your head against a brick wall. America is crumbling, and you need to get out." He could as well have said, "Leave the remains to the little people."

Finally, beyond the recurring motif of "naked greed" throughout *The Cheating of America,* in the conclusion we suggest some obvious, potential remedies. And we explore some rarely discussed, disturbing issues about the unprecedented mobility of money today, and the logistical havoc that it is wreaking on governments, which must raise revenue from their residents. According to the IRS, today an estimated $3 trillion in assets are held as bank deposits offshore. But beyond the scores of jurisdictions offering competing "offshore services" to wealthy individuals and corporations, the new technologies mean that money today has no real home. We now have virtual banks and virtual brokers, virtual money and virtual securities, all confounding to law enforcement authorities around the world whose work is still structured the old-fashioned way: by crime, by country, and by territorially based laws and regulations. Cyberspace, encryption, and other forces of technology and globalization are ensuring virtual secrecy and rendering the essential, nation-state task of taxation increasingly difficult.

As one futurist treatise ominously predicting nothing less than the end of the modern phase of Western civilization observed, "The state has grown used to treating its taxpayers as a farmer treats his cows, keeping them in a field to be milked. Soon, the cows will have wings."

Some of them, we learned, already do.

Chapter 1
No More Than A Living

Jane Morgan is the kind of person upon whom the voluntary tax system depends. Conscientious, organized, and honest to a fault, Morgan faithfully filled out her income tax returns year after year, declaring her earnings, her deductions, and how much she owed in taxes. Like many other middle income taxpayers the Center contacted who had run-ins with the Internal Revenue Service, she was reluctant to speak on the record; her name has been changed to protect her privacy.

A self-employed consultant, Morgan has had contracts with universities and the federal government. To supplement her consulting income, she's worked as a substitute teacher in her local public school system. Like many who are determined to be their own bosses, she's never gotten rich from her efforts, but she has made a living selling her expertise to a wide variety of clients. Unlike an employee of a company who expects a weekly or biweekly paycheck, Morgan's compensation comes at irregular intervals. When she's paid for a long-term project, times are good. During other months, however, she's sometimes forced to dip into assets to pay her bills.

In 1996, while preparing her 1995 return, she was confused by the instructions explaining the penalties for early withdrawals from an Individual Retirement Account. On page 16 of the instruction book the Internal Revenue Service mailed to taxpayers, she read the following passage: "Caution: You may have to pay an additional tax if (1) you received an early distribution from your IRA and the total distribution was not rolled over or (2) you received a distribution in excess of $150,000 or (3) you were born before July 1st, 1924, and received less than the minimum required distribution. See instructions for line 51 for details."

Morgan, who was in her early fifties at the time, had in fact taken a distribution from her IRA in 1995. "I knew I was supposed to declare it on my income tax that year and I did not know how I was supposed to file it," she said. "And so I called the IRS. I do my own taxes."

Morgan wasn't alone. Every year in the months leading up to April 15, IRS employees answer phones to help taxpayers decipher the complicated jargon in the Service's instruction booklets and the myriad forms that accompany them.

In 1999, Form 1040, the basic tax return, had twenty separate lines for reporting income, eleven lines for reporting deductions, one line for reporting personal exemptions, nine lines for reporting tax credits, seven lines for reporting taxes owed, and five lines for reporting payments. There were another ten schedules, used to report business income, self-employment taxes, itemized deductions, capital gains, rental income, and farm income. The seventy-two-page instruction booklet that accompanied each tax return estimated that the total time needed to do just Form 1040 was nearly thirteen hours. The unlucky taxpayer who had to fill out every schedule (assuming such a taxpayer existed) would have required, on average, fifty-six hours and six minutes to complete all the paperwork. In addition to the schedules, there were sixteen more forms specifically referred to by the 1040, used to report moving expenses, to claim the child tax credit and the adoption tax credit, to declare foreign taxes paid, and to report "other gains or losses" not covered by the other forms.

Every taxpayer, no matter what his net worth or employment status, is required to accurately report all of his income on those forms. When the IRS or the Treasury Department describes the system as voluntary, this is what they mean: taxpayers voluntarily report all their income to the government. Of course, matters don't end there. The typical W-2 Form, which reports an employee's wage or salary income to the IRS, contains some variation of the following phrase: "This information is being furnished to the Internal Revenue Service." Form 1099, used to report interest on a savings account, dividend income, or payments made to an independent contractor, carries a similar warning. Each year, the IRS receives copies of roughly 1 billion documents, which it matches electronically, using the Social Security number on each form, to the more than 100 million tax returns submitted by individual and joint filers. The Service checks up on virtually everyone through what it calls the information returns program. If a filer of a Form 1040EZ tries to understate his income as detailed on his W-2, for example, the IRS will catch the understatement. If a filer of a 1040A omits his dividend income, the IRS receives word of it from his broker. If a filer of a regular 1040 doesn't report her interest income, the IRS is tipped off to that omission by her bank.

Even if one merely makes an honest mistake—anything from a math error that inadvertently understates income to forgetting to report the interest on a checking account—the IRS, if it catches the error, will charge the extra taxes plus interest. There may even be a penalty assessed, depending on the nature of the mistake and whether the Service believes there was an intent to pay less than what was owed.

Morgan ran into trouble with lines 15(a) and 15(b) on her 1040, on which taxpayers are supposed to declare any IRA distributions—that is, money they've received from their retirement accounts, along with any penalties (additional taxes for either withdrawing money before reaching age fifty-nine or for not withdrawing enough after turning seventy). "When it came to that portion I did not know how to do it," she said. "And I called the IRS and that's where the problem started."

About two years later, on January 17, 1998, Morgan received a letter from the IRS: $1,234 was owed to the government, it said, for taxes due in 1995. A perplexed Morgan had no idea what the bill was for, but two days later she found out the source of her troubles: the IRS had given her incorrect instructions when she called the agency in 1996 for help.

That year, instead of getting a refund of $329, she should have actually paid an additional $721—an error that Morgan attributed to the bum advice doled out by an IRS employee. Over the next fourteen months, she struggled to resolve the matter with a host of IRS officials. "Please know that I am not trying not to pay the amount I owe, however, I did make the effort to find out what I was supposed to do," she wrote to an IRS manager on January 21, 1998. "If the IRS had provided all the information for filing my return in 1995 as I requested, I would have owed $721, which is the fair amount I would have paid in 1995. Instead, two years later, I am informed that I must pay $1,234 and if I don't meet the allotted time requirements, I will be charged additional interest."

She made every effort to resolve her tax problem, and kept detailed logs of her futile attempts. A sampling shows the maddening lack of progress she made in her case:

> *January 26:* Took day off, no work, waited all day for a call from [an IRS agent], she never called.
>
> *January 31:* Saturday, IRS Problem Solving Day (found out about this day when I called [her congressman's] office and immediately made arrangements to attend. The IRS did not tell me about it). The session with the IRS representative was non-productive. He did not have any knowledge or experience with my type of audit. He left me twice during our discussion and both times said he was going to ask his bosses for clarification and direction. . . . Both times he returned and said his bosses/managers did not know anything either. . . . [He] admitted .. . that I had been given "bum" information by the IRS in 1995. He also said that I had been given a run around by the IRS representatives I have previously contacted.
>
> *February 5:* Todd [an IRS problem resolution officer] . . . called. The discussion was unproductive. He listened and his response to my concerns were: I should fill out Form 843 because the Letter of Compromise [an offer a taxpayer can make to settle for less than the IRS wants] is intended for large sums of tax owed to the government. . . . Todd has already made up his mind even before he has read anything about my situation. He said the IRS would take whatever assets I have. Todd also asked if I filled out my 1997 return and if I was getting a refund, because if I was the IRS would take that.

*February 13:*1 waited all week for Todd's letter. To date, I have not received it.

Morgan didn't hear back from the IRS until July. In the meantime, she wrote letters to her representative in Congress; her two senators; President Bill Clinton and Vice President Al Gore; and Charles Rossotti, the commissioner of the Internal Revenue Service. Her representatives in Congress referred her to various IRS officials in her state. Gore's office responded with the advice that Morgan, for whom the $1,234 tax bill coming out of the blue was a hardship, should hire a tax attorney and settle the affair through legal means. "Without funds," she wrote in her log of contacts with the government, "how do I obtain 'legal means'? What a joke."

On July 6, 1998, one of the IRS agents instructed Morgan in a phone conversation to send a petition to the U.S. Tax Court. "Not exactly sure what Tax Court is," she wrote in her log. "Guess it's my only option. Why didn't he tell me about it before?"

Congress created the U.S. Tax Court in 1924 to give individuals a judicial forum for disputes with the IRS. The president appoints the court's nineteen judges, who hear cases in Washington, D.C., or in federal buildings in locations more convenient to taxpayers. The vast majority of cases filed with the court never go to trial, but are settled through a negotiation process between the taxpayer (the petitioner) and the IRS (the respondent). The burden of proof rests on the taxpayer. Even when a case does go to trial, an effort is made to resolve most of the issues prior to the testimony. The judge will then decide any remaining issues and issue findings of fact, an opinion, and a decision stating either the amount owed by the taxpayer, if any, or his overpayment.

On July 14, Morgan sent a petition to Tax Court. She wrote that she wanted to resolve her tax situation, but added, "I do feel the IRS is also responsible for the current situation. In January of 1995 I called the IRS information line and requested a line-by-line explanation of the 1995 1040 forms and instruction publication, page 16, lines 15(a) and 15(b), IRA distribution. I followed the direction given to me by the IRS. I entered the amount of the IRA withdrawals on lines 15 (a) and 15 (b). When I asked about the caution note, I was told 'it did not apply to me.' I have been told that since I do not have anything in writing and thus cannot prove what an IRS representative told me in 1995 about my IRA distribution amount, that the IRS is not responsible."

On September 23, Morgan received an answer to her petition. It was written by an attorney in the Office of the District Counsel, one of the legal arms of the IRS. "Didn't understand it," Morgan wrote. "Called and received an explanation. Was told my case went to IRS Appeals Department before it goes to Tax Court. Must call appeals office. Now what?"

Once again, Morgan tried to resolve her tax troubles amicably. She met with yet another IRS official, the appeals officer assigned to her case—a meeting Morgan described as "useless." "Meeting was to settle and resolve my situation without going to trial," Morgan wrote in her log. "She was not prepared, had no paper work or information about me."

After the appeals process went nowhere, Morgan prepared to go to trial. She called the IRS attorney who had written the Service's answer to her petition, to discuss the case. Morgan's log from December 23 notes that the attorney suggested a Letter of Compromise. "When I told her I had tried that and was refused, she didn't understand. I told her about all the people I had contact with. She said she had not heard of any of them, that she knew them all and did not recognize any of the names. . . . She's an attorney and doesn't know all that is involved. But I am supposed to." The IRS attorney also said she would draw up a stipulation of facts—an agreement between the two parties in a Tax Court case on what is not in dispute. The stipulations allow Tax Court judges to focus on narrow issues of the tax law, alleviating the necessity of having to establish all the facts of a case during trial.

On February 3, 1999, Morgan received a pretrial memorandum, laying out the issues and arguments that the Service's attorney would make against her in Tax Court. "Didn't even bother to read it, especially when I saw it was full of different cited cases," Morgan wrote. "I don't have money to hire an attorney who can find cases or make legal points for me. Where are my rights?"

On February 17, 1999, more than three years after she called the IRS for help preparing her tax return, Morgan finally wound up before a special trial judge of the U.S. Tax Court. The IRS sent an attorney, the same one who had written the Service's answer to Morgan's petition, to represent its interests. Morgan represented herself.

"The reason I'm here today," the consultant said in her opening statement, "is I'm not sure how I got here. I got here because I kept saying I disagree with . . . whoever I talked to and they said, 'Well, these are your options,' and I kept taking options and the next thing I know I'm here in court because I marked a little box on a piece of paper which gave me the right to be here."

Her adversary's opening statement was markedly different: "At issue in this case is whether the ten percent premature pension distribution penalty under IRC 72(t) [Internal Revenue Code section 72(t)] applies to the distribution paid to petitioner in 1995 from her individual retirement account."

Jane Morgan was the only witness called, and during testimony she explained how she had tried to settle the matter with the IRS. "It's very frustrating when you talk to people and you get different things being told to you and they don't agree," she said. "If you ask questions, they don't know what to tell you. If you ask for advice, they don't know what to tell you. And that's why I said I don't know how I ended up here in Tax Court. I have been trying to get this resolved.

"I feel that they gave me the wrong information. I at no time was trying to withhold money from the government or not pay my taxes. I did what the guy said to do. Two years later I find out it's not what I was supposed to do. ...

"They don't know what they're doing. . . . God forbid you talk to somebody from a different department. 'No, that's collections, I don't have anything to do with collections. You've got to talk to collections.' I talk to collections. 'I'm not on that case anymore.' Oh, who is? 'Well, we don't know.' "

Morgan's frustrations were only compounded as the case dragged on: during the entire time she was trying to resolve the situation with the IRS, the size of her debt to the government kept growing. "What's scary is they tell me that the interest is just going to accumulate and it's like, well, I'm going to go to my grave owing the IRS money."

The judge questioned Morgan, then dashed her hopes of getting satisfaction. "To tell you the truth," he said, "you have a very slim chance of prevailing in the Tax Court. I'm going to go back to Washington. I'm going to look this case over.... If the Government wins, you will owe the tax."

On March 8, 1999, Morgan wrote a letter to the judge, in which, among other things, she apologized for "taking up the court's time." But, she added, "I do feel that what I have been put through this year has added needless stress to my life. It could have been handled efficiently and effectively, but it was not. I am being penalized because a government IRS representative gave me inaccurate information."

She added a final sentiment: "Though I know this would not hold up in court, the American writer Henry David Thoreau argued, 'people have a duty to disobey laws they consider unjust,' but it is how I feel."

In the end, the IRS prevailed. "[Petitioner contends that the application of section 72 (t) in this case is inequitable because she made a good faith effort to correctly file her 1995 Federal income tax and relied on IRS advice. This Court has previously held that the authoritative sources of Federal tax law are statutes, regulations, and judicial case law and not informal IRS sources," the judge's opinion read. "Though it is unfortunate that petitioner may have received unhelpful or incorrect tax advice from IRS employees, that advice does not have the force of law."

Morgan was ordered to pay the entire amount owed, including interest. She came away from her Tax Court experience poorer, but wiser. "The IRS needs to improve in how it does its job," she told the Center. "But the IRS is not responsible for the tax laws and other policies that are decided and voted in by the Congress. It is the judicial, legislative, and executive branches who decide how Americans will live their lives."

And one of the most important ways they decide how Americans live their lives is through the promulgation and enforcement of the Internal Revenue Code, a behemoth of rules, regulations, and fine print that even the IRS has conceded is far too complex for most taxpayers to understand.

The Sixteenth Amendment to the Constitution, which authorizes Congress to levy and collect a tax on incomes from whatever source derived, contains just thirty words. The original income tax law was eighteen pages long. Today, the Internal Revenue Code, the law of the land, stretches to well over 17,000 pages in some editions. The IRS refuses to say how long the tax code is. "It's a meaningless question," Steve Pyrek, a public affairs officer for the Service, told the Center in an interview. "There's no definitive version."

After passing the first tax law in 1913, Congress changed it seventy-five times in eighty years, or once every thirteen months. After the House and Senate pass new tax legislation, and the president signs it into law, the Treasury Department and the IRS write regulations implementing the changes. There are permanent and temporary Treasury regulations; there are private letter rulings that the IRS sends to taxpayers requesting guidance on particular tax problems; there are court decisions and revenue rulings. There is a vast library of complicated rules to decipher, and it has come to pervade just about every aspect of the economic life of the United States.

In the 1930s, for example, in addition to raising revenue, New Deal economists recognized that the tax code could be used to control inflation and limit consumption by draining purchasing power out of the economy. People who paid more in taxes had less money to spend on goods and services. In the 1940s, during World War II, Congress worried that the demands of labor unions for higher wages would lead to inflation. They made fringe benefits like health insurance tax deductible for employers, which gave employers an incentive to offer benefits in lieu of wages to their unions. Some fifty-six years after the need to control inflation in a wartime economy has gone away, health insurance is still a tax-deductible benefit that employers provide to employees (at least, when they wish to).

In the 1950s, when the majority of married women didn't work, the tax code benefited them and taxed single individuals at a higher rate; in the 1960s, Congress revised the code to make it fairer to unmarried individuals, which has led to today's marriage penalties paid by couples in which both spouses work. At various times, Congress has given preferential treatment to oil and gas producers, to real estate investors, to middle-class workers saving for their retirement, and to retirees. At other times, it has taken away those preferences.

In 1981, Congress passed the Economic Recovery Tax Act, an overhaul of the nation's tax laws. Among the bill's provisions was one that broadened the eligibility of workers to establish IRAs. William Fren-zel, a Republican representative from Minnesota, explained the changes in 1981. "Under current law, many employees are barred from making contributions to an individual retirement account because they are active participants in an employer-sponsored pension plan, even though the benefits that they eventually will receive from the plan are very small, or they are not vested in the plan at all. Therefore, these individuals are denied the opportunity to prepare adequately for their retirement by receiving a tax deduction for their contributions to a retirement savings plan."

Five years after the IRA deduction became part of the tax law, a new massive overhaul of the nation's tax laws, the Tax Reform Act of 1986, was passed. Senator Bill Bradley, a Democrat from New Jersey, explained the principle behind that bill. "The choice of tax reform is that you get lower rates in exchange for giving up certain credit exclusions or deductions," he said. "You give up those loopholes which only some people use, so that the tax rates on everyone can be lowered dramatically." Among the loopholes Bradley proposed giving up was the IRA deduction, passed in 1981 to allow workers to prepare adequately for their retirement.

Congress isn't the only legislative body with the authority to levy taxes. State and local governments also have their own revenue codes, and they enthusiastically tax income, assets, and sales of merchandise. More than 268 million Americans pay taxes on everything from candy bars to capital gains, from airline tickets to income, all of which adds up to a staggering amount of money.

In 1997, for example, the total tax burden amounted to some $2.6 trillion. To put that in perspective, the gross domestic product that year—the total economic output of the United States—was $8.1 trillion. Of every dollar earned, governments seized 32 cents in taxes. The federal government took in the lion's share, some $1.6 trillion. More than half of that—some $825 billion—came from individual income taxes. Employment taxes, which pay for programs like Social Security and Medicare, accounted for about a third. The corporate share was $204 billion—a little more than one-eighth of federal revenues.

That year, according to the Internal Revenue Service, the federal per capita tax burden was $6,045. That figure doesn't include the $869 billion that state and local governments raised from taxes and fees (like those for a driver's license or building permit); tack those on, and the per capita tax burden climbed another $3,244, to nearly $9,300. That's $9,300 in taxes for every man, woman, and child in the United States, a far cry from what Americans once paid. Just twenty years earlier, the combined federal, state, and local per capita tax burden was $2,635, or $6,979 adjusting for inflation.

The per capita figures, of course, can be misleading. How much tax an individual owes depends in large measure on his income, where he lives, whether he's married and has dependent children, even what his habits and preferences are. Internal Revenue Service publications caution that there is no such thing as an "average taxpayer," and given the wide range of individual circumstances, that's not an unreasonable assertion to make. Residents of Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming pay no state income tax; workers in Philadelphia pay both a city and a state tax on their wages. Someone who lives in the City of Brotherly Love and relies on the local mass transit system will never pay the state and federal gasoline tax; indeed, because the Southeastern Pennsylvania Transportation Authority—or SEPTA, as it is known—receives part of its budget from local, state, and federal subsidies, her subway trips are partially paid for by other taxpayers. Someone who's too terrified to board a plane won't have to pay the 10 percent federal surcharge on airline tickets, but he might have to pay the $3 tax to cruise on a passenger ship. An individual whose sole source of income is dividends from stocks will pay no taxes to the Social Security and Medicare trust funds, whereas someone who receives all his money from a paycheck surrenders up to 7.65 percent of his income for those social insurance taxes. And a self-employed individual like Jane Morgan had to pay 15.3 percent of her income—both her share and the employer's share of the tax.

Each taxpayer's circumstances are unique, and the Internal Revenue Code is an attempt to fairly levy taxes on each of those taxpayers. And fairness depends, in large part, on the eye of the beholder.

The first income tax law, the Tariff Act of 1913, exempted from taxation all income under $4,000 for married couples. Those who earned more than that were taxed at a rate of 1 percent, so a couple with an income of $4,001, for example, would have paid one penny to the federal government. By contrast, income over $20,000 was taxed at graduated rates between 2 and 6 percent; the top bracket kicked in for incomes over $500,000. "There are those who say that we should begin at $1,000 in lieu of $4,000," Representative William Henry David Murray, a Democrat from Oklahoma, explained on the House floor during the debate over the Tariff Act. "They forget the principle on which this tax is founded, and that is that every man who is making no more than a living should not be taxed upon living earnings, but should be taxed on the surplus that he makes over and above that amount necessary for good living." In other words, income taxes would be assessed on one's ability to pay; those who earned the most would pay the most, whereas those who were "making no more than a living" would not be taxed at all.

Adjusted for inflation, Murray's "living earnings"—that first $4,000 of tax-free income—would be worth nearly $65,000 in 1997 dollars. If the first income tax law remained in effect, adjusted for inflation, anyone earning that amount or less would pay no income taxes. Over the years, however, Congress sacrificed the principle Murray expounded (the ability to pay), in order to raise revenue. The process started just four years after passage of the Tariff Act, when the United States needed money to pay for its entry into World War I. In the ensuing years, the Great Depression, World War II, the Korean War, Vietnam, and the four-decade-long Cold War all required a greater tax bite. So did the creation of the Social Security system, Medicare and Medicaid, Aid to Families with Dependent Children, and all the other social safety net programs the government has created since the first income tax law took effect. So did the space program, the air traffic control network, and the interstate highway system. Through it all, year after year, those "making no more than a living" paid a greater and greater share of their income to the federal treasury. And to state treasuries. And to local treasuries. Over the last half century, in fact, the growing tax bite on the incomes of the middle class has been staggering.

To see how staggering, consider the taxes paid by two families living in Wichita, Kansas, one in the 1950s and the other in the 1990s. In 1956, a family of four—let's call them the Smiths—earning the annual median family income (half of all families earned more, half earned less) would have had $4,780 in income. The personal exemption that year was $600, so the Smiths would have started with $2,400 in tax-exempt income. The standard deduction was 10 percent of adjusted gross income; for the Smiths, that would have knocked another $478 off their taxable income. All told, they would have owed $380 in federal income taxes. The Smiths would have owed an additional $84 in social insurance taxes—used to fund Social Security, the government-run retirement system—and another $30 in state income taxes, for a total tax burden of $494. Altogether, the Smiths would have paid a little more than 10 percent of their income in taxes.

Forty years later, their counterparts—call them the Joneses— would have had income of $42,300, the median family income that year. Their personal exemption would have been worth $10,200—a mere quarter of their income. They would have paid $3,814 in federal income taxes, another $3,236 in social insurance taxes, and $1,026 in state income taxes. The total tax burden for the Joneses would have amounted to $8,076, or 19 percent of their income.

By far the largest source of disparity between the two families are the social insurance taxes. The Smiths paid $84, or 2 percent of their income, to the Social Security trust funds, while the Joneses paid 7.65 percent. Operating right alongside the progressive income tax system is a regressive tax, called the Federal Insurance Contributions Act, or PICA.

PICA taxes are levied solely against wage and salary income—the income reported on a W-2 Form that workers receive from their employers or the 1099-MISC Form that independent contractors and the self-employed receive. Capital gains, along with dividend and interest income, are exempt from the tax. Unlike the income tax, there are no personal exemptions—FICA taxes are levied on the first dollar of income. Further, higher levels of income are taxed at a lower rate: in 1999, for instance, income up to $72,600 was taxed at a rate of 7.65 percent; any dollar earned above that amount was taxed at a mere 1.45 percent. So, a family of four with wage or salary income of $72,600 would pay $5,554 in FICA taxes—7.65 percent of their income—plus whatever they owed in federal income taxes. An athlete with a multi-million-dollar contract paying him one hundred times as much would pay just 1.5 percent of his income to the trust funds.

FICA taxes give the most affluent Americans a free ride. And the affluent with enough savvy to manipulate the tax code to their benefit can reduce their income tax rate to a similarly low level.

Consider, for example, Roy M. Speer, the millionaire founder of the Home Shopping Network, who paid just 1.2 percent of his income to the Social Security and Medicare trust funds in 1989. Speer, a brash, self-made millionaire, possesses a towering ego, an imposing six-foot, 200-pound body, a face more suited to a pugilist than an entrepreneur, and a nature not given to compromise. The native Floridian worked his way through college, served in the Navy, went on to law school and graduated in 1959. He worked as an assistant Florida attorney general, a trial attorney for the National Labor Relations Board, and special counsel for the city of St. Petersburg, Florida, where he specialized in water law and legislative work. Not a bad resume for an attorney, but Speer wasn't satisfied. "One day I woke up and decided that if something happened to me and I couldn't go into [the] law office, I couldn't make any money, and I had nothing to protect my family with, so I decided to be an entrepreneur," Speer once said.

In midlife, Speer changed careers. He went into land development, building, construction, the concrete business, marine construction, and dredging. He tried his hand at oil around the time that prices peaked in 1982, but he lost money when the bottom fell out of the market. "That was something I have been trying to forget," he said of his experience in the energy business. Through it all, however, he was indefatigable. "I am what has been termed as a workaholic. I don't golf; I don't belong to country clubs. I make it a point to spend Sunday with my family. And my day starts about seven and stops at about ten or eleven at night. . . . Six days a week; I work on Saturday. I try not to work on Sunday."

