You . . . can be a millionaire . . . and never pay taxes! You can be a millionaire . . . and never pay taxes! You say . . . “Steve . . . how can I be a millionaire . . . and never pay taxes?”
First . . . get a million dollars.
Now . . . you say, “Steve . . . what do I say to the tax man when he comes to my door and says, ‘You . . . have never paid taxes?’”
Two simple words. Two simple words in the English language: “I forgot!”
— Steve Martin, Saturday Night Live, January 21, 1978

**Introduction**

Lots of unscrupulous big corporations and wealthy people are working hard to hide their profits and income from the tax collector. Their schemes are more complicated than Steve Martin’s comic infomercial envisioned, but they’re just as damaging to our country, and just as reprehensible. In fact, almost three decades after he delivered it, Martin’s tax advice needs only minor updating. Add a few zeros to $1,000,000 and change the punch line to “Seven simple words . . . ‘I have a note from my lawyer.’ ”

The culprits are many. The greedy tax dodgers, of course. Their unscrupulous tax advisers, including America’s most prestigious accounting firms, biggest banks and many law firms—who make billions of dollars facilitating evasion and avoidance. But most of all, the blame lies with demagogic lawmakers in Washington, who have turned a blind eye to tax evasion, and have refused to give the Internal Revenue Service—the tax police—the resources to stop the abuses.

Tax dodging takes many forms. There are, of course, legal loopholes enacted by Congress in response to lobbying pressure. Generally termed “incentives,” they purport to encourage people or companies to do something socially or economically useful. Then there are potentially legal (but often not) tax shelters—what might be called “roll your own” loopholes to cut taxes in ways that Congress never officially intended. And finally, there’s outright cheating—simply failing to report your income or making up deductions.
Distinguishing one from the other isn’t always easy. Taking a deduction for donating your old car to charity is perfectly legal, for instance. But making up an inflated value for the deduction is cheating. Moving your money offshore and failing to declare the income it earns is clearly cheating if you’re a person. But it may be legal—or at least quasi-legal—tax shelter if you’re a multinational corporation.

Likewise, how do you tell a tax shelter from an authorized tax incentive? One rule of thumb might be that “incentives” are tax breaks lobbied into the law fair and square by corporations and people seeking public subsidies for doing what they’d do anyway. (Would-be tax avoiders don’t lobby Congress to pay them to change their conduct—that would be silly.) In contrast, shelters are abuses of the tax laws that nobody paid Congress to allow. Is one more despicable than the other? I suppose you could say that if something is so ridiculous that even the most corrupt Congress can’t countenance it, then maybe it’s worse. Or maybe not. Bill Thomas, the California Republican who chairs the House Ways and Means Committee these days, doesn’t seem to be able to tell the difference, and I’ve always found him to be pretty clearheaded, albeit poorly intentioned.

In the realm of tax shelters, tax lawyers like to draw a sharp distinction between tax avoidance and tax evasion. The former is what they do for a living, whereas the latter is shameful criminal behavior. More precisely, the lawyers call a scheme “avoidance” if it has a reasonable chance of being upheld if the IRS ever detects it. In contrast, they say, “evasion” depends on the IRS never finding out what’s going on.

But given how few tax returns our cash-strapped IRS now audits, the reward-to-risk ratio for playing the audit lottery with extremely shady tax shelter schemes is very high. In fact, an illustration of Gresham’s Law seems to have occurred in the tax field. Just as bad money drives out good in an unregulated market, bad tax advisors can drive out good ones. Accounting firms that don’t market tax shelters fear they’ll lose customers to their competitors. Tax lawyers who honorably refuse to write letters blessing dubious shelters—an essential insurance policy for tax avoiders against being criminally charged if a scheme is detected and rejected by the IRS—find their clients shifting to less principled attorneys.

In fact, all of the major accounting firms, including Ernst & Young, Deloitte Touche, PricewaterhouseCoopers and KPMG, have been involved in marketing clearly abusive tax shelters. So have many supposedly-respectable law firms. Numerous large banks and investment firms, such as Citigroup, Bank of America, Wachovia and Merrill Lynch, have also been implicated in tax evasion and/or aggressive sheltering activities.
The more dubious the scheme, the more the lawyers and accountants charge their clients: “My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit,” a KPMG tax advisor told the firm in May of 1999 (as a Senate investigation revealed this February).

