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Tax Dodgers

DAVID CAY JOHNSTON
U.S. CORPORATIONS ARE USING BERMUDA TO SLASH TAX BILLS

PROFITS OVER PATRIOTISM

Becoming an Island Company is a Paper Transaction That Saves Millions Annually

By DAVID CAY JOHNSTON

A growing number of American companies, encouraged by their financial advisers, are incorporating in Bermuda to lower their taxes sharply without giving up the benefits of doing business in the United States.

Insurance companies led the way, but now manufacturers and other kinds of companies are following.

Stanley Works, for 159 years a Connecticut maker of hammers and wrenches, is among the latest with plans to become a corporation in Bermuda, where there is no income tax. The company estimates that it will cut its tax bill by $30 million a year, to about $80 million.

Tyco International, a diversified manufacturer with headquarters in Exeter, N.H., says that being a Bermuda corporation saved it more than $400 million last year alone. Other companies that have incorporated in Bermuda or plan to do so include Global Crossing, a Beverly Hills, Calif., telecommunications company; Ingersoll-Rand and Foster Wheeler, both New Jersey industrial manufacturers; Nabors Industries, a Texas company that is the nation’s largest oil well services company; and Cooper Industries, a Houston manufacturer of industrial equipment.

Becoming a Bermuda company is a paper transaction, as easy as securing a mail drop there and paying some fees, while keeping the working headquarters back in the United States.

Bermuda is charging Ingersoll-Rand just $27,553 a year for a move that allows the company to avoid at least $40 million annually in American corporate income taxes.

The company is not required to conduct any meetings in Bermuda and will not even have an office there, said its chief financial officer, David W. Devonshire.

“We just pay a service organiza-
tion” to accept mail, he said.

Kate Barton, an Ernst & Young tax partner, said that incorporating in Bermuda “is a megatrend we are seeing in the marketplace right now.” Many corporations that are planning the move have not yet announced it, she said.

In a Webcast to clients, Ms. Barton cited patriotism as the only potentially troubling issue that corporations consider before moving to Bermuda, and she said that profits trumped patriotism.

“If it is the right time to migrating a corporation’s headquarters to an offshore location?” she asked. “And yet, that said, we are working through a lot of companies who feel that it is, that just the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat to that.”

The White House has said nothing about these moves and their effect on tax revenues. Mark A. Weinberger, chief of tax policy in the Treasury Department, said the moves to Bermuda and other tax havens showed that the American system might be driving companies to make such decisions. “We may need to rethink some of our international tax rules that were written 30 years ago when our economy was very different and that now may be impeding the ability of U.S. companies to compete internationally.”

But others have expressed concern about the trend. Senator Charles E. Grassley of Iowa, the ranking Republican on the Senate Finance Committee, expressed alarm. “There is no business reason for doing this, other than to escape U.S. taxation. I believe the Finance Committee needs to investigate this activity.”

There is no official estimate of how much the Bermuda moves are costing the government in tax revenues, and the Bush administration is not trying to come up with one.

A Bermuda address is being recommended by many legal, accounting and investment advisers. Stanley Works, for example, relied on Ernst & Young for accounting advice, Skadden Arps Slate Meagher & Flom for legal advice, and Goldman, Sachs for investment advice.

Ingersoll-Rand’s top tax officer, Gerald Swimmer, said all of the major investment houses and accounting firms had presented the idea to his company. Ingersoll-Rand expects its worldwide income taxes to fall to less than $115 million from about $155 million annually.

Many companies looking for tax havens abroad are choosing Bermuda because it is close, its political system is stable and it uses a legal system similar to that of the United States. But some, like Seagate Technology, the California maker of computer disk drives, have gone to the Cayman Islands and other places.

Insurers have also flocked to Bermuda to escape most insurance regulations, including how much money they must hold in reserve to pay claims.

Since companies that move to Bermuda usually keep their main offices in the United States, they continue to have all the security provided by the American government, the legal system and the courts.

But by moving to Bermuda, their income from outside the United States becomes exempt from American taxes. Also, when the American company borrows from its Bermuda parent, the interest it pays creates a deduction that reduces U.S. taxes, but there is no tax on the interest earned by the Bermuda parent.

These companies say they are moving because their worldwide tax rates are higher than those of foreign competitors. Stanley Works expects its worldwide tax rate to fall to 23 percent to 25 percent of profits, down from 32 percent now, said Gerard J. Gould, Stanley’s vice president for investor relations.

Another company, Cooper Industries, expects to lower its worldwide income tax bill to $80 million from about $134 million.

Robert Willens, a tax expert at Lehman Brothers, said that “any company with a decent amount of foreign income will see its tax rate fall dramatically” by moving its nominal headquarters to Bermuda.

“But the political considerations sometimes prevail,” he added, “and companies are understandably reluctant to do something like this because it will not necessarily be properly construed in the marketplace. It may be seen as not patriotic and in the wake of Sept. 11, that is not a good posture for a company.”

Mr. Willens said that he had personally presented the Bermuda idea to some companies and that the idea had been turned down for just that reason. “The companies most willing to do this are not household names,” he said, “but Stanley Works is verging on a household name.”

Mr. Gould said Stanley Works, whose products can be found in many home toolboxes, had not received a single complaint that it was being unpatriotic. Only a few shareholders complained, he said, and all were longtime shareholders who will owe taxes on their capital gains if the deal is approved by two-thirds of the Stanley Works shareholders.

The Internal Revenue Service has ruled that shareholders must pay taxes on any increase in the value of their shares between the date they bought the stock and the date the deal is announced. Even if they do not sell the shares, the government designed the rule to place a price on what it calls tax-motivated expatriation.

With the stock market depressed, Mr. Willens noted, interest in moving to Bermuda is up because fewer shareholders would owe capital gains. And even when a move to a tax haven occurs, the company is not required to report to the I.R.S. on the holdings of each stock owner. Only the integrity of individual taxpayers ensures that the taxes are paid, as is the case with any tax on capital gains.