In 1981, Speer set up Home Shopping Channels, Incorporated, a company that sold retail merchandise over the airwaves in the Tampa Bay area of Florida. Initially, shoppers who ordered from the show drove to one of Home Shopping's warehouses to pick up their purchases; when the channel went national in 1985, renamed Home Shopping Network, Incorporated, it began shipping its sales directly to customers' homes. "Most people look at home shopping on the television and they think it is simple," Speer said of the business. "It is probably the most complex array of merchandising and computers that you will ever find."

Home Shopping Network went live on July 1, 1985, broadcasting nationally for five hours each day via satellite. Speer owned 60 percent of the company, and he held the reins tightly. "I have a principle in my business: If I don't control it, I don't own it," he once testified in a Tax Court case. "The reason for that is that if it gets in trouble, I am the one that is going to have to bail it out, and I want to be in the position of a controller. ... I have done it several times the other way in my life, and every one of them have been disasters."

Speer's hard work, along with the cable and credit card booms of the 1980s that fueled impulse buying, made the Home Shopping Network a huge financial winner. When Speer cashed out in December 1992, he was paid $160 million for his controlling stake by Liberty Media Corporation, a cable television programmer. He sold the rest of his shares in 1993, for another $100 million, and relinquished his position as chairman.

It wasn't the profits Speer reaped from the sale of his stake in Home Shopping Network that caught the attention of the IRS, but rather the way he ran the firm. Pioneer Data Processing, a company that Speer once owned, developed the software program that Home Shopping

Channel—the Tampa Bay-area predecessor to the national Home Shopping Network—used to take its orders from the throngs of cable TV viewers.

When Speer launched the Home Shopping Network in 1985, he hired Burroughs Corporation to rewrite the program in a different computer language, and he paid the computer company $55,250 for its efforts. He agreed to pay Pioneer, whose program he was no longer using, a far more generous sum. Speer signed a licensing agreement with the firm guaranteeing it 1 percent of the annual gross profits of Home Shopping Network. The agreement was open-ended.

Speer signed the document for Pioneer even though he didn't own the software firm. He was just exercising his parental prerogatives: his son, Richard Speer, owned Pioneer.

After auditing the returns of Pioneer software and Roy and Richard Speer, the IRS concluded that the licensing agreement was a sham— that it was merely an attempt to divert income from Home Shopping to Pioneer and Speer's son, Richard. Pioneer, in turn, paid hundreds of thousands of dollars in consulting fees to companies owned by Roy Speer, which the IRS discovered in a 1991 audit of the closely held software developer.

On December 2, 1988, Pioneer wrote a $300,000 check to Tahitian Investments, Incorporated, for consulting fees, and later deducted it from its tax returns as an ordinary and necessary business expense. Roy Speer, it turned out, owned Tahitian Investments, and the $300,000 in consulting fees was for his time. "Roy Speer stated that as a matter of family tradition," an IRS agent who audited the Pioneer tax returns wrote in his report, "he and his family would discuss business on the weekends, which is when he discussed many of Pioneer Data Processing's business affairs with his son, Richard." Unlike most fathers, however, Roy Speer charged his son for his weekend advice. "He thought about the time that he spent on Pioneer Data's business affairs, and based on his business experience, he pulled a number from the air which he thought represented a fair fee. He stated that he believes in making his children pay for the things that they get, and that they should work for their money. Thus, he makes his children pay for his services." The IRS auditor decided to disallow the deduction from Pioneer's tax returns.

The audit of Pioneer led the IRS to audit the Speers as well. When the Service concludes from an audit that additional taxes are owed, it sends a Notice of Deficiency, stating the amount of tax owed and any interest or penalties assessed. If there's a dispute, the taxpayer may contact the revenue agent to discuss the case. If the matter can't be resolved, the taxpayer has the option of filing a petition with the U.S. Tax Court. In 1994, Roy Speer did just that after he and his wife, Lynnda, received Notices of Deficiency for more than $9.9 million.

The IRS challenged the licensing agreement between Home Shopping Network and Pioneer, arguing that Speer was funneling money from Home Shopping through Pioneer and back to himself. This challenge of the licensing agreement accounted for the bulk of the amount of unpaid taxes assessed against Speer; other deficiencies included losses the workaholic claimed from the operation of various businesses he owned while he ran Home Shopping.

Like Jane Morgan, the combative Speer was unable to resolve the dispute with the IRS through negotiations, and in January 1995, the case went to trial in Tampa. Unlike Morgan, Speer had a team of high-priced lawyers, including James A. Bruton III, who had worked in the IRS chief counsel's office. The Tax Court testimony lasted five days. Among the witnesses called by Speer's half dozen attorneys and the IRS were experts on computer programming; among the exhibits entered into the record was the 1981 program itself. Speer also took the stand. Senior attorney Francis C. Mucciolo, who tried the case for the IRS, asked Speer about the $300,000 his son paid him for his advice. "Probably should have charged him half a million instead," he replied. "He got a break." Mucciolo asked Speer about his home in the Bahamas, which one of his companies bought for him in 1991. "I have probably quadrupled it since then. I have built onto it." Mucciolo asked Speer whether he'd used a 68-foot yacht that his son's company bought. "I think it's a 63-footer, but we might have stretched it a little bit. ... I am sure I have used it on occasion."

Among the documents entered into the record were joint tax returns filed by Roy and Lynnda Speer. Speer reaped rewards from his cable business that put him, in terms of income, among the top 1 percent of all Americans. In 1989, for example, his salary from Home Shopping Network was more than $400,000. Tahitian Development— the company to which Pioneer Data Processing paid $300,000 in 1988—paid Speer a salary of $48,000. Altogether, Speer and his wife earned more than $550,000 in salary. They also received just over $1 million in taxable interest income, another $157,000 in capital gains, and $490,000 in tax-exempt interest income from investments in municipal bonds and the like. Altogether, the Speers' total income amounted to $1.2 million.

Not everything Speer touched turned to gold, as his tax returns show. In 1989, for example, he claimed losses of $1.1 million from Maximo Marina, Incorporated, a full-service marina operating in St. Petersburg, Florida. Speer, as was his habit, owned a controlling interest in Maximo, and could claim those losses on his Form 1040. He claimed losses of $78,000 from another of his companies, Gateway Marine, Incorporated, a tug and barge business. Altogether, he claimed losses from his other business ventures of nearly $1.2 million.

That left the Speers with an adjusted gross income of $578,000— still not a bad year. The personal exemption that year was $2,000; Speer claimed one for himself and his wife. The standard deduction for a married couple filing a joint return in 1989 was $5,200; the Speers instead claimed itemized deductions of more than $400,000. They deducted $61,000 paid in local and state taxes, another $142,000 for interest paid on loans they took out to invest in various businesses, and nearly $200,000 for donations made to various charities.

Altogether, the Speers were left with a little less than $174,000 in taxable income, or about 15 percent of their $1.2 million in gross income. They claimed they owed $89,600 in federal income taxes. In a year in which the Speers, by their own admission, received more than a million dollars in income, they paid taxes at an effective rate of 7.4 percent. Remember the Joneses, the hypothetical family from Wichita earning the median income? Their total federal income tax burden amounted to 9 percent of their gross income. Tack on the Joneses' social insurance and state income taxes, and they paid 19 percent of their income in taxes. The Speers, among the wealthiest Americans, paid $7,200 in payroll taxes and another $61,000 in state and local taxes. Altogether, the Speers' tax burden amounted to a little more than 13 percent of their total income.

In the 1994 Notices of Deficiency, the IRS reduced the losses from both Maximo Marina and Gateway Marine that the Speers claimed in 1989. The Service argued that the losses were passive, not active; a taxpayer can claim only a portion of a passive loss rather than the full amount from a business in which the taxpayer "materially participates." The Internal Revenue Code requires an individual to spend just 100 hours a year on a business to claim active participation.

Speer testified that he was involved with all the business decisions made by Maximo and Gateway. "My money has been hard to come by," he testified in the Tax Court case, "and I am usually very close to it whenever it is spent." He estimated that he spent about 400 hours a year on the two businesses, but could provide no documentation to back up the assertion.

In the end, Judge Robert P. Ruwe ruled that the program owned by Pioneer Data had value, it was the basis of the program Burroughs later wrote, and that the licensing agreement was legitimate. As a result, Speer did not have to pay the bulk of the deficiencies assessed against him.

But the judge dismissed the "ballpark guesstimate" offered by Speer's attorneys of his activities involving Maximo Marina and Gateway Marine. His losses were reclassified as passive, and Speer had to pay taxes on an additional $1.7 million in income—pennies on the dollar, it turned out, of the nearly $10 million that the IRS sought in its original Notices of

Deficiency. That result was par for the course for the IRS. In cases in which $10 million or more is at stake, the Service recoups on average just 17 cents on the dollar. In smaller cases, with less than $10 million at stake (the vast majority of them), the IRS recovers 42 cents for every dollar it claims is owed.

Had Speer been able to document the time he spent on his other business—had he met the 100-hour threshold for active participation in the affairs of Gateway and Maximo—his losses would have been tax deductible. By contrast, Jane Morgan's IRA distributions, which she reluctantly took to cover basic living expenses like rent, health insurance premiums, and car payments, were subject to a penalty. The tax code treats different kinds of money differently. Money spent to make more money is tax deductible. Money spent to meet one's basic needs is not.

Consider the IRS's audit of Pioneer Data Processing. After discovering questionable items on its returns from the 1980s, agents interviewed the Speers—part of the audit process, in which a taxpayer can give his side of the story.

In 1987, Pioneer paid $525 in country club dues for Roy Speer and deducted the cost from its taxes as a necessary business expense. "It has been determined that Roy Speer provided a valued service to the taxpayer and the 'dues' in question represent an ordinary business expense to the taxpayer," said the summary of the audit, called a revenue agent's report. Pioneer paid $20,304 for a security fence for Richard Speer's home and deducted that; the IRS chose not to challenge that expense either. "In light of the fact that Richard Speer made loans to [Pioneer], subsequent to the building of the fence at issue, the Service is conceding this issue in full." Pioneer also paid an architect $5,798 to design a home for Roy Speer and his wife on land owned by the company; the IRS allowed Pioneer to deduct the architect's fees.

The Speers didn't persuade the IRS agents that all of the company's deductions were legitimate, however. In 1988, Pioneer claimed a $41,045 depreciation deduction for a Rolls-Royce limousine purchased the previous September. "The Rolls Royce was never rented or advertised for rent," the revenue agent's report stated. "The Rolls Royce was never permitted or licensed by the taxpayer to be operated as a commercial limousine." An agent interviewed Richard Speer about the car, and in his report wrote: "Richard Speer stated that he intended to lease the limousine when he originally purchased it, but, after he saw the car, he was afraid to let anybody drive it. ... He said the limo was kept under cover in a carport at his house."

After determining that the limo had no business purpose, the agent addressed the question of whether it had in fact depreciated in value. This time he interviewed Richard's father. "According to Roy Speer, only a limited number of these limousines were made by Rolls Royce; thus, they are a collector's item. This particular limo was originally purchased by a lady in Las Vegas, but she died before, or shortly after, it was to be delivered to her."

On the basis of his interviews with the Speers, the agent didn't allow the company to write off the costs of its limo. "The taxpayer is not entitled to claim depreciation on the Rolls Royce limousine in taxable year 1988. The limousine was never placed into service and is tantamount to investment property that is more likely to appreciate rather than depreciate in value."

A corporation can deduct half the cost of providing entertainment to its clients or customers. If it pays for tickets to baseball games or Broadway musicals for its employees, it can deduct 100 percent of that cost as a fringe benefit. In 1997, the IRS even allowed a corporation to deduct 80 percent of a contribution it made to a university in return for a ten-year lease on a sky box in the university's football stadium. Think of it this way: a father who takes his son to a ballgame can't write off the cost. A corporation that sends its employees and customers to a game can. Similarly, a corporation that pays for health insurance for its workers can deduct the cost. An employee of a company that doesn't provide health insurance can buy coverage for himself and his family, but he can't deduct the premiums. A corporation that buys a fleet of automobiles can deduct the expense; as the cars lose value, the corporation can write off the depreciation. An individual who buys a car cannot write off the expense; as the car's value shrinks over time, he bears the loss himself. A corporation that's sued because its product injured someone can write off the costs of its defense, plus any monetary judgment against it; an individual who's sued for causing an injury, say in a car accident, can write off neither the costs of his defense nor the costs of a settlement. A corporation that goes deeply into debt can deduct its interest payments. An individual who runs up a fortune in credit card bills can't do the same.

The disparities are simple enough to explain. The Internal Revenue Code treats certain kinds of spending differently. In essence, money spent to make more money is tax deductible; money spent on oneself, whether it's for rent, groceries, or a family car, is not. The income tax is essentially a tax on money used for consumption—on "living earnings," as Representative Murray opined in the 1913 debate over the income tax. Those who earn a surplus "over and above that amount necessary for good living" can play by many of the same rules corporations use— provided they're willing to use their money to make more money.

Consider interest expenses. A young couple who buys a cradle, bassinet, changing table, and so forth on an installment plan may not deduct the interest payments on the furniture as they await their bundle of joy. By contrast, a millionaire like Roy Speer, who borrows to invest in a slew of ventures, may write off on his taxes the interest he pays on those loans. In 1995, more than 39,700 millionaires deducted more than $4 billion from their tax returns for interest paid to invest in everything from the latest high-tech company to the most old-fashioned speculative property, real estate. Those millionaires, incidentally, represented a mere 3 out of every 10,000 taxpayers; collectively, they claimed 38 cents of every dollar in deductions for investment interest expenses.

The IRS, of course, is the federal agency charged with determining whether all those deductions, made by corporations and individuals, are proper. In 1997, the IRS spent more than $1.6 billion examining returns, employing a staff of more than 17,000 revenue agents and auditors. Of the 118 million individual income tax returns filed that year, the Service conducted formal audits of just 1.5 million of them, or 1.28 percent. Two-thirds of those returns were from taxpayers declaring incomes of under $50,000. The IRS recommended additional taxes and penalties of $3.6 billion against them—an average of $3,520 per audit. For the 119,000 audited with incomes over $100,000, the Service recommended $1.78 billion in additional taxes and penalties—an average of $14,900 per audit.

Few agencies have a greater talent for arousing outright hostility than the IRS. Either they're bureaucratic incompetents, as Jane Morgan found, or jackbooted thugs, as several taxpayers testified before the Senate Finance Committee in 1996, when Senator William Roth, a Republican from Delaware, held a highly publicized series of hearings aimed at curbing the Service's power. Roth later coauthored *The Power to Destroy,* which described the horrors that taxpayers endured at the hands of the Service. Roth's hearings led to the passage of the IRS Reform and Restructuring Act of 1998, which implemented the Taxpayer Bill of Rights—a manifesto that Morgan concluded was ignored in her case.

On January 18,1999, the IRS began sending out a redrafted letter to all the subjects of audits warning that agents may need to contact third parties. "Third party contacts may include, but are not limited to, neighbors, employers, employees and banks," the letter explained. "We may use these contacts to help us determine your correct tax liability, identify your assets, or locate your current address." The new wording, part of the Service's attempt to comply with the Reform and Restructuring Act and become more "taxpayer friendly," fell well short of the mark.

While the IRS withdrew the letter, it has continued to target its audits toward middle- and lower-income taxpayers. This astonishes Jane Morgan. "Why was I put through this ordeal for over a year," she asked. "What has the government to gain? How much has it cost the government? More than the amount I owe!"

The Jane Morgans of the world, of course, pay their taxes. There's a wide assortment of experts who help the wealthy avoid theirs.

Chapter 3
Gimme Shelter

By almost any definition, Macauley Taylor is a successful man. A graduate of Dartmouth College and the Harvard Business School, where he earned a master of business administration, Taylor went to work for Merrill Lynch & Company, the giant brokerage and securities firm, in 1986. Within three years, he was named managing director of the Structured Derivative Financing Group, where he designed complex financial trades for corporate clients. He had a team of three highly trained professionals working for him who held advanced degrees in law, economics, and business administration.

Taylor's job was, in its essentials, not much different from any other stockbroker's. He networked within his firm for leads on existing clients who might be interested in what he was selling. He dealt with a roster of clients, some of them long-standing customers of Merrill Lynch, some of them drawn to the firm by word of mouth or sales pitches. He used his expertise and that of his staff to recommend investments that would suit the needs of his clients. But Taylor wasn't just any other broker recommending blue chip stocks to small investors. His clients were the blue chips themselves. Among them were the *Fortune* 500 giants Colgate-Palmolive Company, the global consumer-products maker; AlliedSignal, Incorporated, the aerospace and automotive firm; and Schering-Plough Corporation, the pharmaceutical manufacturer. And catering to their needs was more than a matter of making a phone call and touting a hot stock.

Taylor and his group made sales pitches to boards of directors and skeptical top executives. They used flip charts and slide shows to explain complicated transactions involving offshore partners, foreign currencies and bonds, and corporate debt. Like all good salesmen, they listened to their customers' concerns and tried to accommodate them. It wasn't always easy.

Steve Belasco, a vice president of Colgate, explained his reaction to a Merrill Lynch proposal made on May 15, 1989. "Well, after looking at it for a while, I decided that while technically it seemed to work and had some merit, it just wasn't something I was interested in pursuing." Hans Pohlschroeder, Colgate's assistant treasurer, said of the same investment opportunity, "I turned it down, and I told them that we wouldn't do anything like this."

Those reactions were not altogether surprising, given what the men from Merrill Lynch were selling: a surefire way for a corporation to lose tens or even hundreds of millions of dollars in an offshore partnership. But Taylor was a very good salesman; Colgate, despite its initial rejection of the plan, eventually signed on, as did at least a dozen other large corporations. The head of Merrill Lynch's Structured Derivative Financing Group arranged everything. He found a foreign bank that would be part of the deals; he jetted to various Caribbean destinations to take part in partnership meetings; he arranged all the swaps—the complicated, hedged sales and buybacks of bonds—that produced those multimillion-dollar losses. For his efforts, he was well rewarded. "I could tell you from the period 1988 through '91," he said, "my compensation went up, on average, 20 to 30 percent a year."

During those years, Merrill Lynch didn't fare too shabbily either. The brokerage firm made over $20 million in fees alone, just by selling those investment partnerships that Taylor explained to Merrill Lynch's clients. It made $1.75 million by producing losses for the Brunswick Corporation, the sporting goods manufacturer best known for its bowling balls. It made $1.75

million in fees and another $2 million in commissions by losing millions for Colgate. It made $7 million in fees from AlliedSignal.

The losses were worth every penny the companies paid for them. When AlliedSignal sold off its shares in Union Texas Petroleum Holdings, Incorporated, in 1990, the company had a capital gain of $447 million. The taxes due on such a gain amounted to roughly $149 million. But AlliedSignal's management had no intention of paying taxes on their gain. G. Peter D'Aloia, AlliedSignal's vice president and treasurer, explained that one of the company's directors pointed out that, "There were ways of avoiding the tax if we were willing to enter into certain types of transactions and make certain types of investments."

Among those certain types of transactions and investments were the sorts that Macauley Taylor and Merrill Lynch had developed. Through an offshore partnership, a corporation could appear to lose, on paper, millions of dollars that would offset the very real capital gains that that company had earned. And Merrill Lynch wasn't the only firm pitching such transactions and investments. Corporate tax shelters have proliferated over the past decade; some have estimated they cost the government over $10 billion a year in lost tax revenue. In a 1999 report prepared by the Treasury Department's Office of Tax Policy, that cost was put into perspective: "Corporate tax shelters reduce the corporate tax base, raising the tax burden on other taxpayers."

"Other taxpayers," of course, means you.

And so it goes in the world of corporate income taxes, where top executives ask not how they can pay their company's taxes but how they can avoid them. Need to offset a capital gain? Sophisticated financial firms have designed the perfect tax shelter. Upset about the latest tax legislation coming out of Congress? A friendly member will write a special exemption into the bill that applies to just your company. Perturbed by the latest Treasury regulations? Hire a former congressional staff member who will persuade his old bosses to pass a bill gutting them. Fed up with U.S. tax laws altogether? Move to an offshore tax haven. Unhappy with the offshore tax havens? There are plenty of developing countries eager to rewrite their tax laws to attract U.S. businesses.

All of which helps to explain why, in the 1990s, the federal corporate income tax accounted for just over one-tenth of federal revenues. By contrast, in the 1950s, corporate taxes provided more than 27 percent of federal revenues.

As the corporate contribution to the treasury declined, so did the rate at which their profits were taxed. In the 1960s, the average effective corporate tax rate—total corporate income taxes divided by total corporate profits—was 35.4 percent. That rate fell every decade, to a low in the 1990s of 23.5 percent. And, as the corporate tax base shrank, that burden was shifted to individuals.

The revenue from the corporate income tax did not dwindle overnight. Presidential administrations and lawmakers of both parties slashed the tax rates for corporations. The Revenue Act of 1964, first championed by President John F. Kennedy and strong-armed into law by his successor, Lyndon Johnson, cut the corporate tax rate from 52 percent to 48 percent. In 1978, Jimmy Carter and Congress cut the rate another two percentage points. In 1986, the Reagan administration pushed through another cut, this time to 34 percent, as part of the sweeping Tax Reform Act of 1986. President Bill Clinton barely persuaded Congress to raise the rate to 35 percent (the measure passed the House of Representatives by one vote), the first time in forty-one years that the corporate tax rate had been increased.

The declining tax rate for corporations doesn't tell the whole story. The Internal Revenue Code grants them generous deductions that ordinary taxpayers can only dream of. If a corporation buys a fleet of limousines to ferry its top managers to and from work, it's a deductible business expense. The car that you buy for your commute isn't. A corporation that goes into debt to expand can write off the interest it pays on the loans. Run up a huge credit card bill, and the interest you pay can't be deducted. While various administrations and Congresses cut the corporate tax rate, they expanded some loopholes in the code that shrank the amount of corporate income subject to the tax. Those loopholes cost the government billions of dollars each year. All of which helps explain why a series of bad business decisions by the management of a department store chain in the second half of the 1980s translates to hundreds of millions of dollars of write-offs through the year 2009.

In 1986, when corporate raiders and junk bond dealers like Michael Milken, Ivan Boesky, and Carl Icahn were flying high, the senior management of R. H. Macy & Co., led by chairman and chief executive officer Edward S. Finkelstein, decided to beat the raiders to the punch. Rather than be bought out by a corporate raider, Finkelstein arranged an insider's leveraged buyout; he and his managers and a few outside investors borrowed $3.5 billion to buy the company. At a party to celebrate the successful conclusion of the deal, held at the Metropolitan Museum of Art, Finkelstein raised his glass to toast, quoting Shakespeare's *Henry V,* "We few, we happy few, we band of brothers."

The brothers seemed to have made a good gamble at the time. R. H. Macy & Co. owned one of the most profitable and storied department store chains in America: Macy's. Its Herald Square store in New York City was featured in the classic Christmas film *A Miracle on 34th Street.* Over the course of its 140-odd years, the chain has sold everything from liquor to linen. In 1960, it became the first retailer to sell Teflon-coated cookware; customer demand was so great that the chain quickly sold out.

Finkelstein was a marketing whiz who rose to the top of the company after turning around the chain's California stores and revitalizing its Herald Square flagship store. He and his fellow investors gambled that the economy would remain strong, allowing their stores to generate enough cash to pay off the interest and principal on their debt. They projected that the payoff for a $75,000 investment would be $1.5 million—a profit of 1,900 percent. Those projections failed to take into account the possibility of a recession, or that management might not always make the right decision.

With his company already deeply in debt thanks to the buyout, Finkelstein, over the objection of some of his fellow investors, saddled Macy's with another $1.1 billion of loans in 1988 to acquire a pair of department store chains based in California. Year after year, he overestimated the strength of the economy; each Christmas, the stores in his empire had disappointing sales largely because he had overloaded them with inventory that consumers, leery of the layoffs and plant closings that made headlines with depressing regularity, were unwilling to buy. In 1992, R. H. Macy & Co. was forced to declare bankruptcy. Finkelstein and his group of senior managers lost most of their investment. But the venerable department store did not just disappear. The Macy's name still adorns stores all over the country, thanks to the chain's new owner, Federated Department Stores, Inc., which completed its acquisition of Macy's in December 1994. Macy's had a new president, a new CEO, a new board of directors. And the old management left it with a tax windfall.

Thanks to the bad management of Finkelstein, Federated Department Stores ended up with some $950 million worth of tax write-offs. Every dollar of profit that Macy's earns can, for federal income tax purposes, be canceled out by the huge losses that forced the chain into bankruptcy in 1992, thanks to the Internal Revenue Code and what it calls a net operating loss. Those net operating losses can be carried forward by Federated until 2009.

It wasn't always that way. For most of its history, the net operating loss could be carried forward for just one or two years. The provision was originally passed as a temporary tax measure in 1918 to help companies adjust to a peacetime economy after World War I. It was eliminated for five years in the 1930s, brought back in 1939, lengthened and shortened to two years, one year, three years in the 1940s and 1950s. In 1976, the Ford administration and a Democrat-controlled Congress extended to seven years the length of time companies could claim net operating losses. In 1981, the Reagan administration requested that the carryover period be extended to ten years; a Democratic House and Republican Senate decided that fifteen would be better.

The result has been a billion-dollar windfall for corporations. In 1995, the most recent year for which complete statistics are available, net operating losses shrank the corporate tax base by some $57 billion. Total revenues from corporate income taxes that year were $198 billion; the write-off was $19.9 billion, or a 10 percent tax cut.

Some of the most profitable companies in America have been able to claim net operating losses, reducing their taxable income. The Dow Jones Industrial Average, which trebled in the 1990s, is an index of the value of thirty top industrial firms. According to their 1999 Form 10K filed with the Securities and Exchange Commission, ten of those companies carried some $3.6 billion in net operating losses. AT&T had federal net operating losses worth $267 million. Coca-Cola had $49 million worth of the write-offs. Exxon had $962 million worth; the company it merged with, Mobil, had $722 million.

