

Letters to Switzerland

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When the IRS sent a new team in to audit the big oil company Unocal in 1997, one of its members was Ron McGinley, a lanky grandfather who goes to church almost every day. McGinley thinks often about moral issues. His deep sense of right and wrong saved him from becoming a felon in the eighties, when he was an executive at Northrup. He refused to sign papers authorizing a payment that, after the Korea-gate scandal broke, was revealed as a bribe. Later, when McGinley was forced out, the best job he could find was at the IRS as an economist working on corporate audits.

As the IRS team planned its Unocal audit strategy, it agreed to closely examine the company's Science and Technology Division in Brea, California, home to one of the world's largest seismic databases for oil drillers. The company had spent many hundreds of millions of dollars on this Oracle database, filling it with knowledge that accurately pinpoints carbon pools far below the surface of the earth. Unocal used the database for its own drilling in places like Indonesia and it sold access to its database to others.

What the audit team wanted to know was whether Unocal was charging its offshore subsidiaries fees that covered the full costs of the database or was charging less than its real value, which in turn would lower Unocal's profits in the United States.

Normally none of this would ever be known outside of Unocal management and the IRS. Congress makes most taxpayer information confidential, though it was not always this way. The IRS treats corpo-

rate audits with such secrecy that McGinley's wife never knew which company he was auditing. If an auditor's car breaks down, he cannot have his spouse or a friend drop him at the company he is auditing; that is a firing offense. Callers reach auditors by dialing their IRS number and leaving a message to be returned later. This blanket of secrecy was broken, inadvertently, by the government in trying to keep McGinley from proving that the Unocal audit was fixed.

Even before they had desks at a Unocal office, the IRS audit team began requesting documents to compare with the company's corporate tax return. The documents flowed slowly, but steadily, except for those about the oil drilling database. Unocal did not want to provide documents or answer questions.

The previous audit team gave the database a pass, McGinley's team was told by Unocal, so it had no business inquiring about it. Unocal's delaying tactics escalated steadily. McGinley said that he found his desk at Unocal rifled, his work papers having been gone through during the night by someone, a not all that rare experience for IRS auditors, who often are not given locks for the borrowed desks they use. Undaunted, McGinley and the others pressed ahead with their requests, only to encounter steadily growing resistance that escalated into stiff words one day between McGinley and the Unocal representative who kept telling him to forget about the database.

Soon the audit team members were getting calls from their superiors, saying that their IRS bosses wanted them to back off. With the Senate Finance investigation, it was not a time to make trouble with a "customer" who was being audited, McGinley was told. But he would not back down despite repeated directives to look the other way.

We know this because later McGinley filed a lawsuit, not against Unocal but against the IRS. He had taken such offense at being told to ignore an issue that could add hundreds of millions of dollars in taxes from Unocal that he complained to the equivalent of the IRS internal affairs squad.

McGinley's complaint should have been investigated by the new treasury inspector general for tax administration, created under Senator Roth's aegis following the Senate Finance hearings. Instead, the investigators handed the case back to the very supervisors whom McGinley had complained about. They would not tell McGinley what

they had done in their own investigation, but it was obvious they had done nothing. So McGinley filed suit in federal court to get access to the investigative file and to make himself into a whistle-blower. A document that the government put into the public record identified Unocal.

What the audit team had come across was just one example of one of the biggest and most important ways that big corporations are shedding their tax burden and shifting it onto you. It is a tax dodge available only to companies with international operations, so it hurts purely domestic competitors as well as individuals.

The technique is simple enough in principal: take expenses in the United States and take profits in countries that impose little or no tax.

Congress requires that companies charge their subsidiaries reasonable prices, those within the range that independent parties would negotiate at arm's length. Without this standard, sweetheart deals could be made to load up costs in the United States to reduce taxes and earn profits in places like Indonesia, which has a long history of giving stealth tax breaks to American oil companies. Over a period of even a few years, the stakes were huge, perhaps several hundred million dollars of federal income taxes from just one company.

ChevronTexaco, the world's fourth-largest oil company, evaded \$3.25 billion in federal and state taxes from 1970 to 2000 through a complex petroleum pricing scheme involving a project in Indonesia, two accounting professors who studied the company say. Their study grew out of accusations of tax evasion that IRS auditors first raised against Chevron in the early nineties. The company paid \$675 million to settle the dispute, far less than the \$1 billion it had set aside as a reserve in case it lost the case, which covered the years 1979 through 1987.