“I am sure a few get missed,” Mr. Willens said with a chuckle.

Peter L. Baumbusch, an international tax lawyer with Gibson, Dunn & Crutcher in Washington, said current tax law does not undermine the strength of existing multinational corporations with headquarters in the United States.

David A. Weisbach, a University of Chicago professor of tax law, said the corporate moves to Bermuda should prompt Congress to review the American corporate tax regime, which was established when American companies sold primarily to the domestic market and few foreign companies had a major presence in the United States.

“Should we be taxing worldwide income or not?” he asked. “That is the really hard question.”

Representative Charles B. Rangel of New York, the ranking Democrat on the House Ways and Means Committee, said the patriotism question also needed to be debated.

“Some companies flying the Stars and Stripes renounce America when it comes to paying their taxes,” he said. “They choose profits over patriotism. So far, the Bush Treasury Department has shown no interest in stopping these corporate moves, or even drawing attention to them. Supporting America is more than about waving the flag and saluting — it’s about sharing the sacrifice. That’s true of soldiers, citizens, and it should be true of big companies, too.”
Vote on an Offshore Tax Plan
Is Roiling a Company Town

By DAVID CAY JOHNSTON

NEW BRITAIN, Conn., May 8 — Over the last 150 years Stanley Works has come to dominate this central Connecticut town, producing tools with the yellow logo that has made it a brand well known in every other American town. But if its shareholders approve a proposal in a vote on Thursday, Stanley will become a Bermuda company in address only, with its legal residence in Barbados.

The company says its plan will slash its income tax bills by at least 28 percent — $30 million a year — and predicts that the resulting higher cash flow could by itself raise its stock price by 11.5 percent. Tax experts say the saving could be much higher.

That does not sit well with a lot of people here and elsewhere — with workers, residents and even some large investment funds. Such critics hope to turn this vote into a referendum on whether the growing number of American companies with proposals similar to Stanley’s should be allowed to promote the interests of shareholders without also considering the interests of the nation and the companies’ home communities.

“This is really about the future of the corporation in America,” said Stephen Sleigh, director of strategic resources for the machinists’ union. “Are companies going to stay loyal to our country and grow jobs here, where they made their money? The notion that stock price is the only measure of a company’s value is shortsighted.”

It is unclear whether Stanley will win this vote — the proposal requires the approval of two-thirds of all shareholders to be passed. But Stanley’s proposal has a lot of support.

The company says it has no choice, and its situation says a lot about the struggle of American businesses to remain globally competitive and satisfy their shareholders. In the past, many chief executives said they had obligations to a number of constitu-

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Stanley Works hears the call of the low-tax Caribbean.

Many in New Britain, Conn., say that Stanley Works’ plan to cut taxes would further erode the local economy.

Stanley has some important backers. Institutional Shareholder Services, which advises pension funds and other large investors, supports approval of Stanley’s plan because lower taxes should mean a higher share price. The organization warned that “there is already fierce and credible opposition” in Congress, though it discounted the threat that Congress might undo the move.

Opponents of such plans make several points. Some say it is just not patriotic to stop paying income taxes and leave the burden to others. Mayor Lucian J. Pawlak of New Britain said, “We will be a much poorer city and America a much poorer country as companies move out jobs and machinery, pay less in taxes and take away the jobs that hard-working people without much education used to get their kids into college.”

Senators Charles E. Grassley, Republican of Iowa, and John B. Breaux, Democrat of Louisiana, have introduced legislation to remove the tax savings in such deals, calling them unpatriotic in a time of war.

Others, like Connecticut’s treasurer, Denise L. Nappier, and New York’s comptroller, H. Carl McCall, say the plan is unfair because it reduces shareholders’ rights, like the ability to enforce American court orders. They do not plan to sell their states’ Stanley shares if they lose the vote, however. The company says the changes are minor.

Still others say the plan will encourage Stanley and other such companies to ship more jobs and money abroad. Once profits are shipped to Barbados, they can be invested tax free in factories abroad, but if the money is returned to the United States, it becomes taxable again.

Many people in New Britain are worried because in the past decade Stanley has eliminated 90 percent of what had been 5,000 blue-collar jobs here, replacing union machinists with less expensive workers in China, Mexico and other countries.

Dowald D’Amato, president of a machinists union local representing the last 500 production workers here, said: “Trani said he will always go to the lowest-cost producer, and that means China. Union wages in New Britain are $10 to $20 an hour, he said.

At a small grocery across from City Hall, the owner, Iftekhar Siddiqui, said his business had declined as Stanley eliminated jobs.

Mr. Siddiqui, who has a master’s in business administration, said people here were angry because they thought Stanley’s manipulation of tax and labor laws could spell economic ruin for themselves but riches for the 10 percent of Americans who own 86 percent of all stocks.

“The C.E.O.’s job is not just profit,” Mr. Siddiqui said. “He has to think about the welfare of society. You have to have a country that is healthy to have profits. If Stanley does this, a lot of other companies will follow, and they will invest the money they made here in China, and a lot of our labor force in this country will become unemployed. Fewer and fewer people will have disposable income. You have to have balance.”

Over on Broad Street, Gregory Adamski, who came from Poland 18 years ago and runs the Cracovia Restaurant, said, “When Stanley Works moves out, they ship the machinery to China, and that means our taxes will increase so they can pay less.”

Herb Holter, who owns a hair-cutting salon, said that when he arrived in 1957, at 16: “New Britain was a buzzing place, and everybody was working to get ahead. Now Stanley just wants to make a lot of money for shareholders and the C.E.O. Soon there’ll be no jobs, and then who is going to buy Stanley tools?”

Mayor Pawlak said he would be surprised if anyone in New Britain spoke favorably about the company, which he said had seemed focused only on its stock price since Mr. Trani took charge five years ago.