Of Course, some have complained about the fifteen-year carryover period. In a June 5, 1997, letter to then Treasury secretary Robert Rubin, Curds H. Barnette, the chairman and chief executive officer of Bethlehem Steel Corporation, wrote, "Annual net operating losses. . . generated by corporations may be carried forward as a deduction against future income for a period of 15 years. But for many companies, particularly those in mature industries that have experienced major restructuring such as steel, the fifteen year loss carry forward period is insufficient." Insufficient, according to Barnette, because companies like Bethlehem Steel, which emerged from the 1980s considerably smaller, and thus able to make a correspondingly smaller amount of profit, weren't able to realize the full benefits of their net operating losses. Bethlehem Steel had some $1.8 billion worth of such losses on its books at the end of 1997.

"Your leadership in helping to obtain a five year extension of the [net operating loss] carry forward period for existing and newly incurred losses will be deeply appreciated," Barnette closed his letter. That year, Congress passed the Taxpayer Relief Act; among its provisions, the bill extended the time a company could claim a net operating loss from fifteen years to twenty. A grateful Bethlehem Steel noted in its 1998 Form 10K, filed with the Securities and Exchange Commission, "The tax law currently provides for a 20-year carryforward of that loss against future taxable income. We, therefore, have sufficient time to realize these future tax benefits."

Most corporations don't have to wait twenty years for their loopholes to kick in. Some of them are set up so that every step in their production process is designed to minimize the tax burden they face. Like Apple Computer Inc., the plucky underdog that for a time outstripped its big rival, IBM, in the race to develop a user-friendly home computer.

In 1984, upstart Apple crashed into the public consciousness with a thirty-second ad that aired just once—during Super Bowl XVIII. A colorfully clad woman raced through a crowd of gray-hued, zombielike spectators and flung a sledgehammer at a monitor beaming an Orwellian, Big Brother-like visage to the assembled audience. The powerful commercial cemented Apple's image as a different kind of high-tech company that produced a different kind of product—the user-friendly Macintosh.

While Apple's technical innovations may have set it apart from other companies in the personal computer industry, its corporate structure was nearly as complex and sophisticated as that of its mammoth rival IBM. Among Apple's subsidiaries were Apple Computer Limited, an Ireland-based manufacturing company; Apple Computer Inc., Limited, an Irish holding company that owned the Irish manufacturing company; Apple Netherlands B.V., an investment company; Apple Computer Foreign Sales Corporation, a Virgin Islands corporation set up to sell to overseas markets; Apple Computer Cayman Finance Ltd., a Cayman Islands investment company; and Apple Computer International Ltd., which Apple once described as "a Cayman Islands corporation incorporated on March 24, 1981, whose function is to conduct manufacturing operations in Singapore." For the record, the Cayman Islands are a mere 10,969 miles from Singapore. Cupertino, California, where the company was headquartered, is 2,486 miles closer.

Apple's complicated structure of subsidiaries is hardly unusual. A multinational firm might have manufacturing, finance, marketing, and insurance subsidiaries scattered in dozens of countries around the world. A car company might make engine parts in a Chinese factory financed through a Dutch subsidiary. Those engine parts are transferred to a Mexican plant for assembly. Meanwhile, the car's body parts—the fenders, doors, hood, and so on—are made in Canada, but the chassis and drive train in the United States. Which government gets to tax the profits from the sale of the car—say, in Wichita, Kansas—is determined largely by how much the corporation says it pays each of its subsidiaries for the parts it buys from them.

Apple manufactured computers in Singapore. Say the cost to produce the completed Macintosh was $200. The Singapore company transfers the machine to the Cayman Islands corporation, which sells it to the American company for $900. Apple in turn sells it to its dealers for $1,000. Total U.S. profit: $100. Total profit in the Cayman Islands: $700. Because the Cayman Islands has a corporate income tax rate that is just a fraction of that in the United States, the company would save hundreds of dollars in taxes on each computer sold here.

Which is precisely what the IRS accused Apple of doing in 1992.

The practice is known as transfer pricing, and it costs the federal government billions of dollars each year. Ernst & Young, the Big Five accounting firm that provides a wide range of international corporate clients with bookkeeping and tax advice, conducts an annual survey of the tax departments of some of the largest multinationals. In 1999, it found that "Tax and finance executives believe the up-front involvement of transfer pricing in strategic decisions could help maximize operating performance and reduce the global tax burden."

Ernst & Young cited an estimate made by the Organization for Economic Cooperation and Development, an international organization that provides economic data and recommendations to its twenty-nine member nations, that some 60 percent of global trade consists of transfers made within multinationals. Companies have wide latitude to set the prices they charge themselves to take advantage of differences in various tax systems. Singapore offers foreign corporations low tax rates; the Cayman Islands charges companies a nominal fee for operating there—income derived from foreign sources isn't taxed at all. By inflating the costs of manufacturing anything from shoes to circuit boards offshore, a U.S. corporation can save hundreds of millions in taxes.

For its part, Apple vigorously denied that its decision to manufacture in Singapore, or manage that manufacturing operation from the Cayman Islands, was made to avoid U.S. taxes. That Apple wanted to manufacture in Singapore isn't surprising. The tiny country on the tip of the Malaysian peninsula had the advantage of cheap, skilled labor and generous financing provisions for companies setting up shop there. Apple's Singapore manufacturing unit handled virtually every aspect of production, according to the company, from finding materials to the final assembly of the computer; from designing the manufacturing process to designing the boxes that the Macintoshes were shipped in.

And when it paid its Singapore subsidiary for that work, Apple included various costs that might seem surprising. The company multiplied the number of man-hours needed for production by a U.S. wage rate, rather than the much lower Singapore wage rate. The company included a U.S. overhead cost per unit, rather than the lower Singapore overhead cost. "Under the transfer pricing method used by [Apple] and Apple Singapore," the IRS charged, "all additional profit earned because of lower labor and overhead costs . . . inured to Apple Singapore." Singapore profits are immune to U.S. taxation.

In 1990, the IRS charged that Apple used its offshore subsidiaries to avoid some $311 million in taxes for 1984, 1985, and 1986. In 1992, the IRS claimed the company had avoided another $275 million in taxes in 1987 and 1988. Apple disagreed with the IRS's conclusions, and in 1993 opted to settle the transfer pricing issue in secret, binding arbitration. The ultimate resolution of Apple's battle with the IRS was never made public; some matters from the two cases are still pending in Tax Court.

At least Apple actually manufactured something in Singapore. Halliburton Company, an oil field services company, maintained a subsidiary in the Cayman Islands, Halliburton Global Limited. The Cayman Islands has no oil industry; the IRS contended that Halliburton used the subsidiary to avoid $38 million in taxes in 1990 and 1991. The company disagreed; it argued that its Caribbean subsidiary was "a corporation duly constituted and in good standing under the laws of the Cayman Islands. Global possessed economic substance. It was established to serve as the entity performing the function of centralized purchasing and distribution of chemicals." That case is still pending.

The triumphs of the pioneers of the automobile industry—like Henry Ford's assembly line and the first workingman's car, the Model T— have attained an almost mythical quality in American history. Part marketing chutzpah, part technological innovation, the stories are as old as the country's love affair with the car.

Chrysler has been one of the blue chip names in that storied history. Walter P. Chrysler unveiled the first car to bear his name, the Chrysler Six, at the Commodore Hotel in New York City in 1924. The story goes that Chrysler wanted his innovative car—powered by a high-compression, six-cylinder engine and the first to use hydraulic brakes on all four wheels—to debut at the New York Automobile Show. Organizers of the exhibition barred the car because it wasn't yet in production. So Chrysler rented space in the lobby of the hotel where wealthy investors attending the exhibition were staying. The gamble paid off. A banker with Chase Securities liked the looks of the first Chrysler and arranged to underwrite $5 million for Chrysler's company, then known as Maxwell Motor Company, to mass-produce the car.

The company introduced the first aerodynamic car, the Airflow, in 1934 (Orville Wright, the aviation pioneer, helped design it), the first car with power steering in 1951, and one of the first muscle cars, the 300-C, in 1955. During World War II, the company ceased production of automobiles and made everything from Pershing tanks and engines for the B-29 bomber to 40 mm antiaircraft guns. In all, the company handled sixty-six military projects, valued at some $3.4 billion, between 1940 and 1945.

Chrysler remained a defense contractor for years after the war, but its close relationship with the government didn't end there. Struggling against Japanese imports, its own bad management practices, and new fuel economy standards mandated by the federal government, Chrysler was tottering on the verge of bankruptcy in 1979. It lost $1.1 billion that year, and $1.7 billion the next—at the time a record for corporate ineptitude. The company was bailed out by Congress and the Carter administration, which put together the Chrysler Corporation Loan Guarantee Act of 1979, a $1.5 billion package of aid that kept the struggling car maker afloat.

Lee Iacocca, the brash, straight-talking CEO, took the government aid package and turned the company around. Chrysler put out the world's first minivan in 1980; the company bought out AMC Corporation, maker of the Jeep line of vehicles; and added the grandfather of the sports utility vehicle to its product line. By 1984, the company that had lost billions in the late seventies and first few years of the eighties turned a profit of $2.4 billion. Iacocca gained fame for his company's resurrection and his attacks on what he considered unfair competition by the foreign carmakers, particularly the Japanese. He starred in more than sixty commercials for Chrysler, many of which hammered home a "Made in America" theme, arguing that the domestically manufactured K-cars and LeBarons were superior to their Japanese rivals.

In 1998, six years after Iacocca left the helm of the company, Chrysler merged with Daimler-Benz A.G., the German manufacturer of Mercedes-Benz cars and trucks. The inherent patriotism of the "Made in America" advertising campaign became as obsolete as the Chrysler Six, at least as far as the company's willingness to continue playing by America's rules.

"The U.S. tax system puts global companies at a decisive disadvantage," John Loffredo, the vice president and chief tax counsel for Chrysler and its successor, DaimlerChrysler, told a hearing of the House Ways and Means Committee on June 30,1999, just twenty years after his predecessors had gone, hat in hand, to beg Congress for a bailout. "This issue became a major concern and when the time came to choose whether the new company should be a U.S. company or a foreign company, management chose a company organized under the laws of Germany."

So Chrysler, one of the Big Three American carmakers, opted out of the U.S. tax system and ceased to be an American business.

For the record, Chrysler's effective federal tax rate under that disadvantageous U.S. tax system through the 1990s was a mere 18 percent— slightly more than half of the statutory rate of 35 percent. The huge net operating losses that Chrysler incurred helped the company avoid paying taxes altogether some years, and steeply reduced its tax bill other years. Adding insult to injury, Chrysler filed a petition in U.S. Tax Court in 1997 claiming it was owed a refund of $49.8 million from 1983 to 1985. The bulk of write-offs the car manufacturer claimed were related to costs associated with the government bailout of 1979. In effect, Chrysler *was* asking other taxpayers to subsidize the bailout a second time. That case is still pending.

By choosing to become a German corporation, Chrysler will no longer owe U.S. taxes on its overseas profits. From 1990 until it merged with Daimler-Benz A.G., Chrysler had taxable overseas income of $3.5 billion. After adjusting for foreign taxes paid, Chrysler still would have owed $590 million on those profits to the U.S. Treasury, assuming that the company paid at the statutory rate set by Congress. Thanks to its choice to be a German company, all the company's future foreign profits—earned by selling Jeeps and Chrysler minivans overseas—will escape U.S. taxation.

According to Loffredo, the companies considered choosing the United States as their home, but rejected the notion of forming "Chrysler-Daimler." "Daimler being a subsidiary of Chrysler would have opened up for review all of Daimler's operations worldwide to the IRS," he told the Center. "That's something no one should volunteer."

Chrysler will still owe some U.S. taxes. The carmaker will join the nearly 60,000 other corporations with 50 percent or more foreign ownership doing business in the greatest consumer market on earth. In 1995, the last year for which statistics were available, there were some 60,157 returns filed by such corporations. Of those, 19,962—or slightly more than 33 percent—owed some federal income tax.

"I want to make it clear that the former Daimler-Benz has been a good corporate citizen in the U.S. and has paid all taxes believed legally due on its U.S. operations," Loffredo testified before Congress. "The same is true for the former Chrysler Corporation. In addition, Daimler and Chrysler will continue to be subject to the U.S. tax laws on their U.S. operations and will continue to pay their fair share of U.S. taxes." The key word in his statement is "believed."

In 1994, Daimler-Benz filed a petition in U.S. Tax Court claiming that the fines it paid to the National Highway Traffic Safety Administration for selling cars that failed to meet minimum standards for fuel efficiency should be deductible as "ordinary and necessary business expenses." Throughout much of the 1980s, most of the Mercedes-Benz luxury sedans that the company sold guzzled more gas than federal regulations permitted. Rather than meet the fuel economy standards, which have both reduced air pollution and helped to reduce demand for gasoline—thus helping to make it cheaper—Daimler-Benz chose to pay a fine to the government. That is an option the company had under the Energy Policy and Conservation Act of 1975, which required manufacturers to meet certain mile-per-gallon averages. But nowhere does the act say that a company that chooses not to meet the standards should be able to pass along the costs of that failure to other taxpayers—something that Daimler-Benz argued in its court petition. Think of it this way: Daimler-Benz was arguing that ordinary taxpayers should foot part of the bill for those wealthy enough to afford a Mercedes-Benz.

In 1988 and 1989, Daimler-Benz's U.S. subsidiary, Mercedes-Benz of North America Inc., made payments to the National Highway Traffic Safety Administration totaling $65 million; the company deducted those payments on its federal income tax returns. "The amounts MBNA paid to NHTSA in 1988 and 1989 are ordinary expenses incurred by MBNA in carrying on its trade or business," the company argued. "The amounts MBNA paid to NHTSA in 1988 and 1989 are necessary expenses incurred by MBNA in carrying on its trade or business. . . . The amounts MBNA paid to NHTSA in 1988 and 1989 are deductible under section 162 as ordinary and necessary business expenses." The company lost its case in Tax Court, and was unable to deduct the fines paid to NHTSA from its taxes. Even without the questionable deductions, the company, taking advantage of legitimate deductions allowed by the Internal Revenue Code, found other ways to reduce its taxable income from year to year, as the documents in the case revealed.

Mercedes-Benz of North America "engaged exclusively in the importation and distribution of Mercedes-Benz passenger automobiles and parts in the United States," according to the company's petition in Tax Court. Those cars, of course, are beyond the means of the average American; in the 1980s, the price for one of those finely engineered German automobiles ranged between $30,000 and $70,000. In 1984, Mercedes-Benz of North America sold more than 79,200 cars in the United States. That year, Mercedes paid $156 million in U.S. taxes. The next year, 1985, Mercedes sold more cars in the United States— just over 86,900 of them. It paid about a third less in taxes—just $99 million. The following year, 1986, Mercedes had its best year in the 1980s, with more than 99,300 new-car sales in the United States. The company's taxes totaled a mere $5.4 million.

Even with all these advantages over the average individual taxpayer, corporations are not satisfied. Top executives view taxes as one more line item on the balance sheet that cuts into profits. In an age when corporations routinely ship jobs offshore and lay off long-term employees without a second thought, it's not surprising that they've come to view their tax burdens as just another line item, another cost, to be reduced as much as possible. And a growing industry in developing and selling corporate tax shelters has emerged to accommodate them.

Joseph Bankman, a professor of law and business at Stanford Law School, noted the difficulty of determining how large the market for shelters is. "Companies and counsel shown the shelters are often required to sign confidentiality agreements; these agreements, together with concerns about attorney-client privilege, prevent many lawyers from discussing tax shelters in print or public," he wrote in a June 21, 1999, article in the respected publication *Tax Notes.* "It is virtually certain though, that annual investments in corporate tax shelters aggregate to tens of billions of dollars, and that the tax shelter market is growing at a breakneck speed."

In 1998, *Forbes* magazine reported that Deloitte & louche, one of the Big Five accounting firms, sent out confidential letters to corporations that began, "As we discussed, set forth below are the details of our proposal to recommend and implement our tax strategy to eliminate the Federal and state income taxes associated with [your] income for up to five years." For the service, Deloitte & louche charged a fee of 30 percent of the tax savings.

On May 4, 1999, PricewaterhouseCoopers L.L.P. sent out a confidential letter, some 22,000 words in length, to invite corporations to take part in its Bond and Option Sales Strategy, or BOSS shelter, which, like the shelter Merrill Lynch sold, involved investment vehicles with foreign partners created solely to provide a paper tax loss. *Tax Notes* obtained a copy and published it. On December 9, 1999, the Treasury Department issued notice 99—59, warning companies that if they made use of BOSS, the IRS would challenge any losses they claimed. Representative Lloyd Doggett, Democrat of Texas and a member of the House Ways and Means Committee, who drew attention to the shelter in a hearing a month before Treasury acted, issued a statement welcoming the notice. "While encouraged that Treasury has quickly shut down an obviously abusive tax shelter," he said, "I am reminded that one Big Five accounting firm requires staff to cook up a new shelter every week."

And for the IRS, discovering, unraveling, and denying them can take years. Tax shelters are designed to follow the form of the tax law—every "t" is crossed, every "i" is dotted. Agreements are signed, transactions take place, money changes hands, and tax benefits are produced. The shelters Merrill Lynch designed and marketed to corporate clients in 1989 mimicked countless transactions that corporations engage in every day for legitimate purposes. Ten years later, some companies that bought Merrill shelters—the entertainment conglomerate Paramount Communications, Incorporated, among them—are still battling the IRS in U.S. Tax Court.

Taken together, the eleven foreign partnerships that the IRS discovered give an inside view into the thinking of corporate tax departments, shelter promoters, and offshore trust companies. Paying their fair share of taxes is not high on their priorities. Not surprisingly, key participants in the Merrill Lynch shelters were not willing to discuss, on the record, their roles in the schemes. What follows, then, is pieced together from Tax Court documents, transcripts, and other public records.

In October 1988, Colgate sold off a subsidiary, Kendall Incorporated, a manufacturer of medical supplies, for $952 million. Instead of rejoicing over the windfall, which included a profit of $105 million, Steven Belasco, the company's vice president for taxation, began to worry. "Once we realized the magnitude of the gain on the sale," he said, "we began to look at alternative kinds of structures or other kinds of transactions we might do to either reduce the gain or defer it." Reducing or deferring the profit would have lowered the taxes due on the profit. Unfortunately for Belasco, others at Colgate didn't share his view. "In my meetings with the investment bankers and our senior management, they indicated to me they were more interested in maximizing the cash for the transaction and getting it done quickly rather than doing some other kinds of things that might reduce the tax."

Given that publicly held corporations are supposed to make as much profit as possible, that's not surprising. Hans Pohlschroeder, the company's assistant treasurer, said that he sees Colgate as a "growth company." "We want to be growing at 15 percent earnings per share after tax," he said. Fortunately for Belasco and Pohlschroeder, another company driven to succeed, one that takes pride in its ability to deliver on its promises to clients, was trying to solve just the sort of dilemma that companies like Colgate encountered. Merrill Lynch devised a tax shelter that wouldn't interfere with getting the Kendall transaction done quickly or limit the cash that Colgate wanted. The shelter would produce losses to offset those profits, but only on paper. And best of all, because of the way the partnership was structured, shareholders would never discover it on the corporation's financial statements.

"I'm not an expert in accounting," Pohlschroeder said, "but I know that much, that when you have less than 50 percent ownership and do not control an entity, that it is deconsolidated and is off balance sheet. ..."

In late 1987 or early 1988, Macauley Taylor, who oversaw the Structured Derivative Financing Group at Merrill Lynch, began arranging installment sales of foreign currency for cash or LIBOR notes for Merrill's corporate clients. (LIBOR stands for London Interbank Offering Rate; the notes are a financial instrument traded internationally to offset the effects of interest rate changes.) Multinational companies that do business in dozens of countries will, naturally enough, earn money in dozens of different currencies—German marks, British pounds, or Japanese yen. They also borrow in all these currencies, all of which have their own interest rates. Since the values of these currencies and the interest rates charged by the central banks that manage them all fluctuate, multinationals hedge their bets by exchanging some of that foreign currency for international bonds. One of the things that Taylor noticed while arranging such hedges is that the transactions also provided a tax benefit for the corporation using them.

In 1988, Taylor hired James R. Fields, who had worked for the IRS from 1984 to 1986 as an attorney adviser and later as a principal technical assistant to then chief counsel Fred T. Goldberg Jr. Taylor wanted Fields to work with his Structured Derivative Financing Group because of his tax expertise; the two of them were the architects of the tax shelter that Merrill Lynch would earn millions selling. Taylor had the initial idea; Fields fleshed out the concept, and together they came up with a scheme in which a corporation would form a partnership with a foreign entity in an offshore location. The foreign entity—called "the tax neutral" partner since it would owe no U.S. income taxes on any profits it made—would drop out of the partnership after a certain amount of time, appearing to receive the lion's share of the income that the partnership produced. The corporation, conversely, would appear to be left holding the bag—with only the costs, or the losses, of the partnership on its books.

Taylor and Fields drew up a schematic with various boxes representing the partners; they played around with the figures to fine-tune the deal. In 1989, they were ready to go, and began looking for companies that had large capital gains they might want to offset. Fields proved to have more talents than devising tax shelters; he was also adept at selling the scheme.

"I would say this is about an investment partnership where you combine with a sophisticated partner," Fields testified in Tax Court on February 14, 1996, recalling the sales pitch he made to potential clients. "The nature of the buying and selling transactions that that partnership can do as part of its investment activities can produce a significant tax advantage." Fields went on to describe the specific IRS regulations that the partnership would take advantage of to produce the huge loss—the contingent installment sale regulations. But, like any good salesman, he quickly got back to the bottom line. "After doing that, I'd say, now, why would that be an advantage to you?" The advantage, of course, was the millions in taxes that a company could save. When asked whether this were the case—if the investment partnership would "accomplish certain tax objectives"—Fields answered unequivocally. "Absolutely," he said.

In 1988 and 1989, Taylor and Fields and others from Merrill Lynch sold the shelter to one company after another. E, S. P. Das, the firm's managing director of investment banking, who had relationships with many of the companies, approached them initially. He broached the subject of the shelter with top managers at Dun & Bradstreet Corporation, the 160-year-old provider of global business and financial information services, and with Schering-Plough, AlliedSignal, Brunswick Corporation, American Home Products Corporation, and Borden, Incorporated. Robert Luciano, Schering-Plough's chairman and chief executive officer, made his company an early participant. He served as a director on Merrill's board; his son Richard worked for Merrill Lynch in Das's investment banking department. The elder Luciano, an attorney who had specialized in taxes, also served on AlliedSignal's board of directors. He was so enthusiastic about the shelter, he recommended it to that company as well.

Judith P. Zelisko, an attorney and the assistant vice president, director of taxes, for Brunswick Corporation, attended a Merrill Lynch sales pitch on December 8, 1989. At the time, Brunswick was in the process of selling its 36 percent stake in Nireco Corporation, a Japanese company that makes precision instruments. "Set forth below is a bullet point summary of a transaction proposed by Merrill Lynch to Brunswick Corporation," she wrote in a January 26, 1990, memo to her superiors, the controller and the vice president of finance, "to generate sufficient capital losses to offset the capital gain which will be generated on the sale of the Nireco shares. The specific dollar amounts can be adjusted to increase or decrease the capital loss required."

Some had reservations about the scheme. Belasco, Colgate's vice president for taxation, who thought that while "technically it seemed to work and had some merit," was nonetheless dubious about the shelter's having any reasonable business purpose. "In looking at this kind of transaction in its just-tax outline," he said, "it's naked. It doesn't do anything in terms of accomplishing something that the company would have wanted to do."

Wanted to do beyond avoiding taxes, that is. On July 18, 1989, after Colgate had made it clear that it wasn't interested in pursuing the Merrill Lynch shelter, Taylor called Hans Pohlschroeder, the company's assistant treasurer, to try to persuade him to change his mind. Court records do not indicate which of the two men came up with the fig leaf that covered the shelter's nakedness, but Pohlschroeder 's handwritten notes of the conversation indicate what it was: "invest in your own debt." In addition to buying LIBOR bonds, Colgate's foreign partnership would also retire some of the company's debt, thus giving it the appearance of having a business purpose beyond the tax savings.

Not all companies that bought in shared Colgate's desire to dress up the shelter. Edward L. Hennessy, AlliedSignal's chairman and chief executive officer until his retirement in 1991, testified that throughout the discussions of his company's decision to invest in Merrill's tax shelter, the idea of possibly making a profit on the deal never came up. "Well, the primary focus was [that] ... it would help our tax situation considerably," he said. Indeed. To the tune of $151 million.

In all, the profits that Merrill offered to shelter from tax are staggering. In 1990, American Home Products sold off its household and depilatory divisions for a pre-tax profit of $1 billion. The same year, Schering sold its Maybelline cosmetics business and a pair of European cosmetic companies for a pre-tax profit of $220 million. In 1988, Dun & Bradstreet sold its Official Airline Guides subsidiary for a pretax profit of $752 million. Two years later, it sold three other subsidiaries for a pre-tax gain of approximately $84 million. In May 1988, Brunswick sold its filtration technology business for a $42 million pretax gain. Two years later, it sold two more divisions for an $84 million pre-tax gain. In October 1989, Paramount sold Associates First Capital Corporation, its consumer and commercial finance business, for a gain of approximately $1.2 billion. Those pre-tax profits amount to $3.4 billion; taxes on them would have totaled as much as $1.1 billion. The shelter that Taylor and Fields had devised would keep all that money away from the federal treasury and in corporate treasuries instead.

Zelisko, Brunswick 's director of taxes, noted the price for turning the trick: "Merrill Lynch's fee is 5-10 percent of the tax savings. Assuming a capital loss of $82 million, the tax savings would be around $28 million and a 10 percent fee on such savings results in a fee of $2.8 million. This 10 percent fee is negotiable." Five percent of $1.1 billion is the tidy sum of $55 million. And, as the Treasury Department made clear in its report on corporate tax shelters, all of that money comes out of the pockets of other taxpayers, like you, who have to pay more because corporations pay less.