Far too many investors and business owners are tempted to understate their gross business receipts and/or overstate their expenses, move their investments offshore, fail to report their capital gains accurately, and so forth. Not all succumb, of course. Even for those who do, the actual alchemy of making income disappear for tax purposes is probably often a mystery. That doesn’t in any way absolve the tax cheats and aggressive avoiders from blame: they’re the demand side of the equation. But without the supply side, the lawyers, accountants and banks that set up the shelters, the demand would go unrequited.

The ethically-challenged tax advisers who are willing to help would-be tax evaders are well aware that the chances of their clients being audited by the IRS are extremely low, so long as a tax return doesn’t raise obvious red flags. Their chief weapons to win this “audit lottery” are complexity and subterfuge.

In contrast, the vast majority of Americans who make almost all their money from wages have few opportunities for serious tax cheating. Taxes are withheld from paychecks, W-2 forms are easily matched against tax returns, and straightforward deductions for mortgage interest, state and local taxes, and (most) charitable donations are easily checked for accuracy.

So the majority of us who honestly pay our taxes have a major stake in getting the tax dodgers to ante up, too—hundreds of billions of dollars a year, in fact, although no one knows the exact amount for sure.

Taxes, as Supreme Court Justice Oliver Wendell Holmes noted a century ago, are “the price of civilization.” Most of us are willing to pay our fair share of the cost of all the things we want and need our government to do—so long as we believe others are chipping in, too. But others—too often those who have gained the most from our society—prefer to shirk their responsibilities and pass the cost onto the rest of us. So let’s take a closer look at tax sheltering, starting with individuals and moving on to corporations. And finally let’s then talk about what we can do about it.
“Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the Treasury. There is not even a patriotic duty to increase one’s taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.”

— Judge Learned Hand, writing for the 2nd Circuit Court of Appeals in *Helvering v. Gregory*, 69 F.2d 809 (1934)

**Tax Shelters for Wealthy People**

From a distance, the tax code can look like a fine work of art. Its overarching principles, to tax “income from whatever source derived” and to do so at graduated rates, are admirable and sound. But closer up one finds that vandals have been at work. Legislators carve large holes in the system. Lawyers and accountants chip away at small defects until they become big ones. Eventually, new laws are passed and regulations are issued to try to deal with these problems, and so the process continues. The length and complexity of the income tax code is often criticized, but much of that complexity is actually devoted to trying to stop the avoidance and evasion that the vandals have created.

Taken out of context (as it often is on right-wing websites), Learned Hand’s statement in *Helvering v. Gregory* appears to offer tax sheltering an official stamp of approval. But the actual decision in the *Gregory* case was quite the opposite: it established the principle that activities engaged in solely for tax avoidance should not stand up. As the Supreme Court said in affirming the Court of Appeals ruling in favor of the IRS, “the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.”

In a later decision in 1949, Hand himself made the principle even clearer: “The doctrine of *Gregory v. Helvering* . . . means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.”

Nevertheless, “transactions entered upon for no other motive but to escape taxation” have continued to be concocted over the years, with their success rate
depending on who’s been in charge in Washington, D.C. Recently, the tax-shelter problem seems to have reached a new peak.

For historical perspective, let’s go back to the 1950s, when the top personal tax rate was a staggering 91 percent. Only a handful of very wealthy people faced this rate, of course, but for them, the impetus for tax sheltering was enormous, since a dollar saved in taxes was the equivalent of earning $11 before taxes.

Tax shelters got a big boost from the Supreme Court in a 1947 case called *Crane v. Commissioner*, which said that corporations and investors could write off investments financed with borrowed money even if they have no intention of ever repaying it and are not legally obligated to repay it. (Ironically, this disastrous case was a Pyrrhic “victory” for the IRS.) Lawmakers helped the tax shelter industry along by enacting loopholes that could be exploited as shelters. In 1954, for example, “accelerated depreciation” let companies and investors write off business machinery, equipment, real estate and so forth much faster than they actually wear out. Investors in oil shelters got *immediate* write-offs for their drilling costs, plus “percentage depletion” deductions. The combination of large write-offs and interest deductions was a bonanza for those seeking shelter from taxation.

At first glance, writing off machinery and equipment faster than it actually wears out may not seem like much of a tax break. After all, eventually investors will get to take the full write-offs; accelerated depreciation just speeds them up. Esteemed tax lawyer Sheldon Cohen, who later went on to serve as IRS Commissioner in the Johnson administration, recalls that when he tried to interest the big accounting firms in depreciation-based tax shelters back in the fifties, the accountants at first brushed him off. What’s the point, they asked. It’s merely a tax “deferral.”