“All those guys walking around with missing fingers and backbends made Stanley,” the mayor said, “but Trani doesn’t want to hear that.”
Tax Treaties With Small Nations Turn Into a New Shield for Profits

By DAVID CAY JOHNSTON

Some large companies, encouraged by top law and accounting firms, are adopting a new strategy to cut taxes legally on profits they make in this country.

The technique works this way: A company transfers profits earned in America to a paper company in another country, like Barbados or Luxembourg, that has a special kind of tax treaty with the United States.

These treaties, originally intended to serve American economic interests abroad, allow companies through accounting sleight of hand to transform taxable profits into expenses that they can deduct on their American tax return. These tax-deductible expenses include interest payments to the overseas company, royalties for use of the company's logo and fees for management advice from the overseas company.

The paper company then sends the money to the United States company's worldwide headquarters in Bermuda, which has no income tax and is the tax haven of choice for many companies. In short, what once were taxable profits have been turned into virtually untaxed dollars for use anywhere in the world.

Large publicly traded companies can use this method to reduce taxes on American profits to as little as 11 percent, from an average of 21.5 percent.

Nabors Industries and Weatherford Industries, two oil drilling services companies in Houston, and Stanley Works, a Connecticut maker of hammers and other hand tools, are among the first companies preparing to use the strategy to reduce taxes paid to the American government on profits earned in the United States. Other companies with headquarters in Bermuda, including Tyco International, Ingersoll-Rand and the consulting firm Accenture, have adopted other methods to accomplish the same goal.

The new techniques are being promoted by leading accounting and law firms, said Beth Brooke, a vice chairman of Ernst & Young, the accounting and consulting firm.

Accounting and consulting firms advising on these strategies include Arthur Andersen, Deloitte & Touche,

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KPMG, PriceWaterhouseCoopers and Grant Thornton. The top law firms include Skadden, Arps, Slate, Meagher & Flom; Baker & McKenzie; Sutherland, Asbill & Brennan; and Arnold & Porter.


Congress imposes a 35 percent tax on profits of large companies, but after taking advantage of deductions and loopholes, the largest 9,669 companies paid an average of 21.5 percent of their profits in American income taxes in 1998, the latest data from the Internal Revenue Service shows. These taxes totaled $141 billion, or nearly 18 percent of the total income taxes paid by companies and individuals.

Just how much companies expect to save on taxes on their United States profits is not known because the companies have not disclosed it.

One of the most common of the new tax avoidance techniques, which does not have a commonly used name, works this way. First, a company reincorporates in Bermuda or a similar tax haven where there is no income tax and where all it needs is a mail drop. That allows the company to eliminate American taxes on its profits overseas.

How much companies pay in taxes on their overseas profits depends on which countries they operate in and their tax strategies. But most of those using this arrangement have said they expect to lower worldwide income taxes from more than a third of their profits to a quarter or less.

The key to the new method is setting up a paper company in a third country that has a tax treaty with the United States allowing companies to move large amounts of money to an overseas parent company and to reclassify these formerly taxable profits as deductions.

For example, the profits made in the United States can be shipped abroad tax-free in the form of royalties for using the company’s logo, the rights to which are owned by the overseas parent. As another example, the overseas parent can lend money to the American operation, which uses its United States profits to pay interest, for which it takes a deduction. The overseas parent can also charge management fees for services provided to its American subsidiary, and, once again, be paid from once-taxable profits.

Without the Barbados or Luxembourg connection, however, the ability to reduce American taxes on American profits is limited by other tax rules.

Companies using the techniques, asked about it last week, either did not respond, declined to comment or reiterated previous remarks about eliminating American taxes on profits earned outside the United States.

“We are pretty much radio silent these days” on taxes, said Paul Dickard, a spokesman for Ingersoll Rand, an industrial manufacturer that maintains its operating headquarters in Woodcliff Lake, N.J.

Under current rules, only publicly traded companies can take advantage of these techniques. Individual Americans are taxed on their worldwide income whether they live in the United States or overseas, making a Bermuda mail drop worthless to them. The treaties exclude family-owned businesses, partnerships and professional corporations.

Lawyers and accountants who are promoting the strategies — they charge hourly fees for this work — say that Congress is forcing companies into them by not modernizing the corporate income tax.

Typical of these statements were remarks by Ms. Brooke of Ernst & Young, who said that “to become globally competitive, companies have to unshackle themselves from the arcane U.S. tax system that in essence results in U.S. company profits being taxed in multiple places.”

Ms. Brooke acknowledged that companies that do this can also pay lower taxes on profits earned in the United States. “The issue is global competitiveness and that includes taxes paid in the United States on profits earned there,” she said.

Mr. Andersen, the tax treaty expert, said the techniques were quite legal. “Congress wrote the statute and the L.R.S. wrote regulations that not only allow this, but give signposts on a perfectly clear road map” showing how to move to a tax haven like Bermuda and take advantage of a second country’s tax treaty, Mr. Andersen said.

“If Congress wants to say this is a time of war and you can’t do this...
anymore and if you do we will put you in handcuffs and throw you in prison that is fine with me," he added. "But until they do, it is perfectly appropriate to do what the law provides."

But Lee Shepphard, a lawyer whose essays in the journal Tax Notes are read by experts in legal tax avoidance, disagreed. "I do not believe for one second that abusing these treaties is what Congress intended," she said.

"Nobody in Congress said you can pretend to be resident in Barbados and not pay your taxes," she added.

"The real problem here is that Congress trusts these guys to act responsibly and so do the tax administrators at Treasury and the I.R.S., and no one who writes the laws and the treaties and the regulations ever thought they would behave like this."

Treasury Department officials, who oversee the tax collection system, said the new strategies reveal "inadequacies in our current tax rules that can be taken advantage of" by companies.