As with Unocal, the case involved in good part oil drilling in Indonesia. And like Unocal, Chevron, as it was then known, refused to provide requested documents. In that case the IRS took the company to court, briefly, until the auditors were shut down on orders from the IRS national office. It was this interference from above, and the frequency with which IRS audit managers were retiring from the agency and then showing up on the payrolls of the big oil companies, that made McGinley so determined to press his case. His concerns were

heightened when an IRS manager announced at a national meeting of IRS petroleum industry auditors that he would retire just as soon as he decided between competing offers of work from two oil companies, one of which he was helping at that very moment to audit. No one objected and no action was taken against the official.

In the Chevron case, a host of documents came into the public record because of the litigation the IRS briefly brought. James E. Wheeler, professor emeritus of accounting at the University of Michigan Business School, and Jeffrey Gramlich, a professor at the University of Hawaii, spent years going through the arcane documents before publishing them and commentary showing that "the evidence is there that fraud exists." ChevronTexaco said the research paper was nothing more than a rehash of IRS issues it had settled long ago and were without merit.

Chevron and Texaco, before they merged in October 2001, each owned 50 percent of a joint venture called Caltex, which pulled crude oil from the ground in a project with the Indonesian state oil company, Pertamina. The professors said that Chevron reduced its tax liabilities in the United States by buying oil from Caltex at inflated prices. One internal Chevron document set the price it paid Pertamina for oil at \$4.55 a barrel higher than the prevailing market price. Spending more for the Caltex oil permitted Chevron to overstate deductions for its costs on its U.S. income tax returns, the authors said. Indonesia appeared to place a 56 percent income tax on this oil, charging far higher than the United States corporate tax rate. Because the United States gives companies a dollar-for-dollar credit for taxes paid to foreign governments, every dollar paid to the Indonesian government meant less money to the United States government.

At first glance that would not seem to benefit Chevron because what it saved in American taxes it paid in Indonesian taxes. As Professor Wheeler put it, "What sense does it make to move income out of the U.S. to Indonesia?"

Plenty. The reason was that the Indonesian government compensated Caltex for the overpriced oil and the extra taxes by giving it free oil. Because Caltex had to pay taxes on that oil, however, the Indonesian government gave it even more oil to cover the taxes. It was the same technique corporations use when they "gross up" the salary of an

executive to pay his taxes on a fringe benefit. The company has to pay not just the taxes, but the taxes on the taxes. If Indonesia wanted to give Caltex an additional \$100 worth of oil after taxes, it had to give it \$227 in oil. That amount, taxed at 56 percent, left Caltex with \$100. That \$100 was never taxed in the United States, the professor said. But that was not the best part of the deal.

Chevron and Texaco got a United States tax credit of \$127—the amount of the Indonesian tax—on every \$227 of oil that the Indonesian government funneled to their Caltex joint venture. That tax credit reduced the companies' U.S. taxes on a dollar-for-dollar basis.

Professor Gramlich said that with this kind of a deal a company is eager to pay all the taxes it can. "They like paying taxes in Indonesia, because they get their tax money back twice. They pay taxes in Indonesia and get it back in oil, and they get a foreign tax credit from the U.S. government."

A much bigger tax trick involves putting intellectual property—a patent, a drug formula, the ownership of a corporate logo—in an envelope and mailing it to a tax haven. The American drug industry tends to favor Switzerland for this purpose because not only is it politically stable, but it has a side deal with Luxembourg that can result in a tax of less than 10 percent on profits.

The Pritzker family did the same thing with the brand name for its hotel chain, Hyatt. It is perfectly legal to move intellectual property offshore, but the price has to be reasonable. The Pritzkers valued the Hyatt name at just \$10,000 per hotel, a figure so low that it does not take a tax expert to know the price was not reasonable.

Putting intellectual property in an envelope and mailing it overseas is "international tax planning 101," according to Richard E. Anderson, an international tax partner at the law firm Arnold & Porter in New York and the editor of a basic reference for international tax lawyers. "You can't pick up a factory and move it to the Cayman Islands," Mr. Anderson said, "so most of the assets that are going to be relocated as part of a global repositioning are intellectual property. In today's economy that is where most of the profit is. When you buy a pair of sneakers for \$250, it's the swoosh symbol, not the rubber" you pay for.

From 1983 to 1999 the value of American corporations' assets in Bermuda, the Cayman Islands and 11 other tax havens grew 44 per-

cent more than their assets in Germany, England and other countries with tax rates similar to U.S. rates, Department of Commerce data show. Martin A. Sullivan, a former Department of the Treasury economist, found in a study for the journal *Tax Notes* that the assets moved offshore were especially lucrative and profits taken in these tax havens grew far faster than anywhere else.

Tax-haven profits rose 735 percent, to \$92 billion, during those years, while profits in countries that are not tax havens grew only 130 percent, to \$114.2 billion.