As Das fed willing clients to Taylor, Fields set about arranging the legal cover for the shelter. Under the Internal Revenue Code, specifically Section 6662(a), a taxpayer who substantially understates his income tax liability—or its liability, in the case of a corporation—must pay a penalty of 20 percent of the tax due. But Section 6664 (c) allows for an exception. It waives the penalties if a taxpayer acted on a good-faith opinion that there was a better than fifty-fifty chance that, if challenged by the IRS, a court would rule in the taxpayer's favor. Joseph Bankman, in assessing the market for corporate tax shelters, wrote that, "In theory, such opinions ought not to serve as protection from the substantial understatement penalty. In practice, any run-of-the-mill opinion letter is thought to insulate the taxpayer from the substantial understatement penalty; there do not appear to be any recent cases in which a taxpayer's reliance on an opinion letter has been held to be unreasonable."

For the Colgate shelter, Fields turned to Mark A. Kuller, at the time a partner in the Washington office of King & Spalding. The two had served together at the Internal Revenue Service in the chief counsel's office. Kuller ended up writing four separate opinion letters, concluding in each, after detailed recitations of prior precedents and congressional intent in writing tax law, that while the shelter might be successfully challenged by the IRS, in his opinion it would probably survive such scrutiny.

With the favorable legal opinion in hand, all that remained to do was to find the foreign partner. In the summer of 1989, Taylor contacted Johannes Willem den Baas, a financial engineer with Algemene Bank Nederland N.V., a Dutch bank that at the time had $85 billion in assets, with roughly 29,000 employees in some 950 offices in 43 countries. Taylor had worked with den Baas before, structuring very complicated derivative transactions with the Dutch banker. He figured that ABN and den Baas would be the perfect offshore partner. "ABN has a big balance sheet and he's a pretty smart guy and he can understand the stuff," Taylor said. He told den Baas what he needed in a foreign partner: someone with a lot of money to invest who was offshore, immune from U.S. taxes.

The Dutch banker, eager to develop relationships with some of America's wealthiest corporations, agreed to participate. So he referred Taylor to Peter de Beer, a trust officer and the head of the legal department of one of the bank's many subsidiaries, ABN Trust Co., Curacao N.V., located in the Netherlands Antilles, an established tax haven. De Beer's four-lawyer staff helped corporate clients set up and manage Netherlands Antilles companies to participate in offshore transactions. He certainly grasped the concept that Taylor and Fields told him about. "My understanding was that the partnership would enter into transactions that would create a capital gain and in a later stage a capital loss, and that, depending on the percentage of your participation, you would either take part in the gain or the loss," he said. "So by having us being the majority partner at the start, we would take the majority of the gain, while in a later stage .one of the other partners would take the loss."

While de Beer understood the mechanics of the shelter, den Baas later claimed he didn't. "We knew that there was a tax angle to these transactions since, during the partnership meetings—or the formation meeting, I should say—a disproportionate number of tax lawyers were present," he said, "and the fact that at the request of Merrill Lynch, but also, Peter de Beer, these meetings were held offshore and, in particular, a foreign partner was requested."

ABN became the foreign partner of choice for Merrill Lynch; in late 1989, a plethora of offshore partnerships sprung up between subsidiaries of ABN and the corporations who'd bought into Merrill Lynch's shelter. There was ACM Partnership, formed with Colgate, Nieuw Willemstad Partnership with Dun & Bradstreet, Kralendijk Partnership with Schering-Plough, Saba Partnership with Brunswick, Maarten Investerings Partnership with Paramount, and ASA Invester-ings Partnership with AlliedSignal, to name a few. All were formed from late September 1989 to late June 1990.

Taylor was a busy man. He attended many of the offshore partnership meetings to update his clients on the progress of the transactions Merrill made on their behalf. For Colgate, he made six trips to the Netherlands Antilles and Bermuda in a ten-month period between October 1989 and August 1990. The first meeting for Colgate's shelter, the ACM Partnership, was held on October 27, 1989, at the Southampton Princess Beach Hotel, a 600-room hotel that stands atop the highest point in Bermuda. In addition to spectacular views of the Great Sound and the South Shore, the Princess offers guests an eigh-teen-hole golf course, eleven tennis courts, two pools, water sports, and a beautiful club on a private pink sand beach. Three weeks later, on November 17, ACM held its second meeting, at the Marriott Castle Harbour Resort in Bermuda, which at the time featured 400 richly furnished rooms. The hotel also boasted three pools, Jacuzzis, a sauna, an eighteen-hole championship golf course, six tennis courts, water sports, cycle rentals, exercise room, three restaurants (including the only Japanese restaurant on the island), and a disco. The third meeting took place on December 12, 1989, in Curacao, the Netherlands Antilles, in the offices of the partnership (which happened to be the offices of ABN Trust Curacao); so did the fourth, on February 28, 1990. Six days earlier, Taylor had been in Bermuda for the first meeting of the Saba Partnership, a tax shelter for the Brunswick Corporation.

Beyond the beaches, tennis courts, and golf courses, there was a more important reason that the partnership meetings for the various shelters Merrill arranged were held offshore. "We wanted to keep the transaction out of the United States as much as possible," de Beer, ABN's man in Curacao, explained. "It was our preference also not to discuss or do anything with regard to this deal in the United States." De Beer spoke from experience. "Well, working in Curagao for a number of years, we did a lot of transactions with United States corporations, and we know how sensitive that can be, and that's to avoid any risk in that respect. Better safe than sorry." The risk was taxation. "Tax risk, yeah. To avoid any risk there, to have all meetings and filings and all the documentation outside the United States."

Of course, Taylor's life wasn't all just travel for meetings in exotic Caribbean locales to avoid tax risks. He oversaw a series of mind-numbingly complex transactions involving the foreign partnerships. Taylor and the members of his Structured Derivative Financing Group at Merrill Lynch purchased—and then sold—the financial instruments for the offshore partnerships. He was the point man who interacted with Merrill's brokers to arrange all the sales, which took place in the span of a year. The amounts of money invested were staggering— Kralendijk, the Schering-Plough shelter, purchased $1 billion of private placement notes on January 18, 19, and 25, 1990, all of which it sold, on March 12 and 16, 1990. On February 28, 1990, Saba Partnership, Brunswick's shelter, purchased $200 million of bonds from Chase Manhattan that it sold three weeks later. ASA Investerings Partnership, AlliedSignal's shelter, purchased $850 million in floating-rate private placement certificates of deposit on April 25, 1990; on May 17 and 24, 1990, it dumped the CDs. When Merrill was unable to find a buyer for the private placements for the Nieuw Willemstad partnership, Dun & Bradstreet's shelter, the brokerage firm issued the LIBOR note itself and paid $42.5 million in cash. Taylor was involved in each transaction.

In the end, the offshore partnerships, the carefully crafted sales of LIBOR notes, the private placements and hedged transactions, all worked perfectly. Neither market fluctuations in interest rates nor falling or rising values of foreign currencies had any effect on the performance of the partnerships. ABN earned profits, and, on paper, the American corporations all ended up with losses. It was too good to be true. So good, in fact, that the IRS began to challenge every Merrill Lynch shelter it discovered.

On March 12, 1993, the IRS denied the losses that Colgate, Merrill's corporate client in the deal, had claimed to offset its capital gain. On April 13, 1995, the IRS denied the losses Borden claimed. On September 27, 1996, the IRS denied the losses AlliedSignal claimed. One by one, as the Service discovered on audit that corporations had made use of Merrill's shelter, it denied the tax losses.

But the companies themselves weren't ready to surrender their paper losses without a fight. Colgate's case, *ACM Partnership, Southampton-Hamilton Company, Tax Matters Partner v. Commissioner of Internal Revenue,* was the first to go to trial, on February 12, 1996, nearly seven years after Merrill Lynch first approached Colgate with its shelter proposal. Fred T. Goldberg Jr., the former IRS commissioner who once worked with Fields at the Service in the chief counsel's office, was one of five lawyers from two law firms that represented ACM, and ultimately Colgate, in court. Thirty witnesses testified, and some 1,200 documents were entered into evidence, ranging from the original charts that Taylor and Fields had drawn up when planning the shelter to the minutes of the final meeting of the partnership.

In its final brief in the case, ACM's lawyers argued that "The ACM transactions had practical economic effects apart from the creation of tax benefits. . . . Each transaction engaged in by ACM had a reasonable prospect for profit or loss. Each transaction had economic substance." They cited Colgate's desire to reduce its debt as the legitimate business purpose for the company's participation in ACM.

In the end, however, it was all for naught. On March 5, 1997, Tax Court Judge David Laro ruled that the ACM partnership had engaged in a sham transaction. "We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage," he wrote in his opinion. "In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance." Colgate would have to pay its taxes on its capital gains after all. (An appellate court allowed the company to deduct some of the costs of participating in the shelter.)

On August 20, 1998, Tax Court Judge Maurice B. Foley ruled that AlliedSignal and ABN were not partners at all, but a debtor and creditor, and that AlliedSignal was not entitled to any of the losses that its shelter, ASA Investerings, had generated. That ruling was upheld on appeal; U.S. Circuit Judge Stephen F. Williams wrote that "AlliedSignal's interest in any potential gain from the partnership's investments was in its view at all times dwarfed by its interest in the tax benefit."

On October 27, 1999, Tax Court Judge Arthur L. Nims III ruled against Brunswick and the Saba Partnership. "At the end of the day, Brunswick's involvement in the [contingent installment] transactions, with their attendant intricate investments in the [private placement notes], CDs, LIBOR notes, money market accounts, hedges, swaps, etc., all carefully masterminded by Merrill Lynch, did not meaningfully change Brunswick's economic position, and it therefore lacked the requisite economic substance necessary to validate Brunswick's targeted capital losses."

The shelters he sold collapsed, but Macauley Taylor didn't. He's still at Merrill Lynch, arranging complex derivative transactions for corporate clients, solving their various accounting, financial, and tax problems. James Fields left Merrill in 1992; he went to work for the Treasury Department as deputy tax legislative counsel in the Office of Tax Policy. (The Office of Tax Policy would later issue the study on corporate tax shelters in 1999.)

While working for the Office of Tax Policy, Fields wrote a number of letters on tax policy that were made public, on topics ranging from the marriage penalty to Section 936 of the Internal Revenue Code, which gives U.S. corporations a tax break if they locate factories in Puerto Rico. Fields also wrote about transition rules (often called "rifle shots," because they're aimed at giving preferential treatment to a single taxpayer), the taxation of international shipping, and the rules on foreign income earned by U.S. corporations. He left Treasury in September 1993, around the time that the IRS began investigating the various players in the Merrill Lynch shelter, and went on to be a vice president at Citibank. As the various Merrill Lynch partnerships wended their way through Tax Court and appellate courts, Congress and the Treasury Department grappled with the issue of corporate shelters. Bill Bradley, the former senator from New Jersey, made shutting them down the centerpiece of his tax reforms when he sought the Democratic nomination for president in 2000. Periodically, Treasury makes headlines announcing new initiatives to crack down on them. Congress has considered legislation that would force corporations to reveal on their tax returns any shelter they had participated in; considering the lengths to which corporations go to secure legal opinions that the tax avoidance strategies they engage in are not tax avoidance strategies at all, that seems to be an impractical approach to the problem.

Kenneth J. Kies, the former chief of staff of the Joint Committee on Taxation—Congress's in-house policy think tank on tax matters—has testified several times before the Senate Finance Committee and the House Ways and Means Committee arguing that there is no corporate tax shelter problem. Kies is now a managing partner in PricewaterhouseCoopers's Washington office, the same firm that promoted the BOSS shelter.

Kies's view carried some weight with Republican members of the House. Dick Armey, the House majority leader, reacted angrily to any suggestion that shelters deserve legislative attention. On February 15, 2000, at his weekly press briefing, he declared, "Since tax is a very large part of [a corporation's] costs, anything they can do to minimize that share of their costs would be a legitimate thing. . . . The fact of the matter is that we write the tax code, and any corporation ought to do what they can to minimize that cost [to] their shareholders."

Indeed. There's no doubt that corporations do so every day.

Chapter 5
Well-to-Do

George B. Kaiser was already a wealthy man when he did the deal that made him a billionaire. Tall and lean, now in his fifties, the Harvard-educated native of Tulsa made his first fortune in Oklahoma’s oil and gas business. It's an industry whose giddy booms, followed by brutal busts, have ruined any number of entrepreneurs. Kaiser, however, managed to prosper through both good times and bad.

And it's no wonder. The impatient Sooner, who can't seem to get his words out fast enough, gets straight down to business and sticks to it. If a meeting strays from the matter at hand, Kaiser will get up and leave. He lives at a pace his friends call "Kaiser Time"—a breakneck pace in which everything must go according to his schedule and needs. Pity the executive whose arrival doesn't coincide with the keeper of Kaiser Time.

The shrewd and thrifty oilman doesn't look like a multimillionaire. He's not showy or ostentatious, and he doesn't stand out in a crowd. He doesn't own mansions in offshore locales. He certainly doesn't flaunt his wealth. Though he could afford the sleekest of sports cars or a fleet of limousines, he prefers driving beat-up company cars. "I just want reliable transportation to get from point A to point B," he told the Center in an interview. Still, some who know him best could see him for what he is.

"He always looked like a winner," said Wayne Swearingen, a one-time oilman, now a semiretired consultant, who knows and admires Kaiser. "He doesn't participate even in some of the oil and gas advocacy organizations that his father was quite active in. I guess he considers it a waste of his time and money."

That may be because Kaiser has made a practice of not following the conventional wisdom of his colleagues and competitors in the energy business. When everyone is buying, he sells. When everyone is selling, he buys. And when he sees an opportunity to make a fortune, he pounces.

In 1990, Kaiser forwent the "black gold" that had so enriched him for an altogether different endeavor: he bought the Bank of Oklahoma, N.A., from the Federal Deposit Insurance Corporation, the government agency that guarantees the soundness of the nation's major savings institutions. At the time, Oklahoma was reeling from the worst financial crisis in its history. But Kaiser saw the potential for profit in the state's largest savings institution, which only a few years earlier had nearly collapsed in a sea of red ink. And that potential was realized soon thereafter: buying the bank landed him on *Forbes* magazine's list of the 400 wealthiest Americans, and ultimately pushed his net worth to well over $1 billion.

What's more, Kaiser pulled it all off at a time when he claimed he had no income, and paid almost nothing in federal income taxes. He didn't need offshore trusts, controlled foreign corporations, or a passport from Belize to make his tax-free billion. With his shrewdness, his eye for a deal, and his adept handling of the Internal Revenue Code, he was able to turn Oklahoma into his own personal tax haven.

Oklahoma's economy rises and falls with the price of oil. In the 1970s, while the rest of the nation suffered through an energy crisis that led to gas lines, high unemployment, recession, and the twin double-digit inflation and interest rates, the demand for oil caused a boom in the state. Wells that had been unprofitable to drill in the days of $10-a-barrel oil suddenly became gold mines when the OPEC cartel pushed the price upward of $40. A bumper sticker of the time captured the mood of Sooners: "If you don't have an oil well, get one."

Thanks to his father, Kaiser had several. Herman Kaiser fled Nazi Germany in 1938 and settled his family in Tulsa. After the war, he arranged sales of oil field pipe between German firms and American companies. In 1949, the elder Kaiser got into oil and gas production, drilling wells in western Kansas. He had relatives in the business who ran a firm called Francis Oil & Gas, Inc.; by the time George was ready to work for his father, the name had been changed to Kaiser-Francis Oil Company, and Herman Kaiser was the owner.

George was born in 1942, attended Tulsa public schools, and went on to earn a bachelor's degree and a master's in business administration at Harvard University. He briefly considered joining the U.S. foreign service, but instead returned to his hometown in 1966 to work for his father. In 1969, George took over management of the business.

At that time, Kaiser-Francis Oil was a company with all of ten employees, just another of the many small, independent oil and gas producers. But in the years that followed, Kaiser turned the firm into the largest privately held producer of natural gas in the state. Like many of his fellow Sooners, Kaiser rode the boom brought on by the 1970s energy crisis. He drilled for oil in western Kansas, he bought natural gas properties in Louisiana and Texas, and he greatly expanded his holdings in his home state. But in 1979, he decided to ride the boom in a different direction.

From 1979 to 1982, when everyone wanted a well of his own, Kaiser made millions by selling off many of his oil and gas properties at peak prices. "We have no pride of ownership," he told *Forbes* in a 1991 interview, explaining the sales. "You can't be emotional." The strategy fit in with Kaiser's business philosophy, which is to go against the conventional wisdom. "I love deals when people on the other side are using rules of thumb," he said in the interview. "That means they're not doing the analysis."

Kaiser's analysis pointed him to banking, so he bought 2.7 percent of BancOklahoma Corporation, the parent company of Tulsa-based Bank of Oklahoma. With his purchase of the stock came a seat on the bank's board of directors, a position he assumed in 1980.

Banks in Oklahoma had made a fortune loaning billions during the boom, on the premise that oil prices would keep climbing; some experts predicted $100-a-barrel crude in a matter of years. As a result, investing in drilling seemed like a sure thing, even as interest rates shot upward in the late 1970s and early 1980s. "The oil and gas industries were one of the few areas where people thought you could borrow at 21.5 percent interest rates and still make a profit," Charles Cheatham, the general counsel of the Oklahoma Bank Association, told the Center. "Money came pouring into the state from all over the country. That had an effect on the whole state. Apartments and office buildings had 99 percent occupancy rates. This was an incredible bubble."

But as OPEC's pricing regime began to collapse, the bubble burst. The price of oil did what had been unthinkable to those who were confidently predicting that crude oil would soar: it declined. The first big drop occurred in April 1981; the price spiraled downward until, by 1986, it had reached levels not seen since the early 1970s. Suddenly, all those Oklahoma wells were unprofitable again. The same banks that had loaned billions during the boom found themselves holding mountains of bad debt. And that debt, it turned out, was backed by devalued assets, as oil producers went bankrupt, apartment and office buildings stood empty, and the state's energy-dependent economy collapsed along with the price of crude.

The Bank of Oklahoma might have weathered the storm, since it had largely avoided the lending binge. But in 1984, the bank had gone on an acquisition spree, buying nine banks in the Tulsa area and a tenth, Fidelity Bank, N.A., in Oklahoma City. Fidelity's books were dripping red ink from the energy sector loans it had made in the boom days. "I think perhaps the company did not do an adequate job of determining how serious the problems at Fidelity were," Kaiser told the *Tulsa World* in an October 1990 interview.

Even though the management at the Bank of Oklahoma understood the depth of the problems at Fidelity, they nonetheless went ahead with the merger. As a board member, Kaiser favored the deal, and even defended it six years later. "It was very important for Bank of Oklahoma to have a franchise in Oklahoma City," he told the *Tulsa World.* "It was the only franchise realistically available without starting from scratch and I think the idea was fine."

That fine idea nearly ruined the bank. After posting a $51 million loss in the second quarter of 1986, the Bank of Oklahoma turned to the Federal Deposit Insurance Corporation for a bailout. Rather than close the bank, the FDIC kept it afloat through a program called Open Bank Assistance; only those banks deemed "essential" to their communities qualified. In exchange for 55 percent of the stock of the bank's holding company, the FDIC pumped $130 million into the institution. Stockholders like Kaiser lost most of their investment in Fidelity. But the FDIC left the board and management in place to administer the bailout. Other Oklahoma institutions weren't so lucky. No one considered them "essential" to the community. By 1994, more than a dozen years after the bust began, 162 of the state's banks and savings and loans had closed their doors—a financial debacle that cost taxpayers, who bailed out depositors, more than $4 billion. Oil and gas producers laid off workers or went bankrupt, as did the companies dependent on their business. For them, there was no taxpayer-financed bailout.

In March and April 1986, Demco, Incorporated, an Oklahoma City-based manufacturer of oil and gas drilling equipment, laid off 98 of its 400 workers. Halliburton Company cut 550 jobs in the first six months of that year at its Duncan, Oklahoma, factories; overall, the oil field services company's employment in Duncan declined from 4,000 in early 1982 to 2,200 in 1986. Philips Petroleum Company, a worldwide oil producer headquartered in Bartlesville, Oklahoma, slashed its workforce there by a sixth; 1,000 of the 6,000 employees who worked in the company's hometown were left without paychecks.

There were record numbers of bankruptcies as well: Seneca Oil Company; Waterford Energy, Incorporated; and MGF Oil Corporation, to name a few. Kaiser picked up all three from various bankruptcy courts and added them to Kaiser-Francis Oil's empire. Just as he had sold off oil properties at peak prices during the boom, Kaiser was acquiring them at bargain-basement prices during the bust.

Other companies disappeared entirely. Colin Schmidt worked for eighteen years as a systems analyst for the Tulsa-based Bovaird Supply Company, another oil field services supplier. The company, founded in 1871, weathered over a century of ups and downs in the oil industry. At its peak in 1982, Bovaird Supply employed 820 workers. Then the bust came. Schmidt still remembers the day in June 1983 when the first job cuts were announced. "They went from department to department, reading a list of names and laying people off," Schmidt recalled. "In my department, we thought, 'They can't lay us off. They need this new system so they can do their job better.' But they came in and laid off people in my department too."

By the end of 1994, Bovaird's payroll had dropped to 250. Oil production in Oklahoma had fallen off so much that the company tried to survive by selling its wares in Russia. "They had the same problem everyone else in Russia did," Schmidt said. "Getting paid."

In January 1996, after 124 years and five generations of Bovairds running the company, the family sold what little remained of the failing business to Continental Emsco Company, another oil field supplier. The new owners promptly closed the doors of Bovaird Supply's Tulsa headquarters, a move that put the last sixteen employees—including Colin Schmidt—out of work.

The job losses at Bovaird Supply were hardly unique. In 1998, State Representative Russ Roach, a Democrat from Tulsa, reported that 108,000 jobs disappeared in Oklahoma from 1982 to 1988. Those jobs were primarily in the high-paying oil and gas industries; they were replaced, for the most part, by low-paying service jobs. Oklahoma's per capita income in 1982 was slightly below the national average, but has since plummeted. In 1998, the finance office of Republican governor Frank Keating noted that "Oklahomans receive an average of 80 cents for every $1 received nationally. Regrettably, this is only half the story. These numbers conceal the fact that the average is even worse in the state's rural areas."

"There was terrible pain for a long time," recalled Charles Cheatham, of the Oklahoma Bank Association. "We had a deflationary economy. Our gross state product decreased, tax revenues decreased, and the value of real estate decreased. The average home decreased in value by 30 percent. There are still people after fifteen years of this with negative equity in their homes."

The Bank of Oklahoma, however, did fairly well. In 1987, thanks to the FDIC bailout, it was able to acquire two more banks, one in Yukon and the other in Norman, expanding its reach through the state. By 1989, the FDIC had the Bank of Oklahoma back on its feet: it recorded a modest profit that year of $3.8 million. The FDIC was ready to return the bank to private hands, and put it up for sale.

All but one of the bidders came from out of state: Kaiser, who held the inside track. Not only did the native son serve on the bank's board of directors but on the audit committee as well, and therefore was intimately familiar with the bank's loans—both good and bad. Kaiser's bid wasn't the highest, but unlike his competitors, he didn't ask the FDIC to bail out any of the bad loans still on the bank's books. In the end, Kaiser's inside track proved fruitful: he paid just under $61 million for a bank that the FDIC had bought four years earlier for $130 million. What's more, the Bank of Oklahoma was losing millions when the FDIC stepped in, but was now turning a profit.

"I never wanted to be a banker," Kaiser told the Center. "Oklahoma is a state that can't be banked by Chase Manhattan. We need relationship banking or community banking. I was concerned that that style of banking would disappear with all the bank consolidation. And really it has, except for us."

Following his successful bid, Kaiser immediately pledged to aggressively finance local business expansion, to provide loans and capital to his fellow Sooners, and to raise the bank's profile in charitable events and community causes. He was proclaimed a "favorite son" for rescuing the Tulsa-based bank and keeping it in hometown hands. "Really, my consideration here is, first of all, the critical necessity for Oklahoma to have a home-owned, home-controlled financial institution," he told the *Tulsa World in* an October 1990 interview. "That sounds a bit holy, but generally, that's the personal motivation. But it will be a profitable transaction as well."

That was putting it lightly. By the end of 1998, Kaiser's shares of BOK Financial (the holding company that owns the bank) were worth nearly $917 million, fifteen times what he paid for them. Kaiser's strike is even more phenomenal considering that, when he bought the shares, he claimed he had no income. At the same time Kaiser was buying the Bank of Oklahoma from one part of the federal government, the FDIC, he was telling another part, the Internal Revenue Service, that he wasn't paying any income taxes because he had lost money that year.

Kaiser paid for the bank in 1991—a year in which he filed a federal income tax return declaring a total taxable income of negative $2,328,639. The previous year, when Kaiser made his successful $61 million bid to buy the bank, he declared a loss of $115,561. Kaiser's total income tax payments those years: zero.

In 1989, Kaiser actually had some earnings. He filed a tax return showing total taxable income of $11,699—equal to an hourly wage of $5.62. For the record, the average hourly wage for nonsupervisory bank employees—tellers, security guards, janitors, and the like—was $8.13 in 1989, or $2.51 more an hour than Kaiser, the future bank owner, claimed he earned. Kaiser paid $2,688 in federal income taxes that year.

In the three prior years, from 1986 to 1988, Kaiser declared losses as well. Over the six years from 1986 to 1991, Kaiser's average annual income was negative $860,000. But before taking up a collection for the George B. Kaiser Relief Fund, remember that in 1992, his net worth landed him on the *Forbes* list of the 400 wealthiest Americans, where he has remained ever since.