"We are aware that these types of transactions may be used to reduce the U.S. taxes paid on U.S. income," said Mark A. Weinberger, Treasury assistant secretary for tax policy. "That is one of the reasons we are so concerned about the marked increase in the number and size of these transactions."

It was not immediately clear how the provisions creating the loopholes were written into the treaties. Experts said there were several ways to close the loopholes, including renegotiating the treaties and rewriting the rules on what constitutes a corporate headquarters for tax purposes.

Senators Baucus and Grassley, who introduced the legislation to close the Bermuda loophole, said the new techniques might require further legislation.

"The companies reincorporating in tax haven countries, and their executives, are still physically located in the United States," Senator Baucus said. "Their executives and employees enjoy all the privileges afforded to honest U.S. taxpayers."

The new strategies, Mr. Baucus said, are "making a mockery of honest taxpayers."

"We need to continue to step up efforts to ensure that they pay their fair share," he added.

Mr. Grassley has said that using the Bermuda methods is unpatriotic.

Both senators said that while they wanted to end these techniques, they would also investigate how to overhaul the corporate tax system and close loopholes.
Big Accounting Firm’s Tax Plans Help the Wealthy Conceal Income

By DAVID CAY JOHNSTON

In private meetings with wealthy Americans and their financial advisers, the accounting firm Ernst & Young has for months been selling four techniques to eliminate or sharply reduce income taxes.

Ernst & Young says the techniques are legal and proper. But some experts on tax shelters say that at least one of them should not pass muster in an audit and that because the techniques hide transactions from the Internal Revenue Service, they may amount to tax evasion, which is illegal, rather than aggressive tax avoidance, which is legal.

Without these deals, the money would be taxed at rates from 18 to 38.6 percent. The savings are significant, and so are the profits for Ernst & Young and the law firms, banks and currency traders participating in the arrangements.

To use one of the firm’s examples, someone selling a business for a $100 million profit on which there could be $20 million in federal capital gains taxes alone could instead pay only about $5 million.

And that money would go not to the government but to Ernst & Young, as a fee. Much smaller amounts would go to lawyers who blessed the techniques and to banks and currency traders who helped execute them.

In another example used by the firm, someone with a $20 million paycheck on which he would owe $7.7 million in federal income taxes — typically, an executive, professional athlete or entertainer — would delay the tax for 20 years, effectively reducing the tax to $1.4 million. The fee charged by Ernst & Young would be $1.2 million.

The other surviving Big Four accounting firms — Deloitte & Touche, KPMG and PricewaterhouseCoopers — sell their own techniques to reduce taxes for the wealthiest Americans. Some of the methods they sold in recent years have been identified by

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the Treasury as improper and were ordered shut down.

Rarely are the terms of such techniques made public. In this case, they were disclosed to The New York Times by a financial adviser whom Ernst & Young briefed on the techniques. The adviser declined to be identified because he had signed a confidentiality agreement with Ernst & Young.

The adviser said he was violating the agreement by giving the document to The Times because he was outraged about methods that were at best morally indefensible, in that they were designed to hide the transactions from I.R.S. auditors. The adviser said keeping the deals secret caused him trouble sleeping.

Essential to the Ernst & Young techniques are strategies that have the effect of hiding them from the I.R.S. They use different layers of partnerships, charitable trusts and a kind of business known as an S corporation so that none of the techniques shows up on the tax return of the individual who uses them.

This layering makes it highly unlikely that an I.R.S. audit, which is itself unlikely, would discover the deals, said Jerry Curnutt, a retired I.R.S. partnership expert. Only one in 142 tax returns of people making $100,000 or more is audited, but the audit rate for partnerships is just one in 400.

“Using partnerships is brilliant,” said the financial adviser who attended a meeting this year where Ernst & Young explained the deal to his firm, whose clients include wealthy business owners.

“All the individual tax return would show is routine income and gain or loss from a partnership,” he said. “You would have to have the most suspicious and thorough and intelligent auditor in the world to find this, and he would have to peer back several layers to find the real stuff.”

In defending the techniques, Ernst & Young says at least one of them has been disclosed to the government and the government has not challenged it. Kenneth Kerrigan, a spokesman for the firm, said neither the Treasury nor the I.R.S., which it oversees, has moved to shut down that technique, which he cited as evidence of its validity.

Just because the Treasury has not acted is no reason for investors to take any comfort in the deal, said Pamela F. Olson, the administration’s senior tax policy official. She said the Treasury was overwhelmed reviewing tax shelters that were disclosed in a brief amnesty earlier this year and has not come around to many of those like Ernst & Young’s.

Sheldon Wohen, a former I.R.S. commissioner, said that if the transactions “depend on keeping them several steps away from the individual’s tax return so they aren’t discovered in an audit, then it’s fraud.” It is impossible to determine how many people use or plan to use the techniques. Ernst & Young would not say.

Jerry Curnutt, a retired I.R.S. partnership expert, said the technique of layering deals made it unlikely that an I.R.S. audit would discover them.

The financial adviser who provided the Ernst & Young document said he had often been presented with financial products in three-ring binders or glossy brochures. But in this case the four deals were outlined on a single sheet of plain paper without the firm’s logo.

Mr. Kerrigan of Ernst & Young said the techniques were on a photographed sheet, rather than in a brochure, only as a cost-saving measure. He said financial advisers were required to sign confidentiality agreements because otherwise they could take the techniques and sell them on their own.

The document describes the four deals, which are all of income needed for each, the value to the wealthy individual and Ernst & Young’s fees or “pricing policy.”

Ernst & Young’s fee for arranging the deal amounted to 3 percent to 6 percent of the amount subject to tax, plus a fee of up to $50,000 for an opinion letter from a lawyer. These letters are used, if a deal is discovered in an audit and ruled impermissible, to win waiver of penalties that can equal 75 percent of the tax due.