Bermuda and the other tax havens accounted for 45 percent of the total offshore profits in 1999, but only a fourth of those assets. A look at the tax rates actually paid shows the reason companies want to move assets to tax havens. The official federal tax rate on corporate profits is 35 percent, while in the tax havens profits were taxed at rates from a fraction of 1 percent to 12.5 percent of profits, the Department of Commerce data show.

In all, the 10,000 biggest American companies reported \$758 billion in profits worldwide in 1999 and paid taxes to the United States of \$154 billion, or 20 percent, which was well below the statutory rate.

A big part of the \$113 billion difference between the statutory tax rate and what the big corporations actually paid is due to tax sheltering, including moving intellectual property offshore. What these companies are doing is systematically reducing the tax base in the United States, and that costs you money. Over time erosion of the tax base has to mean either sharply higher taxes on you or less government services or more government debt, which means both a burden passed on to future generations and a growing share of current taxes being used to pay interest on money the government spent long ago.

The Bermuda moves, which were both high profile and, to many Americans, offensive, involved far less money. The official estimate by Congress was \$6 billion per year, a figure that assumed not many companies would renounce America as Stanley Works tried to do and Ingersoll-Rand and some others did. But the subtle moving of assets offshore goes on every day.

The accounting profession has become so creative at these tricks that it has even found a way to fabricate profits, which conveys two advantages. Higher reported profits mean a rising stock price. And if the

profits can be engineered in a way that no taxes are due, then a company gets to report both fake profits and low taxes. That is exactly what Enron did and it explains how in five of its last six years before bankruptcy it reported huge profits and paid no federal corporate income taxes.

Enron created 881 subsidiaries abroad, almost all of them in tax havens, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius, 8 in Bermuda and 19 others.

After Roth had left office, the Senate Finance Committee ordered a detailed investigation of the collapse of Enron. What the Joint Committee on Taxation staff found surprised even its most veteran members.

Lindy L. Paull, chief of the joint committee staff, told the Finance Committee in 2003 that Enron used tax shelters that allowed it to report \$2 billion of profits almost immediately, even as the company was saving \$2 billion of federal income taxes over a period of years. The tax savings and the manufactured profits "were mostly from internal machinations where we couldn't find any benefit to the company," Ms. Paull said.

Most of the shelters were put together in the nineties by Wall Street firms, led by Bankers Trust, which later became part of Deutsche Bank. It was paid more than \$40 million by Enron for tax shelters. One shelter used a "triad" of Cayman Islands entities to hide money from the IRS, an example of what Ms. Paull said were transactions so complex that the IRS lacked the capacity to deal with them.

She also criticized an 85-page opinion letter by William S. McKee and James D. Bridgeman of McKee, Nelson, Ernst & Young, a tax boutique set up by the Ernst & Young accounting firm. Enron paid more than \$1 million for the letter. Ms. Paull said it skirted crucial issues that made the deals improper. One part of the opinion, the report said, "may not be patently false, but it understates" a crucial issue. The shelter, called Project Cochise, involved the transfer of real estate interests subject to accounting and tax rules that do not match. This generated both income and deductions, which were inflated by taking some of them twice, not unlike the deal Jerry Curnutt uncovered in which he calculated that a \$10 investment would eventually cost the government a third of a billion in lost taxes.

McKee, the lawyer who wrote the million-dollar letter, said later

that "the opinion is fine," and the shelter so carefully conformed to the tax laws that he did not even regard it as aggressive tax avoidance.

Senator John B. Breaux, Democrat of Louisiana, said that "instead of drilling for oil and gas, Enron was drilling the tax code, looking for ways to find more and more tax shelters." Senator Grassley said that "what hit me the most was the moral fiber of the people involved," who he said displayed "unbridled greed and blatant disregard for the law of fairness."

There is a structural reason that abusive tax shelters, the muscling of IRS auditors like McGinley and the widespread use of corporate tax devices that hurt all Americans in the long run have grown so in recent years. This factor has received virtually no mention in the news media, although it is the subject of an extensive and lively debate in law reviews and professional journals. It is the emergence of legal and accounting firms whose names end with the letters LLP, which stands for Limited Liability Partnership.

One law review article described LLPs as "a lamb with mandibles of death."

The problem is that the LLP structure destroys the self-policing mechanism that helps to keep legal and accounting firms from using their enormous power to the detriment of others, especially the third parties like investors who rely on the integrity of audited financial statements to make decisions on buying and selling stocks.

Traditionally, legal and accounting firms operated as professional partnerships. Under this arrangement, each partner was individually liable for misconduct by any other partner. This created a powerful incentive for legal and accounting firms to monitor each partner, to make sure that they not only were honest, but acted reasonably, lest every partner be exposed to lawsuits and damages. All partners had to worry, and watch, to make sure that one bad apple did not destroy everyone else in the firm by such acts as helping a client company cook the books.