His purchase of the Bank of Oklahoma the year before had a lot to do with his landing on the list. In 1991, the Tulsa oilman received more than $100 million from an entity known as GBK

Corporation. Following an audit, the IRS suggested that the entire amount was dividend income. On the heels of the audit, the Service questioned the validity of various deductions and losses Kaiser and his wife claimed. In fact, the IRS sent the couple a Notice of Deficiency in 1997 for $48.6 million for back taxes, interest, and penalties.

The Kaisers, maintaining that they owed no additional taxes, contested the IRS's findings in U.S. Tax Court. Kaiser told the IRS that the $100 million he received from GBK was not a dividend, but a loan. He had paid interest on the amount, he noted—a staggering $3.3 million in 1991 alone. "They dropped it immediately," Kaiser said of the IRS's position on the loan. "There was no issue. The Internal Revenue Service on occasion will raise spurious issues to increase its leverage." After negotiating with IRS attorneys, the Kaisers settled the case for substantially less than the government initially sought: they sent the government a check for $11,891.

From 1989 to 1991, Kaiser's average annual tax burden rose— thanks to the settlement with the IRS—to $4,860 a year. That's less than the amount that a married couple with an income of $41,140 would pay. If that couple saved every penny of their annual income, it would take them more than 22,000 years to accumulate the $917 million that Kaiser made from his investment in the Bank of Oklahoma.

That couple could afford to borrow $151,000 to buy a home. Kaiser was able to persuade GBK to loan more than 650 times that amount to buy the Bank of Oklahoma. That's because GBK stands for George B. Kaiser.

GBK Corporation is a holding company whose principal asset is Kaiser-Francis Oil. In his role as president, chairman, and sole director of GBK, Kaiser loaned himself the $100 million to buy the Bank of Oklahoma. Kaiser was able to satisfy the IRS that the money was indeed borrowed, and not a dividend from his company, as the Service initially contended. "There are about eleven things you have to show to disprove that, and the only one I didn't have was the corporate minutes," he told the Center. "I'm the only director and I hold all the directors' meetings in the shower. I don't take minutes because the ink runs."

Because Kaiser is paying back the money he borrowed from his company, he can even deduct the $3.3 million he paid in interest to GBK from his personal income taxes. It's called investment interest expense, and it's fully deductible under the Internal Revenue Code.

As for GBK, which had enough spare cash to make a $100 million loan, its returns showed losses almost as prodigious as Kaiser's. From 1986 to 1992, GBK filed returns claiming $507,000 in red ink. Some years the company had income and paid taxes; other years, it claimed losses and paid nothing. And some of those losses came from firms that had nothing to do with GBK, Kaiser-Francis Oil, or George Kaiser. Instead, the losses were attributed to those bankrupt companies that Kaiser bought up during the bust—firms like MGF Oil and Waterford Energy, which had more to offer Kaiser than a chance to boost his gas production.

Waterford Energy operated roughly 150 gas wells in Beaver County, Oklahoma. Like many other independent oil and gas companies, it borrowed heavily during the boom and suffered huge losses during the bust. When it ended up in bankruptcy court in 1990, it had about $7 million in assets, and something far more valuable on paper. Waterford possessed $151 million in losses the company had racked up over the years. Those huge losses that Waterford suffered in the 1980s wound up as huge write-offs on the tax returns of GBK Corporation in the 1990s.

In 1992, Kaiser erased a $40 million profit made by his GBK Corporation because Waterford Energy lost millions in the 1980s. GBK can continue to apply those Waterford losses to its tax returns until 2005. By using the net operating losses of bankrupt companies like Waterford or MGF Oil, another company whose tax benefits Kaiser enjoyed, he turned the profits of Kaiser-Francis Oil into paper losses on his tax returns.

The oil bust, with all its business failures and bankrupted energy producers, provided Kaiser the perfect opportunity to use net operating losses to lower his tax burden. In 1997, the IRS challenged the Waterford write-off, arguing that "losses resulting from acquisitions made to evade or avoid income tax are prohibited." Like Kaiser, GBK received a large bill from the IRS—this one for more than $24 million including interest and penalties—covering 1989 to 1992. And like Kaiser, GBK contested the charges. The company argued, for example, that it "acquired Waterford for sound business reasons; the acquisition was not made for the principal purpose of evading or avoiding federal income taxes."

"We acquire oil and gas companies and properties all the time because we're in the business of acquiring hydrocarbon reserves," Kaiser said of the Waterford purchase. "During the desperate depression of the 1980s, there were no oil and gas companies without net operating losses. Any company you'd buy had them. There was no indication that we didn't comply with the Internal Revenue rules."

Kaiser carefully complied with the rules, in part to preserve the net operating losses he used so shrewdly. Waterford filed a plan of reorganization in the U.S. Bankruptcy Court for the Southern District of Texas on November 7, 1990. The filing laid out the steps that the company, which was soon to be managed by Kaiser and a group of his executives, would take to get the company out of debt and satisfy creditors. "The principal motivations of the plan are to reorganize the debtor ... to meet its obligations as they mature and to preserve the tax attributes of the debtor in order to allow the debtor to realize the benefits of the tax attributes, including net operating losses." Once Kaiser took control of Waterford, his company would enjoy the "benefits of the tax attributes" of the debtor.

A November 27, 1989, letter that D. Joseph Graham, the chief financial officer of Kaiser-Francis Oil, wrote to Steven Ensz, then president of Waterford Energy, was even more specific about the company's interest in the acquisition. "I apologize for taking so long to get back to you on the Waterford Energy, Inc. offer," the letter began. "I have been spending almost all of my time on the purchase of another oil and gas company, which, coincidentally, also has very significant tax attributes, and have just now been able to return my attention to Waterford. Although our appetite for an acquisition of this nature is somewhat relieved by the other opportunity, we are still interested in trying to reach an agreement on Waterford. ..."

Kaiser's appetite for acquisitions with "significant tax attributes" wasn't entirely relieved by the purchase of that other oil and gas company: in 1990, he took over Waterford; in 1991, he merged Waterford with Kaiser-Francis Oil and claimed Waterford's net operating losses on GBK's tax return.

In 1998, the IRS finally settled the case with GBK Corporation, without going to trial, for $3.7 million—or roughly 15 cents on the dollar. The IRS refused comment on the settlement, citing the confidentiality of taxpayer information. The Service allowed the deductions for the Waterford losses to stand.

George Kaiser once remarked to Forbes, in a comment he would probably like to take back, that "Gas is the only commodity you can legally steal." A class action suit filed in Oklahoma state court accused Waterford and its new owner, Kaiser-Francis Oil, of doing just that. The suit charges that Kaiser's companies participated in "a scheme which resulted in the systematic underpayment of royalties to royalty owners" of the wells that Waterford, and later Kaiser-Francis, operated.

Two years before Kaiser's company took over Waterford, a royalty owner, Robert A. Funk, had sued the company for $3.4 million. Funk claimed that Waterford was paying him less than he was owed for the gas the company was pumping out of his land. Funk was familiar with the oil and gas business; as president of Funk Exploration, Inc., he was another Sooner who rode the energy boom. His company built the Beaver Gathering System, a pipeline that transported gas in the pan-handle of Oklahoma. Funk Exploration got huge loans from banks in the early 1980s: $20 million from Wells Fargo Bank, a $200 million line of credit from Marine Midland Bank, and a $500 million line of credit from Chemical Bank. He saddled his company with so much debt that, when the bust came, he couldn't repay his loans. In 1985, Chemical Bank forced him out, reorganized the company, and renamed it Water-ford Energy.

When Funk set up the Beaver Gathering System, he also instituted a scheme to secretly charge royalty owners an inflated "transportation fee" for pumping gas from their land. Funk didn't mind paying the fee himself, because much of that money ended up in his own pocket (part of the profits Funk Exploration earned). But after he turned over control of the company to Chemical Bank, he was getting cheated just like the other royalty owners in Beaver County. So Funk sued Water-ford in 1988.

"I am not being paid as a lease instructs to be paid," Funk told attorneys for Waterford in a 1989 deposition. "I should get gross proceeds, [there] should not be any transportation deducted." Funk further complained that his royalty check did not indicate that Waterford had deducted any fee from it. When asked by Waterford's attorneys whether he knew of the fee because he was the one who instituted it, Funk answered yes.

Kaiser told the Center that "We prefer picking up bankrupt companies because you know all the liabilities." Yet he wasn't aware of Funk's scheme until after he had filed the bankruptcy reorganization plan. He didn't schedule the claims of other royalty owners. He discovered Funk's transportation fees when Jack and Verdeen Slatten, two other royalty owners in the Beaver Gathering System, sued Kaiser-Francis Oil. Kaiser settled with them out of court for $25,000 and a promise that they wouldn't disclose the terms of the settlement to anyone else.

Eventually, other royalty owners—some 1,300 of them—found out about the fees. In 1995, they filed a class action suit in Beaver County District Court, alleging that they'd been underpaid some $35 million by Waterford Energy and its successor, Kaiser-Francis Oil. The suit alleges that Kaiser-Francis Oil continued to collect the transportation fee, year after year, long after the Slattens' lawsuit exposed the scheme. The average claim was $17,750; Galen Bridenstine, the royalty owner chosen to represent the class, claimed he was out a little less than $9,000.

Attorneys for Kaiser-Francis Oil argued that Kaiser was not aware of Funk's scheme, and in any case, those claims were barred by the statute of limitations. They filed a motion in bankruptcy court, arguing that Waterford's bankruptcy eliminated any claims prior to Kaiser-Francis Oil's taking over the company. They vigorously denied that the company engaged in any scheme that paid royalty owners less than they were owed. And they attempted to prevent the royalty owners from suing as a class. After five years of litigation, the royalty owners, as of this writing, have yet to get their day in Oklahoma's courts. The trial, scheduled for May 1999, was pushed back to March 2000, then delayed again.

Kaiser told the Center that the suit is groundless. "We were disadvantaged as well," he said. "If the fee for the pipeline is excessive, then we are hurt too. If the pipeline's overcharging, we're overcharged. I don't think anybody is an appropriate plaintiff in this case."

The Waterford royalty owners aren't the only Oklahomans who have claimed that Kaiser's companies have legally stolen from them. A group of landowners in Grady County, in the south-central part of the state, have also alleged that Kaiser-Francis Oil has paid them less than they're owed for the gas the company drains from their property.

Glenn Mayo, whose elderly mother, Murlene, is one of the plaintiffs, told the Center, "When the price of gas was up to $3.50 per thousand cubic feet, they paid 16 to 22 cents on it." Royalty owners are supposed to get one-eighth of the sale price on the gas—almost 44 cents at a price of $3.50. "You can see how much money you're losing," Mayo said.

Over the years, that lost money has added up to about $10,000. Not a fortune by any means, but as Glenn Mayo says of his mother, "When you're old, and you depend on Social Security, every little bit helps."

Mayo isn't optimistic that his mother will ever recover the money, despite being a participant in a lawsuit that was filed in 1993. "My mom's eighty-six, and it's unlikely she'll see any benefit out of it. My grandpa didn't see any, my dad didn't see any, so I guess it's an ongoing thing."

"I've probably been around the oil and gas business for about twenty years and have never heard of anything like this," Richard Alien, the attorney representing Mayo, said. He filed the 1993 lawsuit on behalf of her and thirty other landowners in Grady County. The attorney spent hundreds of hours in the arduous task of unraveling Kaiser's empire, studying leases and sales records and royalty payments.

"Kaiser-Francis owns a few buildings up in Tulsa and you walk in and there's 500 different corporations in those buildings," said Alien. "Those people that I deposed might be the vice president of twenty different companies, all of them owned by Kaiser and his family."

One of those companies, Texas Southwest Gas Corporation, buys gas from Kaiser-Francis Oil for far less than the market price, the suit alleged. The gas is pumped from land owned by Murlene Mayo and the other Grady County royalty owners, who receive their percentage on those Kaiser-Francis sales. Texas Southwest Gas then resells the gas for full price on the open market. The difference in price ends up in George Kaiser's pocket.

"We've run the records and we know what Kaiser-Francis made out of these wells," Alien said. "We've got how much they paid the royalty owners. They admit that they're selling to themselves. They're saying, 'We can get around the law and do this.' "

Kaiser and his lawyers aren't eager to find out if a judge would agree with them. Instead, they challenged the right of Alien's clients to sue as a class of similarly aggrieved plaintiffs. They won the first round in a trial court, and in February 1998, the civil appeals court of Oklahoma upheld the trial court's refusal to certify Alien's clients as a class. The majority held that because Kaiser-Francis Oil had different types of agreements with the various royalty owners, the plaintiffs did not have enough in common to be considered a class. The majority noted, however, that the plaintiffs could pursue their cases individually.

Should Alien's clients sue separately, each would have to pay attorney fees and court costs to recover amounts in some cases as little as a few thousand dollars. "These are people that don't have much income and I'm finding out they've only been paid a tenth of what they're due," Alien said. "The problem is, how can a person getting a hundred-dollar royalty check challenge a person like Kaiser and his lawyers?"

Kaiser, after all, is one of the 400 wealthiest Americans. In 1995, he used some of that money to push the Oldahoma legislature to pass a bill that would limit punitive damages to $100,000. Kaiser wanted to make it harder for ordinary Oklahomans to sue powerful companies. When the legislature balked, Kaiser helped raise $2 million to get tort reform passed as a ballot initiative. Governor Frank Keating threatened to veto a banking bill if it didn't include Kaiser's tort-reform package. Oklahoma's elected representatives bowed to the pressure. Keating remarked at the time that the bill passed thanks to "a very real fear of my veto and George Kaiser's money."

The oilman believes he did the state a service. "The U.S. civil legal system is fatally flawed," he said.

Tort reform isn't the only business-friendly measure to come from the Oldahoma statehouse. As elected officials have struggled with the implications of the oil bust, they've crafted a number of programs to attract businesses to the state. Keating has called for right-to-work laws, aimed at restricting the activities of labor unions, and reform of the state's worker compensation system.

And in 1993, the legislature passed the Quality Jobs Program Act, aimed at attracting companies to the state by offering to pay 5 percent of the wages for new jobs created there for up to ten years. The purpose of the bill was to help Oklahoma recover from the oil bust. The list of companies that have taken advantage of the program reads like a who's who of the *Fortune* 500—Boeing, AT&T, Mutual of Omaha, Hertz Corporation, Amoco Corporation, and Seagate

Technology, to name a few. Some of the wealthiest corporations in the country get a rebate from ordinary Oklahoma taxpayers, whose incomes are already, on average, among the lowest in the country. Or, as the state's finance office put it, "[T]he Quality Jobs program, an economic development incentive, is placing an increasing demand on income tax revenues."

While ordinary taxpayers might be footing the bill for the Quality Jobs program, to date it hasn't made much of a difference for the average Sooner. Six years after it was enacted, the state's per capita income remained among the lowest in the nation. "The problem in our state," the finance office reported in 1998, "is that we have plenty of jobs, they just pay relatively low wages." Layoffs are still common in the oil industry. In January 1999, Governor Keating called for an emergency session of the legislature to address the plight of Oklahoma's oil and gas producers.

One business, however, has done very well. The same month Keating called for the emergency session, the Bank of Oklahoma announced that it had record earnings in the previous year. George Kaiser believes that the profits he earns from the bank are all to the good of his fellow Sooners. "I guess the image we're seeking as a bank is an Oklahoma-based company which wants to be deeply involved in the restoration of the Oklahoma economy," Kaiser told the *Sunday Oklahoman* in June 1992. While that restoration for the rest of the state has been slow in coming, it hasn't prevented Kaiser's bank from enjoying a boom of its own.

He doubled its profitability in his first year as chairman and boosted commercial, real estate, and consumer loan business by 20 percent or more in each category. He expanded in the Tulsa area by buying nineteen branches of the Sooner Federal Savings & Loan in 1992. He bought a mortgage company from the Resolution Trust Corporation, the government entity charged with cleaning up the savings and loan mess, to further expand the bank's presence in real estate lending. "We've been one of the most dynamic banks in the market-place," Kaiser boasted to *American Ranker,* the trade magazine for savings institutions, in a September 1992 interview.

Year after year, the bank has issued glowing earnings reports. By the time it issued its 1998 annual report, Kaiser decided to extend the bank's reach beyond his home state. "Over the past several years, we have succeeded in building the Bank of Oklahoma into a position of dominance in our home state," the report read. "The challenge we face is strengthening that position while expanding into surrounding states. ..." Those states include Texas, New Mexico, and Arkansas. Kaiser's BOK Financial has acquired banks in all three.

There was just one dark cloud hanging over the Bank of Oklahoma's sunny future. The IRS was auditing the bank, a fact also disclosed in the company's annual reports. Unlike other parts of Kaiser's empire, the bank paid taxes—although its effective tax rate ranged between 20 percent and 33 percent in the years after Kaiser bought it, always less than the 34 percent corporate tax rate.

In 1999, the company announced the result of the audits. "During 1998, Internal Revenue Service examinations for 1994 and 1995 were closed with no significant adjustments. During 1997, the Internal Revenue Service closed its examination of [the Bank of Oklahoma] and BOK Financial for 1992 and 1993, respectively. As a result of the outcome of these examinations, BOK Financial realized a $9.0 million tax allowance that was no longer needed."

Like Kaiser and his company, the bank had complied with the Internal Revenue Code and satisfied the auditors. Once again, the IRS cleared Kaiser.

Chapter 8
The Market Wizard

At a time when more and more Americans have a 401(k), mutual funds, Individual Retirement Accounts, and even their own on-line stock portfolios, the Chicago commodities markets have by and large remained a playground for the few. Profits are made by correctly foreseeing the price movements of various commodities and financial instruments, everything from pork bellies to crude oil, gold to government debt. It's an arena where Wall Street powerhouses rub elbows with small-time operators, where the trillions traded each year are backed by a tiny outlay of cash and a great deal of debt—or leverage, as the traders call it—and where fortunes can be made by canny operators with strong stomachs and superior knowledge. Gary K. Bielfeldt is such a man.

Born just outside the little town of Anchor, Illinois, Bielfeldt was raised on a farm, then went off to study agriculture at the University of Illinois at Urbana-Champaign, where he met his wife, Carlotta. After earning his bachelor's degree in 1958, he stayed on another year and was awarded his master's in agricultural economics. After finishing his studies, he began his career running a small brokerage firm in Peoria, Illinois, a city whose very name is synonymous with Middle America. "Will it play in Peoria?" — a saying coined by traveling vaudeville acts — was later made infamous by Watergate figure John Ehrlichman, who tested every bit of misinformation the Nixon administration considered releasing to the press by asking that question.

Conservative with a small *c,* hardworking, independent, and not given to boasting, Peoria is a city whose character was well suited to the modest, laconic Bielfeldt. As a broker, he earned fees and commissions for his services, but the lion's share of the profits from successful trades went to the investors themselves. Trading was where the real money was, and he wanted a piece of the action. He started an account for himself with a mere $1,000. By 1965, after a few years of speculating on fluctuations of the price of corn, he'd managed to build it up to $10,000. Then he took his first big gamble.

After evaluating the market, Bielfeldt was convinced that there was money to be made in soybeans. He asked for outside advice from Thomas A. Hieronymus, his faculty adviser at Urbana-Champaign, who agreed with his student's analysis. Bielfeldt spent his entire $10,000, so painstakingly accumulated, on soy futures contracts, betting that the price would go up. The market went down, nearly far enough to force a margin call that would have wiped out his stake completely. Sure of his reading of the market, Bielfeldt refused to fold. The market turned, the price of soy futures shot up, and by the time he sold his contracts, he had doubled the value of his account. He was on his way to becoming one of the most successful traders in the country.

"I learned how to play poker at a very young age," he confided to Jack D. Schwager, who interviewed him for the 1988 bestselling book *Market Wizards.* "You don't just play every hand and stay through every card, because if you do, you will have a much higher probability of losing." Bielfeldt doesn't consider himself a gambler, but he acknowledged that his trading and card-playing strategies have something in common. "When the percentages seem to be strongly in your favor, you should be aggressive and really try to leverage the trade similar to the way you raise on the good hands in poker."

Bielfeldt kept playing the soy futures until 1983, when he suffered a series of losses. The setbacks made him choose a different dealer: the federal government. The skilled trader positioned himself for huge profits in the Treasury bond futures market, which had hit rock bottom when he got in, and rose as the Reagan economy expanded in the go-go 1980s. Like the contracts he traded in soybeans or corn, T-bond futures are purchased at a fixed price and resold at a future date. Profit is made by correctly predicting which way interest rates will move. Unlike other commodities, Treasury notes carry a very low risk, and offer a very low margin of profit. Bielfeldt, ready to raise the ante, leveraged himself to the hilt.

He regularly bought and sold *$50* billion worth of T-bond futures a year, financing them by entering into repurchasing agreements with large institutional investors like Goldman Sachs & Company, Merrill Lynch & Company, and Salomon Brothers, Incorporated. He became a major player in a field dominated by Wall Street's largest firms, all from his base in Peoria. His margin of profit was small—from 1985 to 1989, he had $154 million to show for the hundreds of billions worth of positions he'd taken in the market. But Bielfeldt wasn't complaining— his average annual profits amounted to $30.8 million.

The big money played well in Peoria, and nationally. His successes were noteworthy enough that he drew the attention of Schwager, whose book of profiles carried the subtitle "Interviews with Top Traders." As for Peoria, Bielfeldt consistently contributed to community services throughout the town and the surrounding area. In 1988, he brought Auguste Rodin's most famous work, *The Thinker,* to the Lakeview Museum of Arts and Sciences, along with forty-four other works by the French master. Bielfeldt's wife, Carlotta, was the chairwoman of the local museum, but her husband landed the exhibit.

Bielfeldt had done some trading with Cantor Fitzgerald Incorporated, an international financial holding company. The firm's founder, the late B. Gerald Cantor, and his wife, Iris, owned the largest private collection of Rodin works at the time. Cantor and Bielfeldt's dealings led to the exhibition. "They didn't even know of my wife's involvement with the museum, it was just based on our business relationship," Bielfeldt told the *Chicago Tribune.* "I'd helped them in the government securities market and they offered this as a way of saying thank you."

His philanthropy hasn't been limited to his hometown. In 1993, Bielfeldt donated $5 million to his alma mater, the University of Illinois at Urbana-Champaign, for the construction of an athletic administration center that now bears his name. The same year, he and Carlotta, along with their children, gave $1 million to establish the Office for Futures and Options Research at Urbana-Champaign through their charitable organization, the Bielfeldt Foundation. The gift also created a professorship in honor of Bielfeldt's former agricultural economics professor, Thomas A. Hieronymus, who helped the trader in his first big gamble.

But by and large, Bielfedt's largesse has been directed to Peoria. "I judge success by what I do with the money I accumulate," Bielfeldt said in his *Market Wizards* interview. "One of the things that my wife and I have done is to establish a foundation so that we could share some of our success with the community by supporting various programs." The Bielfeldt Foundation was formed in 1985; in 1997 alone, it paid out more than $1.8 million for education programs and community development.

One of Bielfeldt's most ambitious—although ultimately failed— hometown endeavors was a downtown redevelopment project he initiated in 1986. His partnership, Bielfeldt & Company, purchased land where he planned to build a $51.6 million, multiblock, 405,000-square-foot shopping mall and office complex. By 1988, residential housing and a 200-room hotel were discussed as possible additions to the centerpiece of the new Peoria.

Neither the millions he gave away nor the millions he earned changed Bielfeldt's lifestyle. He continued to live in a comfortable if modest two-story, Colonial-style home in the Peoria Heights neighborhood, on a street that overlooks the Country Club of Peoria golf course. The assessed value of the property was $145,480 in 1999, about $45,000 above the average value of homes in Peoria, according to the Richwoods Township property assessor's office. The house is not nearly so opulent as some of the larger houses on his block, but it is convenient. His offices are about a half-mile drive from his home. Bielfeldt has also made it a point to keep his friends and family close, living just blocks away from his son, David, and his attorney, Edward Sutkowski, who also invested in some of Bielfeldt's projects over the years. The market wizard continued to trade heavily, working twelve hours a day, and often awakened in the middle of the night to place orders for T-bills on the London and Tokyo markets.

On July 17, 1991, Bielfeldt, who made his fortune from the debt issued by the Treasury Department, tried to swing another profitable deal with the government. He filed a series of amended tax returns with the Internal Revenue Service for the years 1985 to 1988. The amended returns were quite different from the originals: on these new filings, he claimed that he was a dealer of government debt, rather than a trader. That change led him to claim that gains and losses were ordinary, rather than capital. And that in turn entitled him to ask for a refund from the government of some $81.8 million.

What a difference a few words can make.

The third edition of *Webster's New World College Dictionary* defines a dealer, in part, as "a person who deals; specifically,. . . b) a buyer and seller; person engaged in trading." A trader, by contrast, is defined, in part, as "a stockbroker who trades esp. for his own account rather than customers' accounts."

The IRS, and the tax code it enforces, has never been known for brevity or conciseness of language. Section 1.471-5 of the code makes this distinction between dealers and traders:

> [A] dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. . . . Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.

The tax code agrees with *Webster's.* Dealers make money from their customers, traders make money from their investments. But Bielfeldt wasn't in the habit of making such distinctions. He argued, for example, that he and his company were indistinguishable. "I've always viewed both entities as the same," he said. "I never made a distinction."

The IRS, for its part, did. Rather than write Bielfeldt a check for his millions, IRS agents descended on his main office in Peoria and his branch office in Chicago. They audited Bielfeldt, along with his trading partnership, Bielfeidt & Company, and two of his partners in that firm—his son and one of his two daughters. They looked into his trading activities and his company's pension fund. They reviewed all of his records, some stretching back to 1972. And in the end they issued Notices of Deficiency to Bielfeldt, his company, and the company pension plan that totaled some $94 million. The market wizard saw a potential swing in the position he'd taken on his tax returns of nearly $177 million.

Bielfeldt filed eight Tax Court petitions to challenge the IRS. Unlike the commodities markets he had largely mastered over the years, he wasn't able to dump the losers. In 1991, Bielfeldt made one more gamble. The man who made his fortune from government debt claimed that he was owed more than $80 million that he had overpaid in taxes. "I made the biggest mistake of my life when I filed for a tax refund," he said in an interview with the Center.