The opinion letter for one of these deals asserts that it “should” pass muster in an audit, while the other three argue the much weaker case that, “more likely than not,” the deals would survive an audit. In one case Ernst & Young’s own lawyers provide the “more likely than not” opinion on the firm’s own deal. Normally, a legal opinion is sought from someone with no financial interest in the deal.

The techniques allow individuals to delay payment of taxes for years; turn salary income into capital gains, which are taxed at a lower rate; or take capital gains tax free.

One of the four Ernst & Young deals — used by people who want to sell their businesses without paying taxes on the gain — works this way: The business owner contributes his company to an S corporation owned with another business, perhaps a bank that has losses from its credit card operations that are greater than if it otherwise could use to offset profits.

For several years the business owner receives income from the S corporation instead of his business, and a report known as a K-1 showing this income is sent to the I.R.S., Mr. Kerrigan confirmed.

A related partnership, meanwhile, executes foreign currency transactions to generate a gain of $100 million and a loss of the same amount. The two foreign currency trades are then closed out, offsetting each other, so no money is gained or lost, but accounting records are created.

The bank pays this paper gain while the business owner takes the paper loss. The bank pays no taxes on this gain from the currency transactions because it has losses to offset the decline in its bank is compensated for its role in the technique.

The business owner takes the $100 million loss from currency trading, which, again, is only a bookkeeping entry because the currency trades canceled each other. But this artifice $100 million loss offsets the real $100 million gain that the business owner had on the sale of his company, which he had placed in the S corporation.

Showing these huge offsetting gains and losses on an individual income tax return would invite an audit, but these transactions are not reported there. Instead the currency trades are reported on a partnership return and only the final results appear on the business owner’s personal income tax return.

The business owner is issued a K-1 report showing no gain, even though he sold his business at a $100 million profit because the artificial loss in the currency trades — for bookkeeping purposes — the actual gain on the sale of the business.

When the S corporation is closed, decades later, the business owner then takes back in cash and securities the $100 million he contributed to the partnership in the form of his business. (The executive had access to that money long before this, principally through dividends and interest payments, on which he would owe taxes.)

On his personal tax return he reports not a taxable capital gain, the way he would have in an ordinary sale of his business, but instead a return of his capital from the S corporation, which is not taxable.

The firm from now on, the business owner’s opinion that the deal is “more likely than not” to survive an audit. But a similar deal was examined last year by Lee Sheppard, a lawyer who criticizes tax shelters in the weekly journal Tax Notes. Ms. Sheppard said she thought this technique failed on a number of grounds and would be rejected by the I.R.S. “assuming they can find it in an audit.”

The second technique allows someone with a large profit from an investment, especially a single stock, to buy a diversified portfolio of securities and then offset the tax on that profit for up to 20 years. Ernst & Young charges fees amounting to $90,000 or $50,000 profit.

A third technique is aimed at executives with stock options that produce a profit of at least $5 million. On a $5 million stock option profit an executive would owe $1.9 million in taxes, but if the tax is delayed for three decades, as this technique provides, it is the equivalent of paying about 8 cents on the tax dollar owed.

The fourth technique, requiring at least $20 million in capital gains, allows an individual to have his salary taxed at capital gains rates, reducing the federal tax bill on $20 million, to $4 million from $7.7 million.
Death Still Certain, but Taxes May Be Subject to a Loophole

By DAVID CAY JOHNSTON

In recent months some of the wealthiest older Americans have been buying huge life insurance policies on themselves. Curiously, these people have shopped not for the cheapest rates but for the highest rates they can find. In some cases, they delightedly pay 10 times the lowest rates for that insurance.

Why would anyone willingly pay so much?

Taxes.

Through a technique invented by a lawyer in New York and a chemical engineer in California, each dollar spent on this insurance can typically eliminate $9 in taxes. Spend $10 million on this insurance, avoid $90 million or more in income, gift, generation-skipping and estate taxes.

"I'm not saying this is the best thing since sliced bread, but it's really good for pushing wealth forward tax free," said Jonathan G. Blattmachr, the New York lawyer who heads the estate tax department at Milbank, Tweed, Hadley & McCloy and who explained the plan in a half-dozen interviews.

The technique is legal, blessed by the I.R.S. in 1996. But some leading tax lawyers, as well as some accountants and insurance agents, say it shouldn't be. They say it effectively disguises a gift to one's heirs that should be taxed like any other gift. They also say it is but one example of how a tax exemption on life insurance that was approved by Congress in 1913 to help widows and orphans has been stretched to benefit the very richest Americans.

Several thousand of these jumbo policies have been sold, according to agents who sell them, all under confidentiality agreements with the buyers and their advisors. One member of the Rockefeller family took out a policy, according to people who have seen documents in the deal.

The several billion dollars of this insurance already sold, much of it in the last 18 months, means that tens of billions of taxes will not flow into federal and state government coffers in the coming decade or so.

In recent months, policies with

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In Loophole, Death Still Certain, but Not Taxes

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first-year premiums alone of $4.4 million, $16 million, $15 million, $25 million, $32 million and $40 million have been sold by New York Life Insurance, Massachusetts Mutual Life Insurance and other underwriters, according to insurance agents, actuaries and tax lawyers who have worked on these deals.

The agents selling the policies find them hard to resist — they can earn millions of dollars for selling just one such policy.

The technique works this way. An older person — typically someone who does not expect to live long and who has at least $10 million and usually much more — wants to avoid estate taxes, which are 50 percent with such fortunes.

Unpaid tax, money from a life insurance policy goes death to heirs tax free. The premium paid on that life insurance is considered a gift to those heirs. Any annual premium that exceeds $11,000 is therefore subject to the gift tax at 30 percent. Only the wealthiest Americans pay such large premiums and are subject to this tax.

The new technique sidesteps the gift tax in a two-step process. First, the person who is buying the policy reports on his tax return only a small part of what he really paid in premiums.

