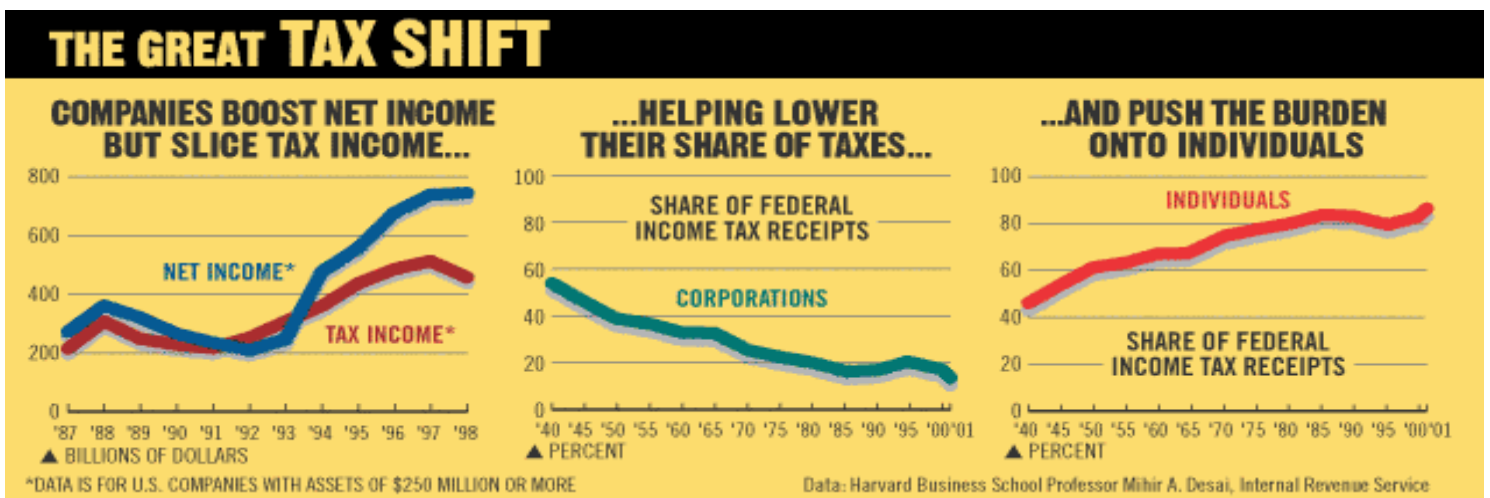


MARCH 31, 2003

The Corporate Tax Game

How blue-chip companies are paying less and less of the nation's tax bill

Walk into any of the thousands of hotels run by Marriott International Inc. (MAR) in glamorous cities and vacation spots around the world, and you know what to expect. The plush carpeting and twinkling chandeliers don't change much from Philadelphia to Paris. But there is something surprising about the company that manages the Marriott, Ritz-Carlton, and Renaissance chains: It has a sizable investment in, of all things, coal-treatment machinery.



Huh? Coal-scrubbing machines may not sound exactly synergistic for an elite hotelier, but the investment serves a different profit center, one that has become increasingly important for Corporate America: tax management, a euphemism for old-fashioned tax avoidance. Using tax credits stemming from a section of the tax code meant to encourage production of fuel from nonconventional sources, last year Marriott recorded a net tax benefit from the coal machines of \$74 million. It expects a similar savings in 2003 -- in all, more than double its initial \$60 million investment. That bonus was the biggest factor in driving the company's effective tax rate down to 6.8%, from 36.1% in 2001, as Marriott clearly disclosed to shareholders. That tax boon accounted for more than a quarter of last year's \$277 million in earnings.

There's nothing illegal about what Marriott is doing, and in fact nothing unusual. The federal income tax rate for corporations is 35%, but few pay that much. Over the past decade, companies across the U.S. have aggressively pursued tax-reduction strategies like Marriott's. Many have achieved the Holy Grail of corporate finance: steadily growing profits coupled with a dramatically shrinking tax burden. To reach that goal, they are taking extraordinary steps -- everything from making tax-favored investments to shifting profits to low-tax jurisdictions overseas to reincorporating in Bermuda or other tax havens.

Companies have also been helped in their quest by a tax code that has become ridiculously complex, a result of the annual welter of revisions from Congress and dogged work by an army of lobbyists. But in the late 1990s, the hunt for tax breaks became a much bigger business. For one thing, a new class of professionals -- Wall Street investment bankers -- joined the legions of lawyers and accountants hawking tax-management services. "Squadrons of lawyers, accountants, and Wall Street structured-finance experts have made an art form of minimizing the U.S. multinational's effective tax rate within this maze of the U.S. tax code, tax treaties, and global tax systems," says Selva Ozelli, international tax editor for RIA, a New York provider of tax information and software.

FIXING CORPORATE TAXES

BOOST ENFORCEMENT The Treasury Dept. has already unveiled new rules to curb what it calls the proliferation of abusive tax shelters similar to those used by Enron. Now Congress should give the IRS the cash it needs to enforce them.

INCREASE TRANSPARENCY The secrecy surrounding corporate tax-reduction strategies should be eliminated. Corporate tax returns should be public, giving investors the information they need to determine whether earnings are inflated by questionable techniques.

EXPENSE STOCK OPTIONS If companies can take a tax deduction when employees exercise stock options, they should have to take a corresponding expense when they dole them out. That way, taxes will still fall, but only when there's less reported income.

SIMPLIFY THE TAX CODE Most shelters take advantage of rules such as accelerated depreciation that give preferential treatment to certain types of income or expenditures. Cutting back on preferences would reduce the opportunities for sheltering.

KEEP INTANGIBLES IN THE U.S. Right now, companies have a huge tax incentive to move intellectual property offshore. Companies using cost-sharing arrangements to develop intellectual property offshore should be a particular IRS focus.

As the economic expansion reached its zenith, there was a much bigger pot of earnings to protect -- and bigger expectations to meet each quarter. Tax avoidance became a competitive sport, with even blue-chip companies aggressively benchmarking their effective tax rates against those of rivals. According to a recent Harvard University study, U.S. companies avoided paying tax on nearly \$300 billion in income in 1998. "In the bubble years there was a huge drive to increase earnings by any means," says former Internal Revenue Service Commissioner Donald C. Alexander. "One of the means was minimizing tax payments."

While the recent corporate scandals have shone a harsh light on weak corporate governance, excessive executive pay, and deceptive accounting, corporate tax avoidance has continued, largely under the regulatory radar. But that could change. The Treasury Dept. on Feb. 27 unveiled new regulations designed to curb what it describes as a proliferation of abusive tax shelters -- transactions that cross the line from tax minimization to tax evasion. Even in Congress, which has been slow to tackle tax reform, there's hope that the big tax-cut bill to be pulled together later this spring will address some of the worst abuses. Some in Congress have also called on the Securities & Exchange Commission to consider a prohibition against accounting firms selling tax advice to audit clients.

Tyco and Enron may have been the masters, but it's not just corporate rogues that have taken tax games to new extremes. After all, Enron Corp. modeled its massive tax department on that of General Electric Co. (GE) and a host of other big companies, according to a recent Senate committee report. Tech companies like Microsoft (MSFT