But as Cohen explained, deferring taxes is a very big deal indeed. For one thing, there’s the time value of money. If the government lets you put off paying your taxes for a year, and you invest the money from the taxes you didn’t pay, then after a year you’ll at least have the interest of your loan. But the magic of deferring taxes, Cohen pointed out, is much more substantial than that. If you have a foolproof, low-cost scheme to put off paying taxes for a year, then when the year is up, you’ll just do it again but in a bigger way. And then again and again and again. Which means you’ll never pay taxes as long as the loophole remains open. It all comes down, Sheldon said, to “Cohen’s Law”: a dollar in taxes deferred is a dollar that the government never collects. Either the original investor will keep finding new deferral schemes, or someone else will take his place.

Once the accounting firms caught on, tax shelters involving equipment leasing flourished. Wealthy people became the nominal owners of boxcars, airplanes, and
a variety of other items about which they know little or nothing, and leased them to corporations. In effect, railroads, airlines and other companies with more tax breaks than they could use sold them to wealthy people, for whom they were very valuable. As an added bonus, when investors sold their boxcars and planes after the depreciation write-offs had played out, they got an additional, huge tax break. Any tax due on the sale was treated as a capital gain, taxed at only 25 percent. So they saved 91 cents in taxes for every dollar they wrote off, but paid back at only 25 cents on the dollar later. What a deal for them, and what a bad deal for the general public.

Since the 1950s, individual tax sheltering has waxed and waned with the political winds. Reforms in the sixties and seventies took much of the oomph out of some kinds of shelters. Ronald Reagan lurchéd from vastly expanding shelter opportunities in 1981 to closing down most of the worst ones in 1986. (Reagan’s budget director, David Stockman, actually promised that Reagan’s loophole-ridden 1981 tax cut bill, by lowering the top marginal tax rate from 70 percent to 50 percent, would “effectively eliminate” the tax shelter industry, despite all the new loopholes—apparently under the theory that no one would mind paying a mere 50 percent rate. As all rational people predicted, precisely the opposite occurred. But the far right continues to make similar ridiculous claims to this day.)

Starting around the early 1990s, the tax shelter industry staged a remarkable comeback, as promoters moved on to esoteric schemes previously unheard of or only dabbled in. “Those kinds of things, that is not what was happening 10 or 20 years ago,” IRS Commissioner Mark Everson told the Senate Finance Committee in June of 2004. “But because we have tightened up on some of the other shelters, now people are finding these channels, and that is very disturbing to us.” Many of these schemes rely heavily on keeping the IRS from discovering what’s really going on—i.e., they’re illegal. So in the nineties the tax shelter industry waged a lobbying war against the IRS in Congress. They found a receptive audience, especially among Republicans, and succeeded in both cutting the IRS budget sharply and putting new restraints on enforcement.

How do current shelters work? There are many varieties. But one widespread type of scheme is to undermine a basic principle of the tax law that deductions by one taxpayer should usually generate income for another. If a company pays wages to its employees, it takes a tax deduction while the workers pay taxes. If a business buys products from another business, one has a tax deduction, the other has taxable income. If this principle holds, then the tax law is self-policing to some degree and is certainly less susceptible to systematic abuses.
But what if X gets a deduction for a payment to Y and Y, for whatever reason, isn’t taxable? Then the self-policing system doesn’t work. Finding, creating or concocting a non-taxable Y is the lynchpin of many tax shelters today.

One well-known way to find a non-taxable Y involves offshore tax havens—countries that impose little or no income tax and have strict financial secrecy laws. If a would-be non-taxpayer in the United States can get a deduction for payments to a tax-haven entity he controls, or move income-producing assets offshore, then it becomes very difficult for the IRS to detect his tax evasion. In one recent case where the IRS did break through the veil of secrecy, it uncovered a major offshore tax-shelter scheme facilitated by major banks and credit card companies. The banks helped their clients move money to a offshore tax haven such as the Cayman Islands. Then the credit card companies let the tax avoiders borrow against those assets on their VISA, MasterCard or American Express card. So rather than paying taxes on their investment income, the customers got to spend it tax-free—at least until they got caught.