Some of the issues involved in Bielfeldt's various disputes with the IRS were fairly complex. A motion filed jointly by the IRS and Bielfeldt's attorneys requested that the same Tax Court judge preside over all eight cases, because the "issues include complicated commodities transactions, deemed distributions from the profit sharing plan, the revocation of the tax exempt status of the partnership profit sharing plan, and prohibited transactions." One issue, however, was relatively straightforward—determining whether Bielfeldt was a trader or a dealer.

On his original 1985 tax return, Bielfeldt had included a note with the return. "During 1985 the above-named taxpayer had a very extreme change in the volume of trading activities conducted on his own behalf," it read in part. "The magnitude of trading activities now qualify the taxpayer as a 'trader' for tax purposes rather than 'investor.' " The Internal Revenue Code allows traders more generous deductions for business expenses and losses than it does for investors.

Dealers are even more favored by the tax code, although they perform a different function: performing trades for customers. Bielfeldt insisted that he had many retail customers. The records he produced to support his claim, however, showed that he traded largely for himself, and only with the "primary dealers" in Treasury notes. Primary dealers—large firms like Salomon Brothers and Goldman Sachs—buy and sell T-bonds every day. By contrast, Bielfeldt had long periods of inactivity, up to 100 days at a time, when the poker player refused to play the cards being dealt. Nonetheless, he insisted that he also had many retail customers. "These people were people that we knew as long-term clients, personal friends, employees, friends of friends of personal friends," he said, adding that "the vast majority of them" were from Peoria. The rest of his customers, he claimed, were the large primary dealers in Treasury notes themselves. He testified that he went to great lengths to remain on good terms with those customers.

"Peoria is not an easy place to get in and out of and if you're going to fly customers in, it's much more convenient for them if you pick them up, fly them in, and take them back, and this is what I did," he said. He entertained dealers from Goldman Sachs, Salomon Brothers, Cantor Fitzgerald, and a number of other firms. He testified that in 1988, he flew Paul Volcker, the former Federal Reserve chairman, and Republican Representative Bob Michel, then the House minority leader, to Peoria to discuss the markets with some of his other guests, including a pair of Goldman Sachs executives.

"I went out to New York, I picked people up. I flew them out to Peoria, I showed them my office, I bought their dinner, I paid for all their expenses." The traders flew in on Bielfeldt's own jets. "Bielfeldt & Company originally had an Aero Commander 800 and then we acquired a Learjet in 1986. We acquired the planes because of the fact that it was helpful in developing the business relationship with the people we were dealing with."

When his tax troubles began, Bielfeldt wasn't quite so confident in those relationships. Under cross-examination, he admitted to contacting eight of the individuals he had listed as customers after he had been informed that the IRS intended to depose them. "I told them I was having a dispute with the IRS," Bielfeldt explained. Asked whether he had "suggested reasons" that he might be a dealer, Bielfeldt replied, "I guess if you—if you classify the fact that you would view another primary dealer as a customer, I suppose I may have said that."

The $81 million gamble didn't pay off. Tax Court Judge David Laro ruled on November 6, 1998, that Bielfeldt was indeed a trader, and not a dealer. In his opinion, he wrote that the market wizard's "definition of the word 'customer,' to wit, any person with whom he had established business relationships and with whom he dealt regularly . . . misses the mark." Laro denied the $81 million refund request, and ordered Bielfeldt to pay $44.9 million in taxes and penalties for the years 1984 through 1988.

Bielfeldt blamed the setback on his ignorance of the tax code and the advice he had gotten from his former accountant, Jack Williams, of KPMG Peat Marwick. "When those tax returns were originally filed, did you understand the tax definition of a difference between one who reports ordinary gains and losses as opposed to one who reports capital gains and losses?" Bielfeldt's attorney, Maureen McGinnity, asked during her direct examination of her client during the Tax Court proceedings.

"No, I didn't," Bielfeldt replied.

Later, he added that he tried to explain to Williams “the activities that I was involved with, how the activities had grown and expanded, and I was relying upon him to give me the best accounting advice.” When contacted by the Center, Williams said he was under a court order not to discuss the case, and added that he was not required to appear during the trial.

The “best accounting advice” had already put Bielfeldt in a $44.9 million hole, and he still had seven outstanding Tax Court cases awaiting resolution.

Some of the other cases involved smaller amounts of money. For example, the IRS billed Bielfeldt more than $1 million in taxes and penalties for 1989 and 1990. Bielfeldt had claimed depreciation and expenses for the property his firm had acquired in downtown Peoria, where it had once planned to build offices and a shopping mall. The firm spent $206,855 to conduct feasibility studies for the project, but nothing came of it. The firm considered demolishing the buildings that sat on the land, and renovating, but it made only one improvement. Bielfeldt & Company "did not raze the buildings, except for one decrepit structure that had been used for sale of pornographic material prior to its acquisition by the partnership," according to a 1996 court petition filed by Bielfeldt's attorneys.

The Service also disallowed losses that Bielfeldt claimed in connection with his sale of a condominium on Marco Island, Florida, a tropical paradise in the Gulf of Mexico with miles of white-sand beaches and no fewer than six country clubs. In 1990, the Bielfeldts sold their condo there, complete with its furnishings, and claimed a loss on the sale of the personal property.

The IRS challenged deductions that Bielfeldt & Company claimed for "professional fees," which included "several outside professional firms, including attorneys, certified public accountants, as well as employee benefit consultants, in order to verify the proper application of the Federal income tax laws," according to a petition Bielfeldt filed in Tax Court. Those fees, amounting to more than $166,000, were incurred "as a direct result of the Service's examination of tax years 1984-1989," the Bielfeldts claimed, and were "ordinary and necessary trade or business expenses." The IRS disagreed, arguing that the Bielfeldts were attempting to write off the cost of their own legal defense.

The Service disallowed deductions taken by the Bielfeldts for trading losses and for the operation of the two planes that the partnership owned, and it also charged deficiencies in self-employment tax and underreported income from a state income tax refund the Bielfeldts received. And all of that in just one of the seven remaining cases. Bielfeldt and the IRS settled the case without going to trial; he ended up paying $5.9 million, rather than the $1 million the Service originally sought. That was small potatoes compared to the tens of millions in back taxes that the IRS sought from the Bielfeldt & Company Profit Sharing Plan, a retirement fund that Bielfeldt originally set up in 1972.

The plan, which qualified for tax-exempt status under section 401 (a) of the Internal Revenue Code, operated under many of the same rules that govern 401 (k) accounts. Any income that the plan earned was not subject to taxes, provided that it would be saved for the beneficiary's golden years. Anyone who dips into a 401(k) or an Individual Retirement Account before reaching their late fifties pays not only taxes on the money withdrawn, but an additional 10 percent penalty. In developing the rules for personal retirement savings, Congress gave taxpayers a carrot to save—the tax-free accumulation of income—and a stick to discourage the premature raiding of retirement nest eggs. In Bielfeldt's case, the egg was more suited to a brontosaurus than a bird.

In 1983, Bielfeldts plan account had a balance of more than $8.4 million. In 1984, the balance was just under $11.8 million. Two years later, it was $44 million. By the end of 1988, it held more than $50 million. In just six years, the worth of his retirement account had increased nearly 600 percent. During those years, the maximum tax-exempt annual contribution he could make to the plan was $15,000. The first-rate returns were largely a product of the savvy of the retirement fund's investment manager: Bielfeldt himself.

In 1974, the predecessor to Bielfeldt & Company, called Bielfeldt, Lauritsen & Hagemeyer, directed the trustee of their pension fund to deliver its funds—less than $15,800—to the partnership. The five participants in the plan, among them the three name partners in the firm, took control of their individual accounts. "The participants believed that the partnership offered the optimal potential for appreciation in value of plan assets," Bielfeldt's attorneys explained in a Tax Court filing. In 1982, when Bielfeldt bought out his original partners' interest in the firm, the plan had done well, but not nearly as well as it would do over the next six years.

One of Bielfeldts former partners, his brother-in-law James Lauritsen, told the Center that although he couldn't recall specific numbers, the company's pension plan was "medium sized" when he left the firm. He added that the amount of money in the pension plan had been "nowhere near the numbers" it rose to in the mid- to late 1980s. "That's when he made his big money," Lauritsen said.

Not everyone benefited from that big money. Bielfeldt's old partners certainly didn't, nor did the employees of Jefferson Bancorp, a Peoria-based financial institution that Bielfeldt came to control in 1986. They were covered by a plan somewhat less generous than Bielfeldt's. Their defined benefit plan guaranteed them a minimum increase of assets of 2 percent a year—a far cry from the massive growth of funds in the market wizard's personal retirement account. How he achieved that growth, and his failure to offer participation in the plan to Jefferson's employees, led the IRS to disqualify the plan— essentially, strip it of its tax-exempt status—in January 1996.

After auditing the plan, IRS agents concluded that the growth of Bielfeldt's retirement account was fueled only in part by the investments it made. The remainder of the growth came from profits of his trading firm, which were diverted to the pension fund, where they would escape taxation. Bielfeldt claimed that the large deposits made to his pension account each year were for interest it had earned; the IRS disagreed, noting that there were no contemporaneous records to prove that. "Under such circumstances these payments cannot be considered payments of interest but rather excess annual employee additions to the plan," the Service concluded.

Bielfeldt had also put the assets of the plan at risk to cover his trading activities on several occasions. In March 1988, he took a huge position on Treasury futures, and, as was his habit, he used a significant amount of debt to finance the transaction. In this case, the market turned against Bielfeldt. After the October 1987 stock market crash, Bielfeldt went from bull to bear, betting that the economy would head south. It frustrated his expectations. Goldman Sachs, from whom he'd bought the futures contracts, needed more collateral to cover his positions as interest rates went against him. Bielfeldt authorized the firm to use the funds in his pension account to cover his trades. Had he not done so, he would have been unable to meet margin requirements, and Goldman Sachs would have been forced to sell off his contracts, at a considerable loss to Bielfeldt. With the retirement plan's assets backing the trade, it was also possible that a further upturn in the economy— against which Bielfeldt was betting—could have wiped out that account as well. The IRS argued that he "placed at risk for payment of partnership debts and liabilities" the millions in his nest egg.

Pension plans, of course, are not to be put at risk in the ordinary course of business. Section 401(a) is clear on this point, as the IRS noted in Bielfeldt's case. Assets in the plan, the Service stated, "cannot be diverted to purposes other than the exclusive benefit of plan participants"—that is, providing income for their golden years. The IRS discovered that not only was he risking the assets of the pension fund in his trading activities, he also allowed his firm, Bielfeldt & Company, to make use of them to buy the Learjet and the downtown real estate in Peoria that was never developed.

The IRS charged that Bielfeldt, his company, and the pension fund it maintained owed $48 million in back taxes and penalties. He and his lawyers fought back, insisting that the plan's tax exemption was wrongly revoked and that its funds had not been used for any improper purposes. One attorney noted in a pretrial hearing before Judge Laro that nearly every issue of tax and pension law was involved in the exceedingly complex case. The exhibits alone totaled thousands of pages and included documents stretching all the way back to 1973.

Bielfeldt never got his day in court. He didn't need it. The dispute was settled by mutual agreement between his attorneys and the IRS. Bielfeldt 's pension retained its status as a qualifying, tax-exempt plan. For various irregularities in the operation of the plan, he had to pay a little over $500,000 in excise taxes, a tiny fraction of the $48 million the IRS had sought. Both the Service and Bielfeldt 's attorneys declined to comment on the settlement reached in the case.

In 1991, a series of losses on the commodities markets finally forced Bielfeldt to cash out of his pension fund. He withdrew nearly $30 million to satisfy his creditors. When the IRS settled the case with Bielfeldt, the bulk of the money he had deposited in it was already gone. The victory for the market wizard was a hollow one.

Despite the taxes he's paid, he's still well off. He still lives in the comfortable home in Peoria Heights. He owns a vacation property in Wisconsin with an assessed value of $531,700. He still makes money on the commodities markets and enjoys a reputation as a local benefactor. In 1995, he faced an ethics investigation by the Commodity Futures Trading Commission, a federal regulatory agency, after he had used his wife's name to mask his own speculation in corn futures. The CFTC recommended fines of more than $5 million, but Administrative Law Judge George H. Painter, citing the "commendable record as philanthropists" of Bielfeldt and his wife, reduced the fine to $200,000. "Gary Bielfeldt has a clean record and positive reputation," Painter said in his decision. "This leads to the conclusion that the conduct under scrutiny here is not a good example of [his] usual practice."

Bielfeldt, who ended up paying more than $50 million in back taxes to the government after trying to get a refund for $81.8 million, insists that he is the victim of a corrupt federal taxation system. "I don’t think that Tax Court judges are going to be objective. They’re paid by the government,” he told the Center. “I don’t think you can beat the system. If someone could eliminate the IRS,” he said, “more power to them.”

Chapter 12
Hide-and-Seek

Joseph and Pamella Ross, like many others in this book, have enjoyed a lifestyle that most Americans only dream of. If the Rosses wanted a yacht, or an airplane, or a ranch in South America, they pulled out their checkbooks. If the weather in Acapulco turned a bit hot, they flew off to Geneva. . If they tired of the endless round of high-society parties among Vancouver's elite, they hopped down to Belize and started a world-class resort in the remote Mopan River Valley. They've traveled to China, Malaysia, Australia, New *Zealand*——even Thailand, where they tarried long enough for Pamella to take a course in the fine art of native cooking.

The Rosses didn't always trot around the globe, however. For most of his life, Joseph Ross called Oklahoma home. He ran an aviation company that trained pilots, and, like many wealthy men, Ross put his time and expertise at the service of his government. A subsidiary of his aviation operation, which schooled both commercial and military fliers, had a contract with the Nuclear Regulatory Commission to transport radioactive materials—including components used to build atomic weapons—to research facilities around New Mexico. He was a consultant to the U.S. Army and the U.S. Air Force, the Federal Bureau of Investigation, and the U.S. Postal Service. By his own estimate, Ross landed more than 100 government contracts during the three decades that he ran his aviation company, and for a time, he claimed, his vital role earned him a top-secret clearance.

Ross—a spry, ruddy-faced septuagenarian who oozes folksy, Oklahoma charm—was also prominent in his local community. In 1970, he was elected director of the Tulsa Community Bank and Trust Company; by 1985, he owned 34 percent of the stock of the bank's holding company and 10 percent of another savings institution, the Bank of Glenpool. He had friendly relationships with several Oklahoma politicians, including Finis Smith, who served in the Oklahoma state senate. For a brief time he retained an attorney named Frank Keating, who would later become governor of the state.

In 1986, at age sixty-two, Ross took an early retirement of sorts. He left behind Oklahoma politics, the banking business, and even aviation (he had already sold his company). He and his new wife, some thirty-two years his junior, traveled from one exotic locale to another via their yacht or private plane. Ross still worked after a fashion—he called himself a bond trader, and bought and sold Eurobonds on the international exchanges. A decade and a half later, he's still involved in one form or another with .a dozen companies scattered around the globe. His wife has remained active as well: she worked for the government of Belize, and now runs a publication that promotes that country's trade and tourism. But the new careers the couple took up did not interfere with their enjoyment of their life as retirees. And the fact that Joseph Ross is a fugitive from justice in the United States, with an outstanding federal arrest warrant, hasn't troubled their golden years either.

Ross didn't cheat on his government contracts or violate the laws that govern the shipment of nuclear material; instead, he is wanted on five counts of income tax evasion. During those years when he raked in millions from federal contracts, he stashed sizable amounts of that money in foreign bank accounts without reporting it on his income tax returns. Ross purposely broke the laws of his country to evade his taxes. And despite the best efforts of federal prosecutors, the State Department, the Internal Revenue Service, and a particularly dogged agent, Ross hasn't paid any penalty whatsoever.

The Internal Revenue Code is littered with loopholes that allow the savvy millionaire to pay proportionally far less in taxes than middle-class, two-earner parents struggling to pay mortgages, save for their children's education, and put a little aside for retirement. George Kaiser used net operating losses, Mario Kassar had his offshore trusts, and Aron and Phyllis Katz made use of real estate shelters. All of them substantially reduced or eliminated their federal tax burdens thanks to the porousness of the code. But it requires some work for the wealthy to legally avoid their taxes. Even Frederick Krieble, who took the extreme step of renouncing his American citizenship, had to engineer a complicated transaction, swapping shares of his Caribbean holding company for shares of the family's business, to make sure he was in the clear.

For Ross, all that was too much trouble. He didn't bother with the niceties of offshore trusts or foreign corporations. He didn't scour bankruptcy courts for companies with net operating losses, nor did he shop around for real estate shelters. He simply hauled cash in his private plane to Mexico, deposited it in a secret account, and used the money to invest overseas. And when the IRS caught up with him in December 1985 and issued a subpoena for him to appear before a grand jury in Oklahoma, he didn't spend a small fortune fighting his case in court. Ross and his wife, Pamella, took their money and ran. And, as they've proven time and again, there's almost nothing that the federal government can do to catch them.

"I analyzed the pros and cons and came to the conclusion that maybe one person out of a thousand could make [fleeing] work, and that was me," Ross wrote in 1994 in a nine-page letter describing his 1986 decision to take it on the lam. "I had all the ingredients—that is, money, travel, knowledge and a great wife to make it all worthwhile."

A man with the highest national security clearances, with a record of achievement and entrepreneurial success in his community, a pillar of the establishment who had created hundreds of jobs in Tulsa, a sixty-two-year-old man who had never gotten in trouble with authorities (including the IRS) anywhere, anytime, decided to abandon not only his relatives, his friends, and his country, but also his good name. It was a huge decision, but his only alternative to flight was a cell in a federal penitentiary—a fate that he had seen befall a friend and close associate.

In August 1984, a federal grand jury indicted former Oklahoma state senator Finis Smith and his wife, Doris, for tax evasion, mail fraud, and concealment of foreign bank accounts. Smith had served as chairman of the board of Tulsa Community Bank and Trust Company, of which Ross owned 34 percent. The Smiths were involved in a kickback scheme that skimmed fees owed to the state of Oklahoma from the sale of license plates. Doris ran the tag service; Finis transferred the money from Tulsa Community Bank to a bank in Texas and finally to a foreign bank account at a branch of Bancomer, S.A., in Tampico, Mexico.

In November 1985, they were convicted on seventeen counts, which carried a maximum penalty of seventy-three years in jail and over $2 million in fines. Many of Smith's former colleagues in the Oklahoma legislature wrote to the judge requesting leniency, and the pair were sentenced to six years in prison and fined slightly more than $90,000. But the former state senator and his wife, who cheated taxpayers while cheating on their taxes, served just one year and were released in the spring of 1987.

During their investigation of the Smiths, IRS agents discovered a similar route of transfers that funneled Ross's money to the Tampico branch of Bancomer. Ross had even relied on the same Mexican attorney—Gilberto Solbes Picon—to set up his foreign bank account.

Former IRS special agent John Thomas, who worked for twenty-five years in the Service's Criminal Investigation Division—the elite group of agents perhaps best known for sending Al Capone to jail for tax evasion—headed the Ross investigation. "We ended up subpoenaing bank records from the Mexican government," Thomas said. "We got his records and we were able to find quite a substantial sum that had been socked away down there and then also traced the transfers when he took it out. But we never seized a dollar from him. Not a dime."

Ross maintained accounts at Bancomer from at least 1978 to 1983—like the Smiths, transferring money there from Tulsa Community Bank—but he moved his bankroll out of Mexico when he realized that the IRS was after him. "He had a lot of money in Mexico," Thomas said. "As a matter of fact, he transferred most of the funds that he later turned into his traveling fortune out of Mexico." Thomas discovered that Ross moved some $500,000 from Bancomer to an offshore account in the Jersey Islands, one of the preferred international tax havens. "That was his grub stake to begin his international flight."

Although the IRS sleuths uncovered evidence of wire transfers, Thomas maintains that Ross's preferred method of evasion was to fill suitcases with cash and fly it to Mexico, thus leaving no paper trail. "He's a pilot and he had a cattle ranch down there, so he flew back and forth without any customs inspections or anything," Thomas said. But neither he nor the IRS got the chance to prove it in court.

With the evidence in hand, and with the knowledge that. Ross had withheld details of his secret Mexican accounts on his tax return, federal prosecutors convened a grand jury in November 1985 and subpoenaed Ross as a witness. He knew the game was up. He had seen one of his closest friends go to prison for a similar transgression, and Ross wasn't about to let the same fate befall him. It was decision time.

Ross decided to run, and the slow wheels of justice—coupled with a masterful stall—facilitated his escape. December 13, 1985: Ross agreed to meet with an IRS agent. December 14: The IRS agent was told that Ross was called away unexpectedly on business. December 17: Former U.S. attorney Frank Keating, whose office opened the case that eventually put Finis Smith behind bars, told prosecutors he was representing Ross and would advise him to cooperate—a statement that bought Ross almost two months. January 31, 1986: Keating said he no longer represented Ross. February 5: A subpoena was served for Ross's foreign bank records. February 17: Thomas got word Ross had flown the coop.

Federal authorities made no attempt to arrest Ross while the investigation was ongoing, as he hardly fit the profile of a man bent on a run for the border. Prominent attorneys represented him, he had substantial property and assets, and he had long enjoyed a relationship with the federal government. Too late, Thomas discovered the kind of man he was dealing with. "We had an agent contact him [in Aspen] and tell him that we had a subpoena for him to appear here in Tulsa," the IRS investigator recalled. "He agreed to meet the agent, and then in the ensuing twenty-four hours decided it was time to get his hat and go." Thomas believes that fleeing had always been Ross's intention. "Joe never wanted to join the ranks of the taxpayers," he said. "He was a small-town farm boy who made good by making bad."

Ross and his wife headed for sunny Acapulco, where they lived for a time under assumed names, beyond the reach of subpoenas and federal investigators. They then flew to Europe, where they found trouble: while there, they learned that one of Ross's relatives had testified about his business affairs to the grand jury. "It was after this conversation that I knew my goose was cooked and that I would be indicted," Ross later wrote in his 1994 letter describing his life as a fugitive. "Anyway, when you know you are guilty why would someone want to stay around and arm wrestle with the long arm of the government when there is no doubt that you are going to lose."

Ross had no intention of losing. He and Pamella drove to Geneva to make a bank withdrawal. "I left Pam in the car and told her that I either was going to come out of the bank with over a million dollars in bonds or I would come out in handcuffs," Ross wrote.

He needn't have worried. The innocuous fugitive, who can even blend into a market crowd in a remote Central American village, waltzed into the bank, signed for his bearer bonds, and returned to his waiting wife. Even if the Swiss authorities had arrested him, Ross had the edge: while Switzerland has an extradition treaty with the United States, tax evasion isn't covered by it. Couple this with the nation's bank secrecy laws, its numbered accounts, and its historic role as a tax haven, and Switzerland has long been a favored destination of fugitives from the IRS.

Gerald Rogers, for example, who also went by such colorful names as Claude de Blue and Ambrose I. Goldsmith, fled to Switzerland while on trial for thirty counts of securities-law and tax violations. Rogers defrauded investors out of millions while running a phony tax shelter scheme that purported to sell interests in gold mines. Swiss police arrested Rogers in 1990 and agreed to return him to the United States, but only on the condition that federal prosecutors drop their tax evasion charges. The Justice Department complied, although it did manage to ultimately convict Rogers on some of the remaining charges. . "If that's the only offense, it's very difficult to get other countries to extradite," Edward Federico, deputy assistant director of the IRS's Criminal Investigation Division, said of tax evasion. Even when there are other charges against a suspect, he added, it's difficult for the federal government to return that fugitive to the country. "Many individuals commit other violations such as narcotics violations, or money laundering, but [extraditing them] is a very time-consuming, laborious process."

Ross and his wife decided that Switzerland, safe as it was, wasn't for them, so they headed elsewhere. "We proceeded to drive across France to another country where we rented a safe deposit box and stashed our loot," Ross wrote in his letter. "All during the drive, I had a grin on my face that was, as they say back in Oklahoma, like I had butchered a fat hog. Which I had."

Ross had plenty to grin about. The federal grand jury that had been investigating him issued a five-count indictment for tax evasion in June 1986. The indictment specified only $34,000 worth of unpaid taxes— small change for both a man like Ross and the federal government. How much more in taxes Ross evaded is a matter of conjecture. The IRS believes he moved hundreds of thousands of dollars out of the United States to avoid taxation; his eventual debt to the Service could have been ten times what the initial indictment sought. Ross never appeared before the grand jury or turned over the records of his foreign bank accounts—as the law obligated him to do—so the exact amount he owes might never be determined. Because Ross fled, he avoided all that unpleasantness.

But he didn't avoid a place on the IRS's list of fugitives. Like the FBI, whose "Ten Most Wanted" list and posters of suspects have become part of the popular culture, the IRS maintains a list of people wanted for tax evasion. In many cases, other government agencies also have an interest in those fugitives. Some are drug dealers, money launderers, mobsters, and thieves. Some are millionaires who made their fortunes through dubious means. Marc Rich, an international commodities trader who evaded $48 million in taxes on an illegal sale of embargoed Iranian oil, is on the list. So is his onetime business partner, Pincus Green. Both of them live quite openly in Switzerland.

Unlike Rich and Green, however, Ross made his millions through entirely legitimate means. His resume is long with strange twists here and there, but one thing remains constant: his biggest customer over the years was the federal government.

Ross was born on an Indian reservation in 1923. His mother was seven-eighths Choctaw Indian; his father, a farmer, was Anglo. Ross developed an early interest in aviation. He skipped college and went to work for Pan Am, making planes for World War II. In 1945, in Tulsa, Oklahoma, he leased an airplane for $3 a day, hired a flight instructor, and began Ross Aviation, Inc. From those modest beginnings the company would go on to win dozens of federal contracts. Ross Aviation trained helicopter pilots for the U.S. Army at Fort Rucker, Alabama. By 1965, at the height of the Vietnam War, Ross boasted that his company trained 95 percent of the pilots on active duty there.