Then along came the savings and loan crisis in the early 1980s, when a number of financial institutions turned out to be giant frauds or piggy banks for their executives. Some of the executives went to jail and the taxpayers were stuck with a bailout to protect savers that cost many billions of dollars. Partners at some of the legal and accounting firms paid by these failed thrifts, the evidence showed, shirked their

duties to find obvious fraud. A few partners were even actively involved in the looting. Under partnership law, these failings of professional duty made the rest of the partners in their firm liable. Some firms went out of business and some partners who had done nothing wrong—except fail to monitor their partners—mortgaged their homes to pay their share of the damages.

The problem for the legal and accounting firms was that they had no way to measure their potential exposure to wrongdoing. One partner who helped executives loot one big bank could wipe out his firm and his partners' personal fortunes.

Had the market been left alone, it would have solved this problem by pricing legal and accounting services, and malpractice insurance, in ways that made sure that legal and accounting firms adequately monitored their partners to stop errant behavior. But the invisible hand of the market was stayed by political interference. The legal and accounting professions, themselves rich with members of the political donor class, went to government for special protection.

First, in 1988, they got the IRS to rule that a professional firm could be organized as an LLP (limited liability partnership). Then in 1991 the legislature in Texas, home to many of the biggest of the savings and loan and bank collapses, passed the first limited liability law. Soon every other state and the District of Columbia followed and most professional firms switched to the limited liability structure.

In doing so, they eliminated the incentive for the partnership to spend much money or effort monitoring the conduct of each partner because the worst that can happen is that the partnership will be put out of business. The individual partner was no longer at risk of his own net worth if one of his partners helped crooks or was himself a crook. The old rule that required partners to stick their noses into each other's business was replaced by a new one. It said that so long as you do not stick your nose in you are not personally liable for any misconduct of your partners.

This new limited liability structure creates what economists call a moral hazard—rules that encourage and even reward misconduct at the expense of others. Clearly, when legal and accounting firms sell tax shelters that do not pass the smell test, yet tell unsophisticated buyers that the shelters are not just sturdy, but safe, we see evidence not just of

a moral hazard, but of real harm. Would the accounting firms and the law firms be so eager to sell abusive tax shelters if each partner had to put her own assets at risk in each of these deals? The answer is obvious.

Some critics have said that the traditional partnership structure is economically inefficient because it encourages excessive monitoring of conduct and these costs lower productivity. That argument may be valid when the limited liability concept is applied to creating companies that sell products and most services. But to apply it to the legal and accounting professions is to extend a good policy into an area where it can only encourage bad behavior by breaking down the duty of loyalty, also known as fiduciary duty, that is essential to the integrity of the economic and tax systems. Delaware has gone so far that it allows limited liability partnerships to hire out fiduciary—duty of loyalty—functions.

Government regulation cannot be the answer to the moral hazard problem and to the actual amoral and immoral conduct encouraged by the new limited liability rules. Government cannot effectively, efficiently or fairly regulate the activities of the legal and accounting fields because their day-to-day operations are all judgment calls. Government can set minimum standards for admission to these professions. It also can pursue wrongdoers after the fact. But the blunt instrument of a regulatory agency can never be fine enough to police the professions. These day-to-day judgment calls can only be made by those in the firms themselves, who can decide what is acceptable conduct and acceptable risk. The old partnership form accomplished just this with the savings and loan scandals serving as a reminder to behave properly, a reminder that was turned into an exercise in shedding professional responsibility.

So long as the limited liability partnership form is allowed for the professions of law and accounting, no investor's dollar is safe. And so long as the structure is allowed, the government will have to divert resources to demolishing abusive tax shelters or else all taxpayers will suffer from this cheating.

Some of the best evidence of how limited liability partnerships are a bad deal for society, how they drive up costs for everyone else because of the bad behavior that they encourage, can be found in the growing problem the IRS has faced since the midnineties trying to

catch tax cheats. While a few like Nick Jesson stand on their cyberspace soapbox and announce themselves, most tax cheats rely on the accounting and legal firms to craft the complex, hard to find and even harder to understand tax shelters that Jerry Curnutt worked so hard to identify by sifting through the inadequate data that the IRS lifted into its computer files from tax returns.

Like guerrilla soldiers, a small army that moves stealthily in darkness can disrupt and perhaps even destroy a society that operates in the open. Hunting down hidden tax cheating is a costly, inefficient and messy business, especially with handcuffs on. In 2002, as his five-year tenure as the first businessman to run the IRS came to an end, that is exactly what Charles O. Rossotti came to realize.