Unfortunately, getting caught in offshore tax evasion is the exception rather than the rule. The Tax Justice Network estimates that there are now $11.5 trillion in offshore assets held by wealthy individuals worldwide. This translates into $860 billion a year in untaxed investment income every year, with a $255 billion a year cost to governments around the world. There’s no doubt that Americans hold a significant share of these assets.

To be sure, hiding money offshore is usually illegal, at least for people. To keep their offshore assets and income hidden, tax evaders and their facilitators have actually organized a Tax Cheaters Lobby in the United States. It’s devoted to keeping up the wall of secrecy that makes it difficult for the IRS and the tax agencies of other governments to discover offshore tax evasion.

This so-called “Center for Freedom and Prosperity” is or has been endorsed by a long list of right-wing luminaries, including former Rep. Jack Kemp (R-N.Y.), former House Majority Leader Dick Armey (R-Tex.), Paul Weyrich of the Christian Right, Steve Moore, formerly of the Cato Institute, the anti-union National Taxpayers Union, the Heritage Foundation, corporatist groups such as Citizens for a Sound Economy, former Chamber of Commerce chief economist Richard Rahn, supply-side economist Arthur Laffer, and the ubiquitous corporate-lobbyist/Republican-operative Grover Norquist. One paper on the group’s pro-tax-evasion web site explains “Why the War on Money Laundering is Counterproductive.” Another offers “The Case for Swiss Bank Secrecy.” And still another worries about “the future of offshore financial centres, such as Vanuatu”—a south Pacific tax haven also known
for its promotion of pay-per-view pornography scams on the Internet. A recent press release claims that “Low-tax jurisdictions serve as an escape hatch for over-burdened taxpayers”—as if those who evade, rather than pay, their taxes are the overburdened parties.

Lest you think a group that bills itself as a lobby for tax cheats might be an ineffectual bunch of kooks, note that in 2001, it helped persuade the Bush administration to back out of an agreement among developed countries to pressure tax-haven countries to stop facilitating money laundering, drug dealing and tax evasion. The Clinton administration had championed this disclosure effort, but soon after George W. Bush took office, his Treasury Department announced that things had changed, and that stopping tax evasion “is not in line with this administration’s tax and economic priorities.”

Since 9/11, the Bush administration has become less strident in its support for bank secrecy and other non-disclosure policies. But it continues to oppose the most effective proposals for disclosure.

Cheating on taxes by moving money offshore illegally is not the only way to find a non-taxable Y. For those who prefer to stay closer to home, a non-taxable place to park income sometimes can be found right here in the USA. Take, for example, an array of tax shelters involving tax-exempt entities such as charities. In its simplest form, a charitable shelter would work like this. First, donate a bunch of money to a charity you control. That’s deductible (with some limits as to timing). Now borrow the money back and spend it as you wish. Borrowing isn’t taxable, so you’ve got your cake free of income tax. You’ll have to pay interest on the loan, but you’re essentially paying it to yourself (and you can borrow that, too.) A scheme this simple probably shouldn’t work if detected, due to rules against abuses of “private foundations.” But tax shelter promoters claim to have found ways around those restrictions, by getting public charities, hospitals, colleges and universities, pension plans, and even local governments and Indian tribes into the act. In recent years, many such institutions have accepted payoffs from tax shelter promoters to allow their tax-exempt status to be so exploited.

For instance, a February 2005 report by the Permanent Subcommittee on Investigations of the Senate Homeland Security and Governmental Affairs Committee found that “charitable organizations, including the Los Angeles Department of Fire and Police Pensions and Austin Fire Fighters Relief and Retirement Fund, participated as counter parties in a highly questionable tax shelter . . . developed and promoted by KPMG . . . The Los Angeles pension fund, for example, . . . participated in 28 [of these] transactions over 3 years, re-sold ‘donated’ stock to 11 of the original
‘donors,’ and obtained $5.9 million in exchange, while the ‘donors’ themselves attempted to shelter from taxation many millions of dollars in S Corporation income earned during the period in which the pension funds held the shares.”

In fact, IRS Commissioner Mark Everson told the Senate Finance Committee in June of 2004 that almost half of the 31 highly abusive tax shelters that the IRS has recently targeted involve the participation of tax-exempt entities.

This winter, the IRS arrested billionaire Walter Anderson and charged him with evading taxes on more than $450 million in income from 1995 through 1999. Besides illustrating how preposterously long it can take the IRS to catch cheaters, Anderson’s alleged tax evasion—the largest ever charged to an individual—provides a litany of tax-evasion techniques.