Thomas, the IRS agent who investigated Ross, had served in Vietnam before joining the agency. "Joe's history and the way he made his money always infuriated me," he said. "The fact he stung the government the way he did and then his arrogance as a fugitive. Joe was originally made rich by government contracts, which adds insult to injury."

Ross became a wealthy man. He owned a yacht and a private plane. Then, at age fifty-two, he was diagnosed with lymphoma, a form of cancer that attacks the body's immune system. Ross was given only a 20 percent chance of survival, but extensive chemotherapy and radiation helped him beat the disease.

The fifty-six-year-old cancer survivor was retired, living in high bachelor style in an 8,000-square-foot home on an Aspen, Colorado, hilltop adjacent to a ski resort. Ross had been divorced twice, and, as he tells the story, life changed with a classified ad placed by a woman who wanted to be a pilot. When Ross met twenty-four-year-old Pamella Denham, he instantly fell in love. The two were married within a year. And they were fugitives within six years, fleeing Aspen— Ross's last-known residence in the United States—to jet around the world, securing his overseas fortune and possessions while fabricating new identities. After picking up the Eurobonds, they drove across France to Costa Brava, the magnificent Mediterranean resort area on the east coast of Spain. Then it was off to a wonderful apartment at a quaint ski village in the eastern Alps. Greece was next on the itinerary, where they set sail for Yugoslavia in Ross's yacht, *Blue Dragon,* which was soon renamed *Joy Ging* ("good-bye" in Chinese). From the deck of their yacht, Ross and his wife videotaped a Christmas message for their family that described their travels—although without providing any clues that could lead to their capture. "He was careful not to reveal any of the details of it in case it fell into our hands," Thomas said of the videotape, adding dryly, "which it did." The couple finally left Europe and flew to South America, where Ross arranged for a new identity and a new citizenship. He remarried Pam, which entitled her to take his new name. "We continued for the next several years flying between our home in South America and our apartment in Europe," he wrote.

Despite his globe-trotting, his lavish spending, and the messages he sent back to America, the trail on Ross grew cold. When the fugitive's mother died, Thomas attended the funeral. He also attended funerals for Ross's brother and sister. "Just in case. That's what I thought. I should have known better. I don't think Joe really cared," Thomas said. "I was at all the funerals. But he wasn't.

"We never had any solid leads on him. Once in a while we'd see a credit card receipt. He traveled around a lot." Thomas feared that Ross's boast had come true—that his wealth, arrogance, and strength of will had made him the one in a thousand who could outrun the tax-man. As far as the IRS could tell, Ross had vanished into thin air. In 1989, a shadowy Liechtenstein-based company called Dordogne D.A. Anstalt purchased a luxury apartment on the seventeenth floor of the prestigious Tudor Manor in Vancouver, British Columbia, for $705,000. The condo came complete with a spectacular view of English Bay, a concierge, and high-security underground parking. A short time later, Gilberto Picon and his wife moved in.

The Picons lived the high life among the elite of Vancouver society. They attended black-tie charity balls. They were active in the Vancouver Opera Society and other cultural organizations. They attended the "best" parties. They were conspicuously wealthy—they vacationed at their French apartment with a view of Mont Blanc, and they spent summers cruising the coast of British Columbia in their new yacht, which they christened No *Refund$.*

Robert Gray, a neighbor of the Picons, said they maintained a high profile at charity events, but at home they kept the blinds closed, blocking out the view that is the prime attraction of the heavily secured building. Gray remembered that no matter what the topic of conversation, the Picons always stuck to "one sort of canned speech"—a recitation of how Gilberto, a South America native, lived in Greece for twenty years, and how the couple met when she came to work aboard his yacht.

"I found them both to be charming," Randall Ward, a Vancouver attorney, said of the Picons. "I saw them all the time. I was quite amazed at how quickly they integrated into Vancouver society." Picon spared Ward the tales of hailing from South America. And it was just as well, because Ward, a native of Kansas, wouldn't have been fooled: "He was from Oklahoma," he said, "because the accent was from there."

Of course, Gilberto Picon was the Mexican lawyer who set up the foreign bank accounts of Finis Smith and Joseph Ross. But his namesake in British Columbia was none other than Ross, who had resurfaced in Canada with a new identity. He was no longer the Oklahoma farm boy who made good by making bad, but Gilberto "Jay" Picon.

In the Vancouver circles in which the couple moved, Jay Picon was a bond trader and his wife, Pamella, was the consul of Belize, a position that entitled her to diplomatic immunity. Among the perks she enjoyed were consular license plates, which granted her the freedom to park her maroon Cadillac limousine anywhere without getting a ticket. According to her neighbors, she often took advantage of the privilege.

The tiny Caribbean nation of Belize, the only country in Central America in which English is an official language, has a population of approximately 200,000. The Belize government had only one consulate in North America before Pam opened the office in Vancouver. "She was an honorary consul," Ward said. "Most are appointed by a country and the duties aren't onerous. It's a question of who's willing to do it, who's willing to entertain and make the social appearances. There are 100 countries represented here and there's a party for one of them almost every day."

In their new identities, Pamella Picon and her husband, Jay, were both citizens of Belize. Anyone can be—anyone, that is, with $55,000 and access to the Internet, where a few dozen companies peddle Belize passports and citizenship. Even pricier diplomatic passports, which aren't advertised quite so openly, are available for purchase. Countries are rarely specified, but the price is always spelled out: Offshore Secrets, Inc., for example, offers United Nations special counselor passports for $75,000. If that's not prestigious enough, the firm also sells honorary consul passports from undisclosed foreign governments for $130,000 and European Union special counselor passports for $195,000.

The Rosses, who had forged new identities and secured their worldwide fortune, also enjoyed diplomatic immunity a mere five years after they fled the United States. Back home, the federal warrant for Ross's arrest gathered dust.

Thomas never gave up on the case, even though the government deemed Ross small potatoes. "These kinds of things fall way down on the list of priorities with terrorists and drug smugglers and all manner of ne'er-do-wells out there," Thomas said. Even among the IRS's own list of fugitives, other criminals drew more attention. "He's not at the top of that list," Thomas conceded in an interview with the *Tulsa World* in 1996. "But he's at the top of mine because he's the only fugitive I have and these crimes are serious."

For Thomas and Ross, 1996 was a pivotal year. That January, someone notified the IRS that Belize's consul in Vancouver was married to Joseph Ross. "We got an anonymous tip that identified his exact address and the name he was using: Gilberto Picon," Thomas said. The IRS agent, nearing retirement, was closing in on the man who for years had reveled in his status as a fugitive tax cheat. "I was overjoyed. I knew we finally had a chance to nab him.

"We got the information earlier in the year and it took nearly the whole year to arrange through the Department of Justice and through the help we were getting from the Canadian authorities," Thomas continued. "It took that long to establish that he was there and we could do something about it. Even though it took a long time, we worked as hard as we could to do it and it all came together right at the end of the year." Finally, on December 20, 1996, nearly a decade after Ross first fled the United States, the Royal Canadian Mounted Police arrested him outside the Belize consul general's office.

Among the documents obtained by the Center from the IRS's files on Ross is a "wanted" poster, complete with a photo of the fugitive, his vital statistics, and a description of the charges for which he's wanted. Someone at the IRS celebrated Ross's capture by writing on the poster, in thick Magic Marker, "GOTCHA!" followed by that fateful December date.

But the celebration was premature. The millionaire fugitive hired Randall Ward, his Vancouver society acquaintance, to represent him at a bail hearing. Ward told Canadian judge Deborah Satanove that he had known Ross for years (albeit under the assumed name of Jay Picon). He insisted that his client wanted to settle his troubles with the IRS, and that his financial support of four local charities proved he wasn't a flight risk. Satanove released Ross—over the protest of Canadian prosecutors—sparing him even a night in jail. She also ordered him to post $50,000 cash bail, relinquish his Belize passport, and report to a bail supervisor once a week until his extradition hearing in January.

Ross dutifully showed up for the first four meetings, but he was a no-show on January 22. Canadian police called off their short-lived search after being informed by Pamella Picon that her husband had left a note indicating he was leaving the country. Joe Ross had successfully fled from another government.

"It's no secret to me now why all the draft evaders during the 1960s went there," Thomas said of Canada. "It's nearly impossible to extradite someone from there. You basically have to try them and present all the evidence, and their bail system there and the court system tends to err on the side of letting someone out pretty quickly." Thomas never believed that Ross had any intention of returning to America to address the charges against him. "He simply didn't want to stay around and waste his time arguing with a bunch of lawyers when he had the means and opportunity to live a wonderful life on his yacht or wherever he wanted to go."

By the end of January, Belize had rescinded Pamella Ross's diplomatic credentials and the Canadian government was threatening to deport her. So she followed her husband south. Randall Ward, the Rosses' attorney, was sorry to see her go. "She would have been the next dean of the consular corps here," he said. "It's funny how you can know people and not really know that much about their life stories."

Before fleeing Canada, Pamella Picon cleaned out her apartment and relegated the couple's furniture to storage (Canadian authorities, who apparently weren't interested in the armoire, seized Pam's limousine and a Mazda sports car). A Vancouver real estate broker, hired by an unnamed law firm, listed the condo for sale. Price tag: $675,000.

Pamella headed to Belize, where she joined her husband. Joseph Ross bragged that, despite his arrest, he was still the one in a thousand who could make his life as a fugitive a success. "He wrote several letters that we got a hold of talking about how he fooled everyone, that his capture in Canada was due to bad luck, and investigative work was not a factor," Thomas said. Noting that they only found Ross through an anonymous tip, he added, "Maybe he's right. He's still a free man."

That was as close as Thomas got to Ross. "This was all happening about thirty days before I retired," Thomas said of the Vancouver arrest and Ross's subsequent escape. "If I thought we could have kept him, I would have stayed on." While Thomas still carries a grudge against the one who got away, Ross has carved out quite a comfortable living in the tropical climate of Belize, a tax haven country that knows how to keep a secret about someone's bank accounts. The U.S. State Department made some effort to get authorities in Belize to return Ross, but got no results. "As it turned out, Joe's connection with the government in Belize was not just incidental, it was quite strong," Thomas said. "The Belizean lawyer who assisted in getting him out of there also happens to be the minister of justice and had a couple of other titles," he added, referring to Dean Barrows. In 1997, Barrows was the country's deputy prime minister, attorney general, minister of foreign affairs, minister of national security responsible for police and the Belize defense force, minister of immigration, and minister of information. In his spare time Barrows also practiced law, and he wisely put Ross's assets into a Belize trust to protect them from U.S. authorities. "He and Joe were business partners," Thomas said.

Newspaper accounts in February 1997 noted that Barrows was also helping the Rosses acquire property in Belize. The land they eventually purchased is in a mountainous region, just north of the Guatemalan border. It is from here that Ross and his wife operate their latest endeavor—a luxury resort in the wilds of Belize.

From the capital of Belize City, it's a two-hour drive to the tiny town of Benque Viejo. There, the traveler must wait for a ferry that will carry him across the Mopan River to the Rosses' new hideaway. The resort's brochure refers to the strange sensation of feeling incommunicado, with no phone in your room, no stores nearby, and no newspapers within reach. "Because the resort is accessible only by our private ferry or boat, it has an atmosphere of remoteness," the brochure boasts.

The so-called jungle lodges of the Cayo District are a relatively recent phenomenon in Belize. Francis Ford Coppola has a resort in the area called Biancaneux Lodge, but Mopan River Lodge is the newest. Designed by the Rosses, it sits on ten lush acres and abuts hundreds of miles of Guatemalan jungle. Belize's "first all-inclusive luxury resort," which opened in November 1999, features orange, fig, mango, banana, and other tropical trees on perfectly manicured grounds, with twelve thatched-roof, river-view cabanas and private, shaded verandas. Atop the hill, overlooking both the town and the resort's grounds, is the large, beautiful house that Joe and Pamella Ross now call home.

The 5,000-square-foot residence, with its high ceilings and striking, orange-tiled roof, is one of the most impressive in the country. All the building materials had to be transported across the Mopan River, adding considerably to the cost of construction. The remoteness of the resort hasn't prevented the Rosses from keeping up with world events, however. Their four-foot satellite dish brings them Direct TV, with 150 or so stations. They watch CNN daily. Ross reads the *Wall Street Journal, Time,* and *Newsweek.* Despite their estrangement from their native country, they are quite aware of news developments from the United States and around the world.

But most of their time is taken up with running their resort. Pamella sees to most of the details, including planning the three gourmet meals served each day. Ross himself, known to his guests as "Jay," is *affable* and warm, full of folksy, Oklahoma charm and ever the host. He conducts tours to nearby points of interest. Xunantunich is a 1,000-year-old Mayan ruin with a 120-foot-high pyramid offering a spectacular view of Guatemala. Ross climbs every step with his guests—not bad for a seventy-six-year-old man. None has a clue that he is an international fugitive.

In December 1999, the Center visited Ross at his Belizean lodge. "Hello, I'm Gilberto Picon," he said, his hand outstretched. "I must be pretty damn important for you to travel halfway around the world to come see me," he added with a twinkle in his eye and a smile. Nonetheless, he declined to sit for a formal interview. "I won, so why do I need to talk to anyone?" he asked. "There's no use in gloating."

And indeed, it's clear that Ross has won. With a beautiful wife by his side, twenty-five cheap workers he hires and fires, and a spectacular home and resort, he is the master of his own universe. The Third World ambiance, with its intrinsic difficulties, is still a reality he can substantially dominate. The poverty around him is not his poverty; Ross believes that he is helping some of the Belizeans—and he is.

He and Pamella advertise their resort on the Internet; Frommer's, the travel book publisher, visited the Mopan River Lodge in its first month of operation in preparation for a feature in a forthcoming guidebook. Pamella is the editor and publisher of an annual tourist booklet called *Belize Report.* The compilation of outstanding Belizean restaurants, hotels, resorts, and diving expeditions is even on the Internet, complete with links to tourist sites, offshore banking advisers, and articles explaining how to become a citizen of the small country. Naturally, you can send them e-mail.

Thomas, who retired in January 1997, just after Ross slipped through his fingers for the second time, takes some comfort in the failed Vancouver attempt to bring the millionaire to justice. "It brought me some satisfaction that we interrupted his Canadian sunset there at the end," he said.

"I regret I never got to meet him face-to-face. I'm thinking about sending him an e-mail and telling him it's not over until it's over. I doubt he'll be much frightened by that, but then again, I don't think he ever expected to be found and arrested in Canada either.

"He still got away and he's still got his money."

Chapter 13
What You Can Do

Frustrated that the wealthy can find ways to avoid paying their fair share? That movie moguls move profits offshore, *Forbes* 400 members play the code like a fiddle to lower their taxable income to zero, and that one tax evader, a former government contractor, lives the good life in Belize without a care in the world? Does it seem like only the rich can avoid their taxes, and why can't someone in the middle class ever get away with it?

That may sound like a pitch for the latest book or Internet site touting dubious tax avoidance methods, but there's a good reason not to try them yourself. Just ask the Skalas.

For more than a dozen years, Christopher Skala and his wife, Nuris, ran a video production firm in Charlotte, North Carolina, called Television Innovation Company, Incorporated, that produced instructional videos. Skala also served as a producer for a number of British sitcoms—most notably *Brighton Belles,* which tried to export the geriatric charm of *Golden Girls* to the British Isles. The couple had built his company into a lucrative venture. From 1994 to 1995, according to the Internal Revenue Service, the Skalas' company had increased its revenues from more than $300,000 to slightly less than $1 million. During that time, they moved much of their profits—more than $531,000 in the two-year span—into a pair of trusts, which, they had been promised, would substantially reduce their taxable income.

A trust is a legal arrangement that allows an owner, the grantor, in legal parlance, to transfer the title of his assets to an independent entity. A trustee manages the assets for the trust's beneficiary, who is chosen by the grantor. The trustee has a fiduciary duty to ensure that the beneficiary's interests are protected. Under the Internal Revenue Code, a trust owes taxes in much the same way a regular taxpayer does.

If it earns income, it must pay taxes.

In 1994, the Skalas heard about a series of seminars offered by National Trust Services, a Missouri-based firm that promised to protect their assets from lawsuits and provide a tax benefit. The firm claimed on its Internet site that "Trusts are taxable entities but many taxes can be deferred by the ability to distribute cash and assets between the trusts." After attending a seminar, the couple hired National Trust and paid it $10,000 to set up their two trusts.

The Skalas frequently called National Trust Services representatives for help with their two trusts. They found out how to transfer income from their business, how they could deduct all their personal expenses from the trusts' income. At tax time, they used a National Trust accountant to prepare their returns. In 1994, the Skalas filed a return claiming $37,331 in income. The next year, their return showed they had lost $1,984. Their National Trust-recommended accountant claimed the Earned Income Tax Credit, intended to help the working poor, for their two children. The Skalas were satisfied that the low taxes they paid were "legal and acceptable."

The IRS disagreed. When the Service audited their 1994 and 1995 returns, the Skalas turned again to National Trust Services for advice. They were referred to Frank Kowalik, who they were told was an expert in dealing with the IRS. He's an expert of sorts; in 1984, he told the Center, he was jailed for refusing to file a tax return. Kowalik is a tax protestor, and a relatively famous one at that. Like the self-proclaimed offshore tax haven guru Jerome Schneider, he's written a book on his area of expertise, called *IBS Humbug: Weapons of Enslavement,* that can be purchased from a few dozen sites on the Internet. He claims that the Sixteenth Amendment, interpreted literally, applies only to federal workers. "If you're not a federal government employee and you file a 1040 form, the federal government accepts your money as a gift," he said.

When contacted by the Center, Kowalik emphatically denied having anything to do with either National Trust Services or the Skalas. Twice. "I never advised anybody to do anything," he said. Eventually he admitted that the Skalas contacted him directly. "They got us into the act to help with what they were doing; they needed somebody to help them make a response to the IRS," he said.

Kowalik told them to make no response at all. He advised them to refuse to sign for certified mail from the IRS, or answer letters or phone calls from auditors. If agents did manage to reach them, he told them to answer any questions with a series of their own questions. The Skalas took the advice. Then, in July 1998, the Service slapped them with a Notice of Deficiency for taxes and penalties for more than $991,000.

"There were criminal fraud charges brought against us," Nuris Skala said, "but they were all dropped." That's because the Skalas hired a tax attorney, one not connected with National Trust Services, who filed a petition in U.S. Tax Court claiming the couple had been victimized. "The Skalas were victims of an elaborate and sophisticated 'tax protestor' organization, and did not commit fraud or negligence in reporting their income or expenses. . . . [T]he Skalas have reasonable cause for the deficiency, and should not be charged any negligence, fraud, or other penalties."

Abraham R. Brown, who represented the Skalas, said, "The IRS just asks the taxpayer to redo the returns." The Skalas, who in all their years of paying taxes had never had a problem with the IRS prior to hiring National Trust Services, refiled their returns, and paid what they owed.

Abusive trust and shelter schemes have proliferated in the last few years, and both the IRS civil and criminal divisions have tried to crack down on promoters of illegitimate schemes that promise tax-free living but instead provide tax nightmares for the people who buy into them. There are certain warning signs—the Service calls them "red flags"— that should alert any potential taxpayer that a tax planner's services are too good to be true. Promises that an individual can deduct the cost of his residence or his children's education expenses are sure signs something's amiss. There are also advertising slogans that should make a taxpayer wary, including the ever-popular line, "The IRS doesn't want you to know about this."

The IRS maintains a hotline for individuals to check the claims of tax shelter promoters, and report abusive operators. The Service encourages individuals who've just been told something that sounds too good to be true—a lifetime of living without paying taxes—to run the scheme by them. They can tell you whether or not a scheme will get you charged, as the Skalas were, with criminal fraud.

But beyond ensuring that your own return is "true, correct, and complete," as the bottom of Form 1040 makes you avow, under penalty of perjury, when you sign it, there is not a great deal you can do to limit tax avoidance and evasion. You can refuse to pay cash for services. If an auto mechanic or a plumber or an accountant who does bookkeeping for you in his spare time asks to be paid in cash, it's quite possible he might not report some or all of the amount you paid on his tax return. It may seem penny-ante, but collectively, what the IRS calls, "informal suppliers" and a closely related group, sole proprietors, who have businesses in which they are paid partially or primarily in cash cheat the government out of some $29.2 billion a year.

Payments by check or credit card both leave paper trails; cash, by contrast, can be used without detection by the IRS. Someone who doesn't deposit the fees he earns in a bank account can spend it without fear of the Service discovering it. By insisting on writing a check or using a credit card, you can ensure that the people you do business with will be more likely to report their earnings accurately to the IRS.

More and more Americans own stock, and if you happen to be one of them, you are entitled to receive copies of each corporation's Form 10K, the annual report it files with the Securities and Exchange Commission. Unlike the glossy annual reports that tout the company's achievements in the past year, Forms 10K—which are generally printed on cheap paper in small type—include information on the taxes the company expects to pay. The figures in the Form 10K don't necessarily accurately reflect what the company will pay, but rather represent the company's good faith estimate of the amount of taxes it will owe from its operations. Buried in the notes at the end of the report, the company will explain whether it paid taxes at the federal statutory rate and, if not, why not.

As a shareholder, of course, you have a vested interest in the company's performance, but not everything that helps its bottom line helps yours. As the percentage of the tax burden paid by corporations has dropped dramatically in the last half century, individuals have had to pick up more and more of the tab. Think of it this way: the taxes that a company you own doesn't pay come out of your pocket.

Corporations don't always have the best interests of their shareholders first and foremost in their minds, but that shouldn't prevent you from writing the company to express your displeasure. You might be told that the company had in fact paid more in taxes than it claimed in its 10K, or it might convince you that all the deductions it took were proper. But as an investor, if you have any doubt that the company you own a piece of is paying its fair share of taxes, you can always take your money elsewhere.

Of course, that would be easier to determine if corporations, like charities and some nonprofit groups, were obligated to make their tax returns public. Any number of commentators have argued that the strength of American companies and financial institutions relative to other nations is a result of the transparency—the amount of information corporations, banks, and the like must make public. If corporate tax returns were public, investors would have another tool to determine whether the glowing earnings statements companies like to release had any basis in reality. For the truth of the matter is that many profitable companies tell the public one thing and the IRS something else entirely. Corporations might be less willing to engage in elaborate tax shelters if they had to reconcile the bottom lines they report to the public with the ones they report confidentially to the government.

While these few modest suggestions might help a little, the fact remains that tax avoidance and evasion costs the government more than $195 billion a year, and if the past if any prologue, that number will continue to grow.

Conclusion

Taxes are as old as recorded time. Indeed, as Charles Adams wrote in *For Good and Evil*, “the three roots of modern civilization – ancient Greece, Rome, and Israel – involved histories filled with drama centered on taxation.” Not only have many great upheavals of history been tax related, but the American independence movement was founded when colonists began meeting with one another to protest the Stamp Act taxes.

There can be no taxes, of course, without something of value to assess. From the first days that *Homo sapiens* walked the planet, they have accumulated wealth, in the broadest sense. And the accumulation and concentration of wealth has always occurred alongside the relative absence of it. The perpetual challenge of public governance is how to achieve fairness and consensus between the wealthiest and the poorest of society. The extent to which that difficult equilibrium actually exists can sometimes be gauged by who really pays the taxes, and how much.

As we have shown in *The Cheating of America,* many of the nation's wealthiest individuals and its largest corporations are *not* paying their fair share of taxes today. Beyond that disturbing fact, it is no secret that the United States now has the widest gap between rich and poor of any industrialized country. One percent of the population controls 40 percent of America's assets. More billionaires have been created in the last fifteen years than during any other time in U.S. history. At mid-year 2000, the economy was growing at a sizzling rate of 5.8 percent a year, generating $1.5 billion worth of new wealth each day. That is enough to create sixty-two new millionaires every hour.

At the same time, the number of "full-time, year-round workers" living in poverty shot up 459,000 in 1998 to 2.8 million, the biggest such increase in U.S. history. Between 1995 and 1998, mean net worth dropped for the lowest income group and increased for all other income groups, with the largest gain for families with incomes of $100,000 and above. One American child in five today lives in poverty. And the number of bankruptcy cases has increased almost 70 percent since 1995.

Generally, the least-advantaged Americans are also our least-enfranchised citizens politically, neither substantially contributing to political campaigns nor voting. Ordinary citizens are in no position financially to hire Washington lobbyists to attempt to influence U.S. tax policy or urge greater enforcement of the current tax laws. Poor and middle-class taxpayers are not organized en masse as an interest group. They do not have a telegenic spokesperson omnipresent in national news media coverage. They possess neither the carefully marshaled information nor the access to influence policymakers.

Against this stark dichotomy today, to what extent are our federal government officials maintaining the equilibrium between the wealthiest and the poorest segments of society?

Well, the United States does have a progressive tax system, in which the wealthiest citizens pay a higher percentage of their annual income in taxes, and, as we have noted, more than a million Americans making $200,000 or more do in fact pay their taxes. But at the same time, *thousands* of the most affluent individuals and corporations routinely avoid and evade paying billions of dollars in taxes each year. And the level of unabashed greed seems to be increasing. Everyone from the principals of the largest accounting, law, and brokerage firms to the sleaziest, fly-by-night Internet shysters are promoting offshore, cyber-space, and other avoidance schemes, and many of the most respected corporations and individuals are heeding their advice. There is no more audacious example of today's tax-shirking shenanigans that we could have cited than ex-con Jerome Schneider, author of *The Complete Guide to Offshore Money Havens,* who wrote, "It helps to realize that the [IRS] audit process is not so much an investigation as it is a negotiation. Your tax return was like your first offer to the IRS."