Wouldn’t the IRS say that is cheating? No. It’s perfectly legal. The reason is that insurance companies offer many different rates for the same policy. And the buyer is allowed to declare on his tax return the insurance company’s lowest premium for that amount of insurance, even if that premium could never qualify for that rate because of his age and health, and even if no one has actually ever been sold a policy at that rate.

A low premium means a low gift tax. But in fact the buyer has really paid the very highest premium offered by that insurer for that amount of insurance. The insurer then invests the difference between the highest premium and the lowest premium. That investment grows tax free, paying for future premiums on the policy. At death, the entire face value of the policy is paid tax free to heirs.

In an example cited by one agent, a customer paid a $500,000 premium for the first year alone, the highest price offered by the insurance company, for a policy that was also offered at $300,000, the price. So $200,000 can be passed on to heirs tax free. Yet the gift tax is only $25,000 — 50 percent of the lowest premium, instead of $75,000, which is 50 percent of the highest premium.

The I.R.S. would not comment officially. But an I.R.S. official who specializes in insurance matters said he had not heard that so many people were using this loophole. He could not say whether the issue would be reexamined.

The deal gets better because of a second step. Even though $25,000 tax can be avoided by shifting the gift-tax obligation to the spouse through a trust. In 1982, Congress made all transfers between spouses tax free, so the gift tax disappears.

If the policy holder continues to pay huge premiums year after year, he can pass along much or all of his fortune tax free if he lives long enough. Michael D. Brown of Spectrum Consulting in Irvine, Calif., said, many clients in their 50’s and 60’s, working with other agents, are now trying to do just that.

By far the biggest deals have been made by two insurance agents who work together, Mr. Brown, a former chemical engineer, and Louis P. Kreisberg of the Executive Compensation Group in Manhattan.

The technique was devised in 1995 by Mr. Blattmachr and Mr. Brown. Mr. Blattmachr has since expanded his idea and other estate tax lawyers have copied his methods.

“From 1995 I was told that this was the stupidest idea ever by a guy who is now collecting millions in commissions from selling such insurance,” Mr. Blattmachr said.

Among his peers Mr. Blattmachr is renowned for his creativity in finding ways to pass down fortunes without paying taxes and without breaking the law.

He is a busy man. Recently he set off to counsel clients in eight cities over three days — a trip made possible by a client who provided him with a private jet. Afterward he spent the weekend fishing with his brother, Douglas, whose company, Alaska Trust, helps wealthy Americans set up perpetual trusts, some of them using Mr. Blattmachr’s insurance plan.

One buyer of an insurance plan like Mr. Blattmachr’s paid $32 million in the first year for a policy that will pay $127 million tax-free to the grandchildren, according to a lawyer who worked on the deal and spoke on condition of not being identified. No gift taxes were paid.

Sales of such insurance soared after the Internal Revenue Service announced 10 months ago that it was considering restrictions on similar

Regulators have moved to stop similar plans, but not this one.

The last year, state records show. This month, when the I.R.S. issued its proposed restrictions, it did nothing to stop Mr. Blattmachr’s plans.

Indeed, the proposed I.R.S. rules can be read as strengthening the validity of his plans, Mr. Blattmachr and some other estate tax lawyers say.

Mr. Brown said that in some cases, when the policy holder dies quickly, both the government and the heirs come out winners, at the expense of the insurance company.

“This is a good deal because both the government and the heirs get 90 percent of what they could have gotten,” he said.

He added: “We think it is good policy to allow this because it discourages games like renouncing your citizenship or investing offshore.”

But many estate tax lawyers and insurance experts think that because Mr. Blattmachr’s plans are similar to the plans the I.R.S. moved to stop on July 3, it should be ended as well.

While the I.R.S. in 1996 approved the outlines of the Blattmachr plan, these opponents argue that the plan as sold by agents like Mr. Brown and Mr. Kreisberg stretches that ruling so far that it no longer provides protection in an I.R.S. audit.

Some of them say it is the huge fees involved that are blinding their competitors to aspects of the Blattmachr plan that make it vulnerable to being banned as an abusive tax shelter.

Commissions for the insurance agents run between 70 percent and 20 percent of the first-year premium when it is $1 million or so, while on the jumbo policies commissions are typically 9 percent to 11 percent, or up to $4.4 million on a policy with a $40 million first-year premium, Mr. Kreisberg said.

He acknowledged that many peers in the estate tax world say that he earned $10 million in gross commissions last year, but said, “I wish it were half that.” Mr. Kreisberg did not dispute a statement by someone with knowledge of payment records that his small firm’s commissions this year have already reached $20 million.

Lawyers who opine on the validity of the deals can also earn big fees. Mr. Blattmachr gets $100,000 for his basic opinion letter and is reported to have charged as much as $300,000.

Sanford J. Schlesinger of the law firm Kaye Scholer said he passed up a chance to collect a six-figure fee for advising on one of these deals because he thinks the deals should not pass muster with the I.R.S. “‘My mother taught me that if something seems too good to be true, it isn’t true,’” he said.

Other leading estate tax lawyers, as well as some accountants and insurance agents, say Mr. Blattmachr’s insurance technique should fail because it is wholly outside the intent of Congress in giving tax breaks for life insurance, the I.R.S. ruling on the plan notwithstanding.

“If the I.R.S. understood this they would say that it relies on a disguised gift — and if you have to pay gift taxes, then Jonathan’s insurance deal does not work,” said an estate partner at a tax firm in New York, who like others, said they could not be identified because they have signed confidentiality agreements that are part of all such insurance deals.

Another legal expert said paying 10 times too much for insurance in a plan like this reminds him of a matrarch selling the family business to her granddaughter for $10 million when it was actually worth 10 times that amount. “The I.R.S. wouldn’t let a family get away with selling the business for a dime on the dollar,” this lawyer said, “and they should not allow it to work in reverse through insurance.”
A Tax Break for the Rich Who Can Keep a Secret

By DAVID CAY JOHNSTON

When most Americans sell stock they must pay taxes on their profits by the following April 15. But a few Americans are delaying taxes on their stock profits for years or decades — or, in some cases, never paying at all.