In 1999, for example, Anderson reported total income of $67,939 and paid income tax of only $494. The IRS says his actual income that year was $126 million. According to the IRS, Anderson set up a network of offshore corporations, sometimes under assumed names, to hide his ownership of three telecommunications companies and cover up hundreds of millions of dollars in earnings. He “donated” artworks worth millions of dollars to his private charitable foundation, yet kept the art on the walls of his house. He claimed to live in no-income-tax Florida to avoid income taxes in the District of Columbia, although at other times he asserted that he was a citizen of the Dominican Republic. “Mr. Anderson ran the table when it came to violating the tax laws,” said Mark W. Everson, the current IRS head.

These well-publicized cases where the IRS has been able to crack down on certain shelters and tax cheats are edifying. But are they just the tip of an iceberg of tax evasion and avoidance that goes undetected? Or put another way, is the tax-shelter problem worse today than in the past?

In late March of this year, I posed this question to my friend Sheldon Cohen, the former IRS Commissioner. His first reaction was to laugh. “Is that your whole answer,” I asked. He chuckled again and went on: “Yes, of course, the problem is worse, much worse than it used to be. The enforcement is now more lax and the audit rate lower than it has ever been in the 53 years I have practiced.”

How much is all this aggressive tax sheltering and evasion by high-income people costing honest American taxpayers? The truth is, nobody, including the IRS, knows. But Tax Justice Network’s data suggest that the U.S. may be losing upwards of $60 billion a year in personal income taxes due to offshore investment accounts alone. The IRS just settled 1,165 cases involving a single tax shelter for $3.2 billion—an average of $1.7 million per tax avoider. All evidence points to a total cost that is staggering.
“Is it the right time to be migrating a corporation’s headquarters to an offshore location? 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.”

— Ernst & Young webcast advising its corporate clients to shelter their profits from U.S. taxes by reincorporating in Bermuda—issued in the fall of 2001 soon after the 9/11 terrorist attacks

“My father said all businessmen are S.O.B.s but I didn’t believe it until now.”


**CORPORATE SHELTERS**

Big corporations have an advantage over people in sheltering their income from tax. First of all, of course, they have tremendous lobbying power in Congress. So they can get special tax concessions enacted that ordinary citizens never could. In addition, unlike individuals, corporations are allowed to break themselves into pieces on paper and treat completely phony, non-existent transactions among those pieces as if they really happened. Because large corporations typically operate in many jurisdictions through multiple subsidiaries, they have lots of opportunities to move profits away from where they’re actually earned and into places where they’re not taxed.

Corporate America, outside of a few industries like oil, was a bit slow to get into the tax-avoidance game. That’s why as recently as the 1950s, corporate taxes paid for about a third of the federal government. Indeed, in the early sixties, much of Big Business actually opposed the Kennedy administration’s “investment tax credit” as an unwise interference in the marketplace. But by the time that loophole had been repealed in 1969 on grounds of cost and general uselessness, big American companies had gotten a taste of tax dodging and wanted more.

President Nixon was happy to oblige, with expanded depreciation write-offs, tax breaks for exporters and a number of other giveaways. There was a brief tax reform moment in 1976, but it was soon followed by the “supply-side” period that began in 1978 and continued through 1981. Ronald Reagan in his first term was particularly devoted to loopholes. By his second term, however, Reagan (or at least his staff) had come to his senses, and presided over the 1986 Tax Reform Act, which repealed most
of the 1981-enacted tax breaks, along with many others, in exchange for lower tax rates.

But tax reform didn’t last. Due to enacted loopholes, new tax-dodging schemes and insufficient enforcement, corporate tax sheltering has run amuck. Some of the shelters that corporations use are identical to the tax-avoiding schemes that wealthy people engage in. But corporations can do much more.

For example, a company may make products in one place and sell them in others. If the place it makes the products has low taxes, it may charge its selling subsidiaries, on paper, a lot for the products. That means high profits in the low tax country where the products are made, and low or no profits in the places where the products are sold. Conversely, if the place products are made has the high taxes, then the company will “sell” its products cheaply to its selling subsidiaries, and shift profits to the places where the products are sold.

Or a company may borrow from one of its subsidiaries in a low-tax place. The interest will be deductible against income that would otherwise be taxable in a higher-tax place, and taxed little, if at all by the low-tax place.