If you have a team of paid accountants and lawyers, Schneider is unfortunately correct. Most Americans, of course, can't afford such high-priced talent, and are practically terrified at the prospect of being audited. But hundreds of the best tax minds in the nation, including former commissioners and other ex-IRS officials, reap millions of dollars annually by helping the largest corporations and wealthiest citizens avoid paying their fair share of taxes. They overwhelm and wear down the IRS staff, dragging tax cases out literally sometimes for ten to twenty years, typically settling with the government in the end for pennies on the dollar of what they actually owe. Recall the disconcerting words of an IRS lawyer who told us, "When there are ten thousand documents, some of which are bank statements containing thousands of transactions, and the opposition argues over the significance of every single item, the process becomes extraordinarily difficult." The attorney, who requested anonymity for obvious reasons, added, *"Why do you think we go after the little guys? They can't fight back."*

In other words, it is well known, both inside and outside of government, that the Internal Revenue Service cannot stop this annual hemorrhage of major potential income to the U.S. Treasury, due to tax avoidance and evasion by the nation's most powerful and privileged interests. The IRS commissioner acknowledges that nearly $200 billion a year in taxable income is not being paid; the actual number is likely much higher.

Given the extent of this problem, then, perhaps the most surprising finding of *The Cheating of America* is the lackadaisical nonresponse by federal officials, from Congress to the White House, from the Office of Management and Budget to the Justice Department to the Internal Revenue Service. Instead of increasing the number of revenue agents and auditors, instead of increasing examinations of individual tax returns, instead of finding ways to prosecute more tax cheats, exactly the *opposite* is occurring.

From fiscal year 1989 to 1999, while the total number of individual tax returns filed jumped 14 percent (from 107 million to 122 million), the number of permanent IRS employees dropped 26 percent (from 111,980 to 82,563). The president and Congress also cut the number of IRS Office of Examination staff, including revenue agents and tax auditors, by 34 percent, from 31,315 to 20,736. Not surprisingly, the percentage of audits of Americans keeps declining each year. Worse, under political pressure, the IRS is auditing poor people more often than well-heeled taxpayers. And tax-related prosecutions are half what they were nearly twenty years ago.

Why, in the face of garish flouting of the nation's tax laws, would our public officials reduce the resources available to enforce those laws? Why would they sharply reduce the number of revenue agents, auditors, and, over time, taxpayer audits? Why would they reduce by half the number of tax-related criminal prosecutions?

To try to get some answers, we requested an on-the-record interview with Charles O. Rossotti, the commissioner of internal revenue. But he declined to talk with us.

Is it entirely coincidental that as presidential and congressional campaign costs have skyrocketed into the billions of dollars—political careers brought to you by the wealthiest 4 percent of America—the tax enforcement dogs have been called off of the wealthiest individuals and corporations? Is it remotely possible that the political parties and their top politicians who control Washington have been told repeatedly by their powerful patrons that they don't particularly appreciate being pestered by persistent revenue agents, auditors, and prosecutors? We don't know how to explain this intriguing confluence of circumstances, and our public officials would no doubt be shocked at *any* suggestion that they do not fully favor enforcing the nation's tax laws. But how else would they explain these odd, but compelling, facts? Getting a straight, dead-honest answer to any inconvenient political question these days is nearly impossible, certainly, but that does not mean that we should stop asking them. These curious facts confound easy, pat, ideological dogma. Conservatives, for example, have never seen a government agency voluntarily slash thousands of its own employees from the public payroll—and no one is suggesting the IRS is different from any other bureaucracy in that regard. And liberals, not known for being "tough on crime," have watched the Justice Department nearly double in size in the past decade and probably cannot fathom why the level of any type of tax-related federal prosecutions has declined.

So we have a series of questions that no one in Washington is particularly able or anxious to answer. The first prescriptive remedy toward even attempting to achieve the above-described equilibrium between the wealthiest and the poorest segments of society when it comes to taxes is very simple: demand that our elected representatives answer our questions. Why have tax return examinations and enforcement efforts decreased at the IRS in recent years? How serious are our federal officials in both parties, at both ends of Pennsylvania Avenue, about upholding the current tax laws today for all Americans? Politicians should be asked bluntly whether or not they favor increased enforcement of the existing tax laws. Do they think the poor should be audited more often than the rich? Should billionaires be able to renounce their U.S. citizenship in order to avoid taxes, and still be able to return home for months on end because the law barring their reentry is rarely, if ever, enforced?

Expect considerable squirming, hemming, and hawing. They're not used to getting such direct questions, whether from the public or the news media. But not until there is a serious, honest dialogue in this country about the thousands of wealthy individuals and corporations who don't pay their fair share of taxes will the cold winter of silence, obfuscation, and denial begin to thaw. It's great to conduct public hearings in Washington featuring tearful anecdotes about how ordinary taxpayers have been harshly treated by IRS officials, and it's great that new legislation was enacted increasing taxpayers' rights to redress wrongs committed against them. Who is against that? But how about a traditional congressional investigation into the issues raised here? Why, when it comes to paying taxes and being audited or prosecuted, do certain members of our society lead charmed lives?

Even if you assume the absolute worst in answering these questions, and thus succeed in elevating your blood pressure, the entire tax fairness subject is further complicated by our own deep personal ambivalence. On the most basic level, it is counterintuitive—indeed, almost heretical—to yearn for better enforcement of the tax laws, even in the name of fairness. Let's face it—no one particularly enjoys paying his or her taxes. And the tax collector consistently has earned the contempt of citizens of all societies for centuries.

Throughout the ages, raising revenue frequently has been a brutally repressive and corrupt means of controlling the populace and maintaining power. And citizens have sometimes fled their country in protest, or vented their intense anger directly at the tax collector. Weeks before the 1989 Tiananmen Square massacre in China, for instance, the official government newspaper, the *People's Daily,* reported that tax evasion was widespread. Over the preceding two years, thirteen income tax agents had been murdered, and over 7,000 had been injured by rebelling taxpayers.

Over the years, this intense, universal anger about taxes and those people with the unenviable job of collecting them has produced at times a somewhat perverse, corollary effect—admiration for the tax evader. In his 1776 classic, *The Wealth of Nations,* Adam Smith did not regard tax evasion as a crime. Indeed, he believed the tax evader is:

> in every respect, an excellent citizen, had not the laws of his country made that a crime which nature never meant to be so. In those corrupted governments where there is at least a general suspicion of much unnecessary expense, and great misapplication of the public revenue, the laws which guard it are little respected.

One of the reasons we have conflicted feelings about tax evasion is, frankly, because so many people at all levels subtly cheat on their taxes, from dubious deductions to underreporting cash earnings to ... you name it. Beloved humorist Will Rogers once said, "the income tax has made more liars out of the American people than golf has." No improvement of the U.S. tax laws and their enforcement, of course, will ever completely eliminate human greed and fraud. And as citizens, because of our historic ambivalence about taxes, tax collectors, and the power of the state, it is difficult to muster great enthusiasm for increasing the number and resources for government auditors and prosecutors. That is certainly understandable, and this natural reticence of the populace partly explains why no one is really protesting the tepid enforcement of tax laws for certain individuals and corporations.

The central issue of *The Cheating of America,* and the subject a majority of Americans are frustrated about today, is tax fairness. Does our tax system and the Internal Revenue Service's enforcement of tax laws today maintain the equilibrium between the wealthiest and the poorest segments of society? Clearly not. Two-thirds of Americans already viscerally recognize this. They're convinced that upper-income taxpayers do not pay their fair share, and the information presented in this book affirms that sense.

Unfortunately, the opportunities for avoidance and evasion by our most fortunate citizens and corporations are increasing exponentially, because of the forces of technology and globalization.

On the most basic geopolitical and economic levels, the balance of power between governments and corporations clearly has shifted. As Hans-Peter Martin and Harald Schumann wrote in the international bestseller *The Global Trap,* today democratically elected governments can no longer dictate the level of taxes. Instead, "the people who direct the flow of capital and goods themselves establish what contribution they wish to make to state expenditure." For example, in April 1996, at a dinner with Bundestag deputies, Jurgen Schrempp, the chairman of Daimler-Benz A.G., announced that his company would no longer be paying to Germany any taxes on profits. "You won't be getting any more from us," he told the members of the German parliament.

Similarly, because of the exploding technologies and their inability to regulate cyberspace, governments today find themselves impotent to tax trillions of dollars in potential new revenue from electronic commerce. As one aptly titled book, *The Sovereign Individual,* put it, "anyone with a portable computer and a satellite link will be able to conduct almost any information business anywhere, and that includes almost the whole of the world's multi-trillion-dollar financial transactions. This means that you will no longer be obliged to live in a high-tax jurisdiction in order to earn high income. . . . Cyberspace is the ultimate offshore jurisdiction. An economy with no taxes. Bermuda in the sky with diamonds."

So besides corporations and individuals tax shopping around the world and utilizing creative bookkeeping—which they have been doing increasingly for decades—the new technologies further enable those who are hell-bent on outright criminal evasion to achieve it. Not only is cyberspace the final frontier of finance, it is also a growing safe haven for secrecy. With the emerging encryption technologies, financial transactions are becoming virtually impossible to track by the authorities. Since foreign income is often undetectable, people now more than ever—without leaving home—can choose where to officially "domicile" their business activities and the extent to which they choose to pay income tax.

And the combination of offshore banks and cyberspace is the ultimate elixir to tax evaders and others. Today, there are more than 3 million corporations operating worldwide with no identifiable owner. Virtually untaxable, offshore bank deposits (not just from U.S. citizens) are now estimated at $3 trillion, and rising. The offshore destination of choice is the Cayman Islands, with 585 banks and $700 billion in deposits. Meanwhile, the British Virgin Islands has over 370,000 "anonymous" corporations. The IRS estimates there are sixty to ninety jurisdictions today offering "offshore services."

But consider the haunting case of the now defunct European Union Bank of Antigua, which billed itself "the world's first Internet bank." Owned by Russians with ties to organized crime, the bank was chartered by the corrupt government of Antigua. It had two purposes: to serve as a "cutout" to conceal the origin and destination of funds coming from the former Soviet Union, and to solicit deposits on the Web. Most of the depositors were Americans evading U.S. taxes.

As it turned out, the computer server was in Washington, D.C. The man operating the "bank"—and the personal computer he relied on— were in Montreal, Canada. And depositors were strewn all over the world. The bank collapsed when money was "loaned" to a mysterious Bahamian shell company, and then disappeared. Depositors lost $15 million.

Former Senate investigator and Washington lawyer Jack Blum, who is a consultant on bank secrecy and financial havens to the United Nations and the IRS, testified before Congress about the EUB affair. "Who has jurisdiction in cases like the European Union Bank? Where was the crime committed? Which country should pay for the investigation and where should the offenders be prosecuted and imprisoned? These jurisdictional problems are reaching crisis proportions," he said in his testimony. Years earlier, in the late 1980s, Blum was instrumental in uncovering the notorious Bank of Credit and Commerce International (BCCI) fraud in twenty-six countries. He told the Center that now, because of the virtual nature of money, and the amazing speed with which offshore cybercriminals can operate and disappear, government-to-government, international cooperation is ineffectual and outmoded.

"Traditional law enforcement tools simply don't work," he said in an interview. "We need an entirely new international system. . . . This is *the* issue of the future."

Most of the anecdotes in *The Cheating of America* involve "good old-fashioned" tax avoidance and evasion, gleaned from thousands of pages of U.S. Tax Court records filed over the past decade. And those traditional tax avoidance schemes and crimes, as we have discussed, are frankly beyond the current competence and budget of the Internal Revenue Service. The full dimension of the tax fairness crisis becomes much clearer when viewed in the context of globalization and the new technologies. Money today has no real home, and those with the most money will be the most aggressive and proficient at hiding it from government authorities. The rest of us, not inclined or able to afford access to offshore havens or cybertax avoidance schemes, will continue paying our taxes, in full.

All of which means that, unless something is done very soon, we may lose even the pretense of maintaining the equilibrium between the wealthiest and the poorest segments of American society. Cynicism about the United States as a government *of the people, by the people and for the people* will rise inexorably.

In August 1864, in the closing months of the Civil War, the first U.S. president to implement an income tax, Abraham Lincoln, said: "It is fair that each man shall pay taxes in exact proportion to the value of his property; but if we should wait before collecting a tax to adjust the taxes upon each man in exact proportion with every other man, we should never collect any tax at all."

Then and today, the government muddles forward, year after year, collecting taxes in an inexact manner. We, as a people—call us "the little people"—complain and correctly perceive that this imprecision favors wealthier folks over us. The rich and the large corporations are more able to exploit the loopholes than we are. In fact, their lawyers and lobbyists wrote those loopholes. When wealthier folks do more than exploit those loopholes, and actually cross the line from avoiding to evading taxes, chances are nobody will be going to prison.

But despite the fundamental unfairness of it all, despite our simmering outrage, we also intuitively know that no civilization and no government can exist without taxes. And so we keep on paying them, because whether or not we want to admit it, despite the many imperfections, we like living in the United States of America. As nation-states go, and probably as long as nation-states exist, this is still the best show on Earth.

And taxes are the price of admission.

Source Notes

PREFACE

Leona Helmsley's tax evasion trial and conviction were well documented in the popular press. In particular, we relied on reports from the *Washington Times, Chicago Tribune, The Record* (Hackensack, N.J.), *St. Louis Post-Dispatch,* and the *Washington Post* during the latter part of 1989.

INTRODUCTION

The continued fascination with the television show *Dallas* and the Southfork Ranch have been captured in numerous articles over the years. Information about the Southfork Ranch and its parent company, Forever Resorts, came largely from press reports and the organizations' respective Web sites, *www.southforkranch.com* and *www.foreverresorts. com.* Especially helpful were Sheryl Smith-Rodgers's July 5, 1998, article in the *Houston Chronicle* and Diana Scott's March 10, 1996, *Sunday Telegram* (Worcester, Mass.) article.

For background on Rex Maughan and his company, Forever Living Products International, we consulted numerous magazine and newspaper sources, including Duncan Maxwell Anderson's interview with Maughan in *Success,* September 1995, and Christopher Palmeri's August 14, 1995, *Forbes* article, as well as Forever Living Products' Web site, *www.foreverlivingproducts. com.*

Information on Rex Maughan and his company's tax struggles with the Internal Revenue Service comes from several cases filed in U.S. Tax Court: *Rex G. Maughan and Ruth G. Maughan v. Commissioner,* Docket No. 23130-94; *Selective Art, Inc. & Subsidiary, Deco Container Print, Inc., formerly Forever Living Products, Inc. & Subsidiary, Deco Container Print, Inc. v. Commissioner,* Docket No. 23129-94; and *Selective Art, Inc. v. Commissioner,* Docket No. 26338-96.

We relied on several books, articles, and Internet sources in documenting the history of tax evasion in the United States. Robert M. Willan's *Income Taxes: Concise History and Primer* (Claitor's Publishing Division, 1993) was extremely helpful in documenting the numerous changes in the tax code. Donald L. Barlett and James B. Steele's *America: Who Really Pays the Taxes?* (Simon & Schuster, 1994) provided much valuable information on the changes in the income tax system, as well as several anecdotes of evasion. We are also grateful to Tax Analysts Online *(www.tax.org)* for its very thorough and often in-depth discussion of tax history in its Tax History Project. Also helpful in writing this section were Charles Adams's *For Good and Evil* (Madison Books, 1993), Ron Chernow's *The House of Morgan* (Touchstone, 1990), and the Department of Treasury's *(www.ustreas.gov)* Learning Vault.

In discussing corporate tax rates, we cited the Department of Treasury's white paper "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals," issued in July 1999, as well as William Greider's *One World, Ready or Not: The Manic Logic of Global Capitalism* (Simon & Schuster, 1997). We also cited data and processed numbers from the 1995 Corporate Income Tax Returns annual, published by the IRS's Statistics of Income Division. David Cay Johnston published several articles in the *New York Times* that were helpful in the sections on corporate income tax and individual audit rates. We used data from the 1995 Individual Income Tax Returns annual, published by the IRS's Statistics of Income Division, and audit rate analysis from an April 1996 General Accounting Office report, "Tax Administration: Audit Trends and Results for Individual Taxpayers." Also cited in the introduction were Jerome Schneider's *The Complete Guide to Offshore Money Havens: How to Make Millions, Protect Your Privacy, and Legally Avoid Taxes,* revised and updated 3rd ed. (Prima Publishing, 2000) and James Dale David-son and Lord William Rees-Mogg's *The Sovereign Individual* (Simon & Schuster, 1997).

1: NO MORE THAN A LIVING

The information about Jane Morgan came from a small Tax Court case (those involving disputed amounts of $50,000 or less). Like many other average Americans the Center interviewed in the more than two years spent researching this book, Ms. Morgan preferred that we not use her real name. Some cited fear of future IRS retaliation when they declined to speak to us, others feared that their friends, coworkers, and neighbors would think that they had done something unethical or illegal, and still others did not want details of their personal finances revealed in a commercially published book. In all cases, the Center respected the wishes of those ordinary, private citizens who preferred not to have their tax returns scrutinized a second time, in a far more public way.

For historical information on the tax code, Robert M. Willan's 1994 book *Income Taxes: A Concise History and Primer* (Claitor's Publishing Division, 1993) proved invaluable. Tax Analysts, a nonprofit organization based in Alexandria, Virginia, was also an amazing source of information on the history of the Internal Revenue Code. Its Tax History Project, an archive of documents from the twentieth century ranging from presidential speeches to analyses by Treasury Department bureaucrats, sheds valuable light on an all-too-neglected subject. Its work is available on the Internet at *http://taxhistory.tax.org.*

Statistics came from a wide range of sources, including the Internal Revenue Service, the Bureau of Economic Analysis, the Economic Report of the President, the Census Bureau, and the Bureau of Labor Statistics. The calculations on the relative tax burdens from 1956 and 1996 are the authors' own.

The information on Roy M. Speer comes primarily from the briefs, transcripts, and exhibits in *Roy M. and Lynnda L. Speer v. Commissioner,* Docket No. 6627-94, filed in U.S. Tax Court.

3: GIMME SHELTER

Details on the Merrill Lynch tax shelter scheme were derived primarily from briefs, court rulings, transcripts, and exhibits in the following cases filed in U.S. Tax Court: *ACM Partnership, Southampton-Hamilton Company, Tax Matters Partner v. Commissioner,* Docket No. 10472-93; *ASA Investerings Partnership, AlliedSignal Inc., Tax Matters Partner v. Commissioner,* Docket No. 27320-96; and *Saha Partnership, Brunswick Corporation, Tax Matters Partner v. Commissioner,* Docket No. 1470-97.

The information on corporate income taxes and effective corporate tax rates are the authors' calculations based on data from the Internal Revenue Service's Statistics of Income Bulletin, various years; the Economic Report of the President, various years; and the Survey of Current Business, various years, published by the Bureau of Economic Analysis of the Department of Commerce. For the history of various provisions of the corporate income tax, we relied heavily on Robert M. Willan's book *Income Taxes: Concise History and Primer* (Claitor's Publishing Division, 1993).

We used the annual reports filed with the Securities and Exchange Commission to calculate the tax burden of individual companies and the thirty companies that make up the Dow Jones Industrial Index, unless otherwise noted.

Information on Apple Computer Incorporated's offshore subsidiaries and transfer pricing practices came from the Tax Court case *Apple Computer Inc. and Consolidated Subsidiaries v. Commissioner,* Docket No. 5496-93, while details on the company's use of offshore tax havens were taken from the Tax Court case *Halliburton Company and Subsidiaries v. Commissioner,* Docket No. 7838-96.

The history of Chrysler was downloaded from the company's old Internet site, *http://www.chrysler.com.* John Loffredo's testimony before the House Ways and Means Committee took place on June 30, 1999. Details on Chrysler's dispute with the IRS came from *Chrysler Corporation v. Commissioner,* Docket No. 22148-97, filed in U.S. Tax Court. The information on Daimler-Benz's tax dispute came from the Tax Court case *Daimler-Benz of North America Holding Company, Incorporated and Subsidiaries v. Commissioner,* Docket No. 8851-94.

As always, the work of several commentators in *Tax Notes Today* was helpful, notably that of Joseph A. Bankman and contributing editor Lee Sheppard.

5: WELL-TO-DO

The boom and bust cycles of Oklahoma's economy, and the failure of many of the state's banking institutions, are well documented in numerous articles in the *Tulsa World* and the *Daily Oklahoman.* We also relied on a pair of thorough reports on the banking crisis of the late 1980s prepared by the Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and the RTC Experience, 1980-1994,* and *History of the Eighties: Lessons for the Future.* The office of State Representative Russ Roach, along with Oklahoma's Department of Commerce and the State Finance Office, provided invaluable historical and current economic statistics on the state's last great boom and bust.

We relied on numerous sources for biographical information on George B. Kaiser, including interviews with fellow oilmen in Tulsa, William P. Barrett's March 4, 1991, article in *Forbes,* "Shrewd Sooner," and Jim Killacky's profile, "Quick-witted Tulsan Leads with One Eye," in the *Daily Oklahoman,* April 18, 1999.

We found Robin Robinson's daily reporting in the *Tulsa World* on the sale and recovery of the Bank of Oklahoma particularly helpful. We also sifted through dozens of documents the bank's holding company filed with the Securities and Exchange Commission regarding the bank's sale and subsequent financial performance.

The information on George B. Kaiser's tax situation comes from *George B. Kaiser and Betty E. Kaiser v. Commissioner,* Docket no. 10755-97, and *GBK Corporation and Subsidiaries v. Commissioner,* Docket no. 10756-97, both filed in the U.S. Tax Court.

The suits filed against Kaiser-Francis Oil Company by royalty owners in Oklahoma include *Galen Bridenstine, for himself and all others similarly situated v. Kaiser-Francis Oil Company et at.,* Docket no. CJ-95-54, filed in the District Court of Beaver County, Oklahoma, and *Murlene Mayo et al. v. Kaiser Francis Oil Co, et al.,* filed in the District Court of Grady County, Oklahoma.

Finally, we are indebted to the dozens of Oklahomans who told us their experiences living through the boom and the bust, which greatly broadened our understanding of the 1980s economic collapse that some, including George Kaiser himself, have said was statistically worse than the Dustbowl Depression of the 1930s.

8: THE MARKET WIZARD

The bulk of the information on Gary Bielfeldt and his battles with the Internal Revenue Service is derived from testimony and documents from the U.S. Tax Court case *Gary K. Bielfeldt et ux. v. Commissioner* Docket No. 5936-96. Several other cases proved helpful in documenting the pension plan aspects of the case, including *Bielfeldt & Company v. Commissioner,* Docket No. 116-96, 120-96, 6080-96, and 6081-96. Gary Bielfeldt also sued the IRS to contest the Service's denial of development costs for a downtown Peoria commercial center (see *Gary K. and Carlotta L. Bielfeldt v. Commissioner,* Docket No. 7264-96). Bielfeldt's son and business partner, David, sued the IRS in connection with his income tax returns (see

David andjulie Bielfeldt v. Commissioner, Docket No 6155-96). His daughter, also a partner in Bielfeldt & Co., sued the IRS in *Linda S. 'Bielfeldt v. Commissioner,* Docket No. 6154-96.

We collected other valuable information about Bielfeldt, his business dealings, and his Tax Court cases in several telephone interviews, including with Gary Bielfeldt himself. Bielfeldt's former accountant, Jack A. Williams, and his former business partner, James E. Lauritsen, also provided particularly useful information. Commodities and Futures Trading Commission case information was obtained from the CFTC Internet site, *www.cftc.gov.*

Several sources about Bielfeldt's philanthropic activities included news articles in the *Chicago Tribune.* Bielfeldt's early business dealings and the growth of his company were well chronicled in *Market Wizards: Interviews with Top Traders,* by Jack D. Schwa-ger (HarperBusmess, 1993). We are also grateful to the Foundation Center for providing financial information regarding the Bielfeldt Foundation.

12: HIDE-AND-SEEK

We are particularly grateful to former IRS special agent John Thomas, who gave us a great deal of insight into Joseph Ross's tax evasion scheme, his flight from justice, and the IRS's long pursuit of him. We made extensive use of the public portion of the IRS case file on Ross, which included the original indictment against him and supplemented charges added later as Thomas continued to doggedly pursue him. The file also contained information on his life as a fugitive and the somewhat poignant "wanted" poster. For background, we also relied on various news accounts, including stories from the *Tulsa World,* the *Daily Oklahoman,* and the *Vancouver Sun.*

We tracked Ross down through the Internet site his wife maintains, *www.belizere-port.com.* Apparently, being a fugitive from the IRS doesn't require maintaining a low profile. We traveled as far as Ross's resort in Belize to try to secure an on-the-record interview with him, but he declined to speak for the record.

13: WHAT YOU CAN DO

The information on the Skalas came from *Christopher A. andNurisSkala v. Commissioner,* Docket No. 16559-98. Information on abusive trusts, and contacting the IRS about them, can be found on the IRS's Internet site at *www.irs.gov/ind_info/abuse/index.html.*

CONCLUSION

Although the conclusion was largely a review and analysis of the preceding chapters, there were several key sources used in its writing. Charles Adams's *For Good and Evil (Madison* Books, 1993) once again provided valuable historical perspective. We again consulted James Dale Davidson and Lord William Rees-Mogg's *The Sovereign Individual* (Simon & Schuster, 1997), as well as Hans-Peter Martin and Harald Schumann's *The Global Trap: Globalization and the Assault on Prosperity and Democracy* (Zed Books Ltd., 1997).

The Transactional Records Clearinghouse at Syracuse University *(http://trac.syr.edu)* proved to be a useful resource for IRS statistics. We relied heavily on the respected publication *Tax Notes* as a source of congressional hearings, GAO reports, news stories, and analysis.

We are indebted to Jack Blum for his insights on financial havens and the cyber-space explosion.

The ending quote from Abraham Lincoln can be found in *Lincoln: Speeches and Writings 1859-1865* (Library of America, 1989), in his "Speech to the 164th Ohio Regiment."