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Tax Cheats Called Out of Control

by David Cay Johnston

So many superrich Americans evade taxes using offshore accounts that law enforcement cannot control the growing misconduct, according to a Senate report that provides the most detailed look ever at high-level tax schemes.

Among the billionaires cited in the report are the owner of the New York Jets football team, Robert Wood Johnson IV; the producer of the "Mighty Morphin Power Rangers" children's show, Haim Saban; and two Texas businessmen, Charles and Sam Wyly, who the Center for Public Integrity found in 2000 were the ninth-largest contributors to President Bush.

Mr. Johnson and Mr. Saban, who are portrayed as victims in the report, are scheduled to testify today before the Senate Permanent Investigations subcommittee. They are expected to say that professional advisers assured them their deals to avoid taxes were more likely lawful than not. The Wyly brothers told the committee that they would invoke their Fifth Amendment right against self-incrimination and thus were not called to testify. The report characterizes them as active participants in tax schemes.

Cheating now equals about 7 cents out of each dollar paid by honest taxpayers, as much as \$70 billion a year, the report estimated.

"The universe of offshore tax cheating has become so large that no one, not even the United States government, could go after all of it," said Senator Carl Levin, the Michigan Democrat whose staff ran the investigation.

Senator Norm Coleman, the Minnesota Republican who is chairman of the subcommittee, adopted the minority report on Sunday as the product of the full committee.

The report details how the Quellos Group, a tax shelter boutique based in Seattle, "concocted a tax shelter" using \$9.6 billion "worth of fake securities transactions that were used to generate billions of dollars of fake capital losses."

Senator Levin said that when investigators asked for trading records they were first told

the trades were private, over-the-counter transactions. He said investigators asked for trading tickets or other evidence of who owned the \$9.6 billion worth of stock and were told the stocks were never owned by the parties involved.

“They just wrote down numbers on paper and claimed losses,” he said. “It was just like fantasy baseball, except the taxes not paid were for real.”

Quellos, in a statement, said, “we fundamentally disagree with the report, which presents a one-sided view.” It said the transactions, which the Senate committee describes as fabrications, were real and involved “a significant possibility of economic gain and loss.”

The investigation, which took 18 months, involved 74 subpoenas, 80 interviews and the collection of more than two million documents, and yet Senator Levin said “the six cases we present are just examples, just a pinhole look.”

The 400-page report recommends eight changes, some of them aimed at going after the law and accounting firms, banks and investment advisers that the report says enable tax schemes that rely on complexity, secrecy and compartmentalizing information so that advisers can claim they had no idea that the overall transaction was a fraud.

“We need to significantly strengthen the aiding and abetting statutes to get at the lawyers and accountants and other advisers who enable this cheating,” Senator Levin said, adding that “we need major changes in law to stop the use of tax havens” by tax cheats.

It also recommends new rules that strip away the underlying legal presumptions that make offshore tax havens like the Cayman Islands, Nevis, the Isle of Man and Panama attractive places for Americans to hide assets and income from the Internal Revenue Service.

Senator Levin said the law “should assume that any transaction in a tax haven is a sham.”

He said that during the investigation he grew angry as he learned how common cheating had become and how existing government rules aided tax cheats. He said that complex schemes were broken into discrete pieces, allowing professional advisers working on each piece to assert that they had no idea that, taken as a whole, a scheme was improper.

“I get incensed by people who use tax havens to not pay their taxes while the average guy has to pay his taxes because they are taken out of his pay before he gets it,” he said.

Both Mr. Johnson, the football team owner and scion of the Johnson & Johnson health care fortune, and Mr. Saban, the television mogul, are portrayed in the report as victims.

The two men, through representatives, said yesterday that they relied on professional advisers who told them the transactions were lawful, and that they were now settling with the Internal Revenue Service.

Mr. Johnson, known as Woody, told Senate investigators two weeks ago that to buy the Jets in 1999 he had to sell assets, incurring the 20 percent tax on long-term capital gains in effect at the time. He said that a way to defer the tax was proposed by Larry B. Scheinfeld, who had been his accountant at KPMG until he joined Quellos, where he worked closely with Chuck Wilk, a tax lawyer.

The technique involved a complex set of circular transactions using what the Senate report characterized as sham corporations in the Isle of Man with shell corporations given names like Jackstones. Their ownership was kept secret.

“Ain’t capitalism great!” Mr. Wilk wrote to Mr. Scheinfeld in an e-mail message extolling the tax benefits of the Johnson deal. Three weeks later, when the deal was set, Mr. Scheinfeld wrote back: “I just hope Woody doesn’t get cold feet or have the I.R.S. select his return for an audit!”

The report details a scheme created for Mr. Saban to avoid more than \$300 million in taxes from sale of his half interest in the Family Channel and related properties.

Mr. Saban told Senate investigators that he never understood the transactions but undertook them after asking two questions of Mr. Wilk and his personal tax lawyer, Matthew Krane.

Mr. Saban said he asked whether the deals were legal and whether a major law firm would certify them as proper. The two lawyers, Mr. Saban said, answered “yes to both,” so he went ahead.

Later, when Mr. Saban learned that he had paid \$54 million in fees to Quellos; Cravath Swaine & Moore, a New York law firm; and others for what turned out to be what the report described as fake transactions, he said he felt “misled, lied to and cheated.”

Lewis R. Steinberg, who as a Cravath Swaine partner helped design the deal and wrote an opinion letter attesting that it was more likely than not to work as a tax shelter, told Senate investigators last week that he relied on assurances from Quellos and Mr. Johnson that real transactions took place, not fake trades. Mr. Steinberg, who is now at UBS Securities, another firm named in the report, is a prominent tax lawyer and in 2004 was chairman of the tax section of the American Bar Association.

The report also dissects deals by the Wyly brothers of Texas, showing how they made at least \$190 million through stock option exercises offshore but had yet to pay taxes on most of the money. They then borrowed against their offshore accounts to buy jewelry, pay for portraits of family members, buy homes and operate properties named Rosemary’s Circle R Ranch, LL Ranch, Stargate Horse Farm, Cottonwood Galleries and 36 Malibu Colony.

Senator Levin said he might propose limiting or barring the transferring of executive stock options to others, as well as more disclosure when they are exercised.

The report says that Credit Suisse First Boston, Lehman Brothers and Bank of America “all knew that the offshore entities” for which they made trades were associated with the Wyls, but ignored rules requiring disclosure of these transactions and helped them hide the true ownership of the assets. Only when Robert M. Morgenthau, the New York District attorney, issued subpoenas in 2004 did Bank of America close the Wyly accounts.

William Brewer, a Dallas lawyer for the Wyls, said that while the Senate report “intends to present a balanced view, the committee report is reflective of a number of misunderstandings.”

“The Wyls believe they have paid all taxes due,” he added. “And in any event, as the report makes clear, the Wyls were counseled by an armada of lawyers, brokers, financial professionals and offshore service providers to ensure that they were at all times fully meeting their obligations.”

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