Or a company may have a very valuable asset, such as a trade name. If it transfers the ownership of that name to a low-tax place and then charges its taxable operations large royalties to use the name, it can avoid huge amounts in taxes.

One of the more blatant corporate tax shelter schemes that we know about involves a foreign company, the Yukos Oil Company, until recently Russia’s biggest oil producer. After the break-up of the Soviet Union, many of Russia’s previously state-owned businesses were transferred into private hands, typically at bargain basement prices. Some of the new owners became instant billionaires, and their corruption didn’t stop there.

The new Russian tax code was drafted with the help of major American accounting firms, and was, on its face, as full of holes as Swiss cheese. One oddity of the Russian corporate income tax is that its revenues are dedicated to the Russian republics (the rough equivalent of our states), and those republics are authorized to give tax “incentives” to corporations, ostensibly to encourage economic development.

The republics where Yukos pumped and refined its oil weren’t about to offer Yukos tax breaks. After all, they didn’t need to. They already had the oil and the refineries trapped within their boundaries. But on the advice of its accountants, who included PricewaterhouseCoopers, Ernst & Young and KPMG, Yukos found what it thought was a way around that problem. Yukos went to one of the Russian republics,
Mordovia, and sought a tax break for its oil profits. This probably seemed pretty weird at first to Mordovian officials. After all, Mordovia’s official website notes:

“There are no large deposits of natural resources except building materials on the territory of Mordovia. However . . . there are some parts of the Moksha, the Vad and the Sura rivers with deposits of the unique type of resources that is stained oak.”

One can imagine the conversation between Yukos and Mordovian officials going something like this:

Yukos: We’d like a tax exemption for our Mordovian oil profits.
Mordovia: But you don’t have any oil profits here in Mordovia.
Y: Maybe not yet, but we will soon.
M: What’s in it for us?
Y: We’ll make it worth your while.
M: And if we say no?
Y: Don’t even ask.

Once Yukos got its tax exemption in Mordovia it simply transferred its profits, on paper, to that republic, and slashed its Russian income taxes down to near zero.

Unfortunately for Yukos, its thuggish billionaire chief executive, Mikail Khodorkovsky, decided to get involved in Russian politics and television. Russian President Vladimir Putin didn’t like the competition and charged Khodorkovsky and Yukos with billions of dollars in tax evasion. Although the Russian tax authorities had previously ignored this misbehavior and the Russian tax code was vague at best, it wasn’t a hard case to make.

Yukos’s inside-Russia tax shelter was particularly crude, but American companies do much the same thing inside the United States to avoid their state income taxes, with only a patina of added sophistication. Toys “R” Us, for example, transferred the ownership of its trade name to Delaware, which doesn’t tax royalties, and then charged its stores around the country hefty fees to use the name. From 2001 through 2003, Toys “R” Us paid no state income tax on its $549 million in reported pretax U.S. profits. Similarly, many Wisconsin banks have avoided taxes by transferring ownership of their income-producing loans to subsidiaries located in Nevada, which has no income tax. Texas-based corporations such as Dell and SBC Communications have shifted the nominal ownership of their companies to partnerships located in Delaware to avoid Texas income taxes. And on and on.

This February, my group, Citizens for Tax Justice, released a study of the state income taxes of 252 of America’s largest and most profitable corporations. We found that from 2001 to 2003, these companies avoided paying state income taxes on
almost two-thirds of their U.S. profits—at a cost to state governments of $42 billion. Overall, corporate state tax avoidance has led to a 40 percent drop in state corporate income tax collections as a share of the economy from 1989 to 2003.

Shifting profits to no-tax states is just the intramural version of the much larger international tax sheltering that America’s big corporations also engage in. The infamous Enron, which paid no federal income tax at all in four of five years from 1996 through 2000, had 881 subsidiaries in foreign tax-haven countries, 692 of them in the Cayman Islands alone, which it used for both tax evasion and financial shenanigans. Halliburton has hundreds of such offshore entities. Famous American logos, such as “Ford” and “Coca Cola,” are now being held by offshore affiliates in the Cayman Islands, in an international version of Toys “R” Us’s state tax dodge. Most other big corporations have tax-haven subsidiaries, too, all for the purpose of hiding profits from tax.