It's all perfectly legal — but only if you have $5 million of stocks and bonds. And only if you promise to keep it secret. It's one example of how the tax laws currently grant certain favors only to the very wealthiest.

The deals work this way: Executives and investors with $5 million of stocks and bonds contribute at least $1 million of their stock in a single company to a pool into which others in the same situation contribute their own shares. In return they receive shares of a partnership that owns the pool.

When they are ready to withdraw from the pool, the partnership gives them not their original shares or cash but instead shares of a variety of stocks held by the pool. As a result, someone with too much money in one stock can quickly diversify into a more balanced portfolio. But unlike other investors, who have to pay taxes on profits when they sell a stock, no taxes are owed on the profits of the shares contributed to the pool.

If investors stay in the pool for seven years, the stocks they get when they withdraw their investment do not incur the tax on investment profits that other investors must pay. Only if the investors then sell the various stocks they received from the pool are they supposed to pay taxes.

Those taxes are by law owed on their investment profits all the

Continued on Page 4
of exchange funds must form partnerships that are not offered to the general public, only to qualified purchasers. Other tax and S.E.C. rules require that the partnerships be treated as private placements, rather than a public offering to investors, so no advertising is allowed and prospective investors must sign confidentiality agreements.

Why limit qualified purchasers to people with $5 million in stocks and bonds? The rationale is that exchange funds are considered suitable only for people who do not need to touch the money for 7 to 15 years — in short, only for people wealthy enough to afford the risk of such a long-term investment. A lot of early withdrawals make the fund unmanageable.

Eaton Vance sells its exchange funds under similar names. One is called Belrose Capital and funds created since 1997 are called Belair, Belcrest, Belmart, Belport and Belvedere.

Most of the exchange fund investors are longtime shareholders, including heirs of families that own large stakes in a single company. About 10 percent to 15 percent are executive of the companies whose stock they are contributing to the exchange fund, investment executives at Eaton Vance and other firms said.

The funds benefit more than just their investors. They also generate lucrative fees for both the firms that organize them and the outside brokers who find investors for them.

Brokers who sell Eaton Vance funds are paid 2 percent of the value of shares their clients contribute to the exchange fund. Individual brokers typically share a portion of this fee with the firm that employs them. The brokers also get, and split with their firms, an annual fee of one-quarter of 1 percent of their client’s investment. Because most clients stay in an exchange fund for seven years the broker and his firm stand to collect at least 3.75 percent of his client’s account.

Investors pay Eaton Vance total annual fees of a little under 1 percent of their investment, about the same fee charged by a mutual fund that actively trades, even though exchange funds rarely incur commissions to buy or sell securities.

Some years ago the exchange funds came to the attention of Representative Richard E. Neal, a Massachusetts Democrat. He introduced legislation to stop them. But the legislation never went anywhere.

Eaton Vance, in a report to Mr. Neal last year, said its exchange funds “are not tax shelters” and “benefit our markets and our society” because they provide “risk reduction that otherwise would not be achieved.”

Two Eaton Vance executives, in background talks, said that rather than further restrict or even shut down the funds, Congress should allow anyone to invest in them.

“Why should the guy with a $1,000 gain not be allowed in?” said one Eaton Vance executive, who the company insisted not been identified.

Not everyone agrees with that approach. Mark Seaman, a vice president with the Legg Mason Wood Walker brokerage in Baltimore, a securities dealer that markets the Eaton Vance funds, said that because people were expected to stay in an exchange fund for seven years the funds were not appropriate for people who might need access to their cash.

And if all investors were allowed to use exchange funds, government tax revenues would plummet, Mr. Neal said.

“We have individual retirement accounts where you can trade stocks without immediate taxes,” he said, "but they are limited by Congress." Also, when investors in I.R.A.'s withdraw their money, they must pay taxes at ordinary income rates, which are higher than, and sometimes almost double, the capital gains rates on investment profits.

No one knows how much exchange funds cost the government in taxes because no official study of their costs has been made. But the Eaton Vance and Goldman Sachs exchange funds alone represent as much as $3.6 billion of deferred capital gains taxes at current rates.

The Congressional Joint Committee on Taxation, without any supporting data, has written Mr. Neal to say that no revenue would be raised by closing exchange funds because “the class of investors engaging in swap funds” would find other ways to avoid the tax.

Mr. Neal said he pressed Mark A. Weinberger, then until recently was the chief tax policy official at the Treasury Department, about why the Bush administration would not shut down exchange funds as loopholes, which the administration had said it opposed on principle.

Mr. Weinberger, the congressman said, replied that the Bush administration “is not for or against swap funds, but we are against taxes on capital gains in general and so we will not take any action against the funds.”

Mr. Weinberger, who has returned to the Ernst & Young accounting firm, and is now its vice chairman, said that he recalled making much less-definitive remarks, but did confirm that he said that the administration had not developed a position on exchange funds.

A Treasury spokeswoman, Tara Bradshaw, said the Bush administration was not currently considering any action on exchange funds and therefore had no policy position on them.
Affluent Avoid Scrutiny on Taxes Even as I.R.S. Warns of Cheating

By DAVID CAY JOHNSTON

The government looks for tax cheating by wage earners far more carefully than it looks for cheating by people whose money comes from their own businesses, investments, partnerships and trusts. This is true despite many warnings by federal tax officials that cheating is becoming far more common among affluent Americans.

Even as Congress finances a crackdown on tax cheating by the working poor, it is appropriating little money to detect abuses by people, usually among the wealthiest Americans, who do not rely entirely on wages for their income.