To be sure, there are some rules against companies shifting otherwise taxable profits out of the U.S. and into tax-haven countries. Indeed, a major section of the tax code, called “Subpart F,” is devoted to curbing such behavior. These rules are full of loopholes, hard to enforce and in need of reform, but they do have some salutary effect. In fact, the reason that Ernst & Young advised its corporate clients in the fall of 2001 to renounce their U.S. citizenship and reincorporate in Bermuda was that it would help get around these restrictions, since the Subpart F rules are harder to enforce or don’t apply to “foreign” companies.

Some of the tax schemes that multinational corporations engage in look downright wacky on their face, but they’re very lucrative. For example, one of our biggest banks, Wachovia, used a leasing tax shelter in which it pretended to own a German town’s sewer system. That strange scheme allowed Wachovia to eliminate all of its U.S. federal income taxes in 2002.

The list of complicated corporate tax avoidance activities is almost endless, but the effects on federal corporate tax collections is easy to understand.

When Citizens for Tax Justice examined the federal taxes of 275 of the largest U.S. corporations last September, we found that in 2003 these companies, on average, paid only 17.3 percent of their U.S. profits in federal income taxes—less than half the 35 percent rate that the tax code purportedly requires. From 2001 to 2003, 82 of the 275 corporations enjoyed at least one year in which they paid nothing at all in federal income tax, despite pretax U.S. profits in those no-tax years totaling $102 billion.

In 1965, federal and state corporate income taxes in the U.S. equaled 4.0 percent of our GDP, much more than the 2.4 percent average in the other major developed
countries. By 2001, the latest year available for international statistics, corporate taxes in those other countries had risen to 3.2 percent of GDP. But American corporate taxes in 2003 had plummeted to only 1.6 percent of GDP. (European countries are becoming increasingly worried, however, about growing corporate tax sheltering in their jurisdictions, too.)

The bottom line is this: Due to enacted corporate tax breaks, rate reductions and tax sheltering, U.S. corporate tax collections at the federal level alone have fallen from 4.8 percent of the gross domestic product in the 1950s to only 1.6 percent in 2004—a drop of two-thirds. To put that in perspective, if corporations paid the same effective tax rate now that they paid in the fifties, corporate tax payments to the U.S. Treasury would be $380 billion a year higher than they actually are.

Some of that decline in federal corporate tax payments since the 1950s reflects a drop in the corporate tax rate from 52 percent to 35 percent. So cracking down on corporate tax evasion and tax sheltering wouldn’t restore all of the lost revenue. But it would be a major step toward reducing the budget deficit, maintaining essential government services and protecting honest taxpayers.
“I have not seen any material decrease in the amount of tax shelter activity. It is not as public. It is done quieter.”
— “Mr. ABC,” an IRS confidential informant who provided original information concerning significant and ongoing tax fraud involving major Wall Street firms, testifying at the Senate Finance Committee’s Tax Gap Hearing, July 2004.

“Yeah, they can pick out [a single dubious shelter] and say, ‘We’re putting a hell of an emphasis on this.’ But will they do it the next time? Will they do it consistently? Do they have the manpower? Because the bad guys get it. They will behave according to the enforcement they see.”
— Former IRS Commissioner Sheldon Cohen
The Washington Post, March 25, 2005

Solutions

Late, the IRS has gotten a lot of publicity for its crackdown on some particularly egregious tax evasion activities, including the Walter Anderson case and the so-called “Son of BOSS” tax dodge—one of the many complicated shelters marketed by the big accounting firms. President Bush brags in his latest budget proposal that he’s proposing a big increase in IRS enforcement resources. The accounting firms claim that they’re making so much money helping corporations comply with the Sarbanes-Oxley Enron-inspired corporate-governance reforms that they’ve sworn off marketing tax shelters.

So have we turned the corner on combating tax evasion by corporations and the wealthy? Hardly.

The majority of us who pay our taxes honestly have the right to be assured that others do so, too. So it’s disheartening how severely the IRS’s ability to curb tax sheltering and evasion—or even to know how much is occurring—has been reduced over the past decade by Congress. Consider:

○ From 1994 to 2005, the overall IRS budget has been slashed by more than a fifth, both as a share of the economy and in terms of the number of IRS employees compared to the total U.S. population.

○ In the enforcement area, the cutbacks have been even more severe. Last summer, the Inspector General for Tax Administration reported that the IRS’s “enforcement staff declined from 25,000 at the beginning of FY 1996 to 16,000 at the end of FY 2003, a 36 percent decrease.”
IRS audit rates, of both businesses and individuals, declined precipitously, especially for upper-income tax returns. In 1996, the IRS audited 210,000 returns of people reporting more than $100,000 in income. By 2001, the number had fallen to only 92,000—even as the number of returns with incomes above $100,000 jumped by 80 percent.

In the mid-nineties, Republicans in Congress, probably at the behest of their allies and contributors in the tax-cheating business, even prohibited the IRS from doing any research on tax evasion.

Very recently, the IRS has finally been permitted to do some limited research on tax evasion (the preliminary results have just been released). Audit rates have begun to climb again, but they’re still well below where they were a decade ago. Although Bush’s latest budget would move a small portion of the IRS’s resources away from taxpayer assistance and into enforcement, total enforcement outlays would still be no higher than in 2004 as a share of the economy, and the enforcement staff would remain more than a third below what it was a decade ago, despite the explosion in aggressive tax shelters and outright fraud since then.

Many of our political leaders in the White House and Congress are so enamored with the idea of low taxes—at least for corporations and the wealthy—that they seem to perceive allowing tax evasion as just a backdoor tax cut.

On the plus side, honest taxpayers do have a few prominent allies in the fight against tax cheating. Sen. Carl Levin (D-Mich.) has been instrumental in exposing some of the worst tax-sheltering activities by the big accounting firms. Sen. Byron Dorgan (D-N.D.) has fought against corporate offshore sheltering for decades. Senate Finance Committee Chairman Charles Grassley (R-Iowa) has held some excellent hearings on tax evasion and even sponsored legislation to curb cheating a bit—although so far Grassley has rather missed the point of reform, by insisting on devoting the revenues from his limited reform measures to opening new loopholes.

But much more typical in our current Congress are people like House Majority Leader Tom Delay (R-Tex.), who, among other things, condemns attempts to force tax havens to disclose the identities of Americans engaged in illegal offshore tax dodging as “assaults on financial privacy.” As Sheldon Cohen points out, “You would have to go back to the early 50s to find a time when the IRS has had such low morale and support on the Hill.”

As for the accounting firms, well, as Mr. ABC notes, they’ve definitely been embarrassed into becoming “quieter” rather than crowing about their tax sheltering business. But have they really stopped helping clients shelter their income from
taxes? Have they closed down their tax haven offices in Gibraltar and the Cayman Islands? Don’t bet on it.

If we really want to make serious progress against tax evasion, we need to do a lot of things.

We need international cooperation to force comprehensive sharing of information among countries, especially from tax havens. The Tax Cheaters Lobby and its backers are especially afraid of this kind of reform, because offshore hiding is at the heart of many tax evasion schemes. Many foreign governments would welcome a cooperative crackdown on international bank secrecy—it was the Bush administration that pulled the plug on such cooperation when it took office in 2001.

We need stiff fines on tax-exempt entities, including charities, pension plans, and local governments, that cooperate with tax shelter schemes. Right now, the IRS’s only weapon is to take away a charity’s tax exemption, a punishment so severe that the IRS almost never dares impose it.

We need to frighten the lawyers and accountants with monetary penalties for abusive behavior, so that they stop selling and blessing tax sheltering behavior.

We need to force tax lawyers to file their often bogus shelter-blessing opinion letters with the IRS, so that schemes that rely on non-detection and playing the audit lottery will get scrutinized.

We need to fix the loopholes in our anti-tax-haven laws and expand the court-made rule that tax deductions must have some real economic substance. A good start would be to repeal the new multinational loopholes adopted by Congress last year, and instead adopt the anti-avoidance provisions that the Senate approved but were dropped at the insistence of the House and the tax avoidance lobby.

All of these and other changes are important. But none of them will do the trick unless we have enough tax police to use the disclosure and enforce the laws. So the most essential step that needs to be taken is simply to give the IRS more resources. Just to return to the staffing levels of a decade ago would require a 50 percent increase in the IRS enforcement budget. Given the increase in sheltering since then, phasing in a doubling of the resources devoted to tax enforcement would not be an unreasonable goal. Fortunately, we don’t have to worry about the cost. On the contrary, increasing the IRS budget is one kind of government spending that actually increases revenues.

The stakes are very high and the forces in favor of tax evasion and avoidance are well-financed and politically connected. Honest taxpayers won’t win this fight until we wake up to the fact that it’s our money the tax cheats are stealing—and then demand that our lawmakers do something about it.