Executives at the Internal Revenue Service have mentioned this discrepancy in several reports to Congress. They have not focused attention on how little they can do about it. But an examination by The New York Times of I.R.S. statistics including audit rates and staff deployment figures, as well as interviews with current and former I.R.S. officials, shows that the agency can identify at best only a tiny percentage of the cheats and pursue even fewer of them.

That the I.R.S. audits the working poor more frequently than wealthy people is well known. What has not been discussed is that the agency does not track nonwage income as closely as wage income — and in some cases does not verify it at all, even as the I.R.S. says that cheating on nonwage income is rising.

The greater scrutiny of wage earners begins with their employers, who must report wages in detail to the Internal Revenue Service on W-2 and 1099 forms. Banks report interest earned on savings accounts and paid on home mortgages. Churches and charities must issue receipts on donations of more than $249.99. A Social Security number is required to take a child as an exemption.

I.R.S. computers then compare every one of these 1.4 billion independent reports to the entries on each

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Another reason is the widespread knowledge among sophisticated taxpayers that the I.R.S. has never matched income from partnerships, known as K-1 income, to individual tax returns, said Jerry Curnutt, a retired I.R.S. expert on partnerships. A few accountants and tax advisers have been caught in recent years helping business owners cheat on their taxes by exploiting these weaknesses. More commonly, though, family members or longtime business associates conspire, making it difficult for the I.R.S. to detect fraud.

Cheating on partnership income illustrates weaknesses in stopping up perfectly with the lines on Form 1040 individual income tax returns.

In addition, the I.R.S. is examining only K-1’s reporting taxable income, officials said. It is ignoring those reporting losses even though the losses may have been fraudulently calculated.

When unreported partnership income is found, the I.R.S. will send notices demanding taxes or an explanation. But the I.R.S. was given no additional money for “the actual casework to follow up” when unreported income is found, Mr. Rossotti said.

After analyzing federal and state tax data at the request of The Times, Mr. Curnutt estimated that by spending just $9 million the I.R.S. could recover $1.8 billion in taxes on partnership income alone, a ratio of $200 of revenue for each dollar of added expense, before counting interest and penalties.

Tens of billions more are lost through other forms of cheating, such as secreting money in tax havens like the Bahamas. Jack Blum, a money-laundering expert and I.R.S. consultant, has estimated that offshore accounts alone cheat the government of at least $70 billion annually.

Perhaps $160 billion is lost in the underground economy, in which people are paid in cash and report little or no income, based on I.R.S. estimates.

But the focus of Congressional action on tax cheats since 1995 has been on those among the working poor who actually file tax returns.

The I.R.S. employs 2,200 people to stop what is at most $9 billion in cheating by these low-income wage earners applying for the special tax credit. It employs only about eight times that many people to hunt for all other kinds of cheating, which some experts estimate at more than $300 billion annually.

As a result, the chance of being audited if one applied for the special credit for the working poor was 1 in 47 last year. But the chance was much less for high-income taxpayers — 1 in 145 for people earning more than $100,000. It was even less for a business arrangement favored by lawyers, doctors and other professionals, called an S-Corporation: 1 in 233. And the chance of an audit was less still for partnerships: 1 in 400.

S-Corporations and partnerships provide two opportunities to cheat. The entity can understated its taxable profits or even report a loss. The
Levels of Scrutiny

Taxpayers who earn money from sources other than wages have the most opportunities to understate their income. But partnerships, S-Corporations and the largest sole proprietorships face little risk of audit from the Internal Revenue Service.

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<tr>
<th>TAXPAYERS IN 2000</th>
<th>CHANCES OF BEING AUDITED: ONE IN:</th>
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<tbody>
<tr>
<td>Biggest corporations $250 million or more in assets</td>
<td>3</td>
</tr>
<tr>
<td>Small sole proprietorships (also freelancers) $25,000 or less gross revenue, schedule C filers</td>
<td>37</td>
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<tr>
<td>Working poor Earned income tax credit applicants</td>
<td>47</td>
</tr>
<tr>
<td>Smaller corporations $1 million to $5 million in assets</td>
<td>49</td>
</tr>
<tr>
<td>Larger sole proprietorships (also freelancers) $100,000 or more gross revenue, schedule C filers</td>
<td>83</td>
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<tr>
<td>High-income individuals $100,000 or more adjusted gross income</td>
<td>145</td>
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<tr>
<td>Subchapter S corporations Owners, rather than the businesses, pay taxes directly</td>
<td>233</td>
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<td>Partnerships</td>
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<tr>
<td>Individuals $50,000 to $100,000 adjusted gross income</td>
<td>435</td>
</tr>
<tr>
<td>Individuals $25,000 to $50,000 adjusted gross income</td>
<td>455</td>
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Source: Internal Revenue Service

The New York Times

entity then has more money left for its owners or partners. Those people can then understate their own income from the entity because, unlike wage income, the I.R.S. does not verify it.

The I.R.S. has also sharply reduced audits of people who work for themselves, especially those making business and investment income undermines the tax system because “the effect may be perceived as, and will in fact be, unfair because higher-income taxpayers will not have their returns verified to the same degree as middle-income taxpayers.”

The principal Congressional committee assigned to oversee the I.R.S., the oversight subcommittee of the House Ways and Means Committee, has held no hearings on tax cheating by the wealthiest Americans.

The chairman of the subcommittee is the wealthiest member of Congress, Representative Amo Houghton, a New York Republican and former chairman of Corning Glass. In an interview last week, he said he was unaware of any problem of tax cheating by high-income Americans, except for recent newspaper reports of people using credit cards to tap secret accounts in Caribbean tax havens.

Mr. Houghton said that he had not heard of problems with unreported business and investment income but that he would look into them. He said hearing that there was official concern about cheating by higher-income Americans made him ponder whether “we have enough money going to the I.R.S. to do the job at the same level as in the past.”

Officials must trust people to report all of their business and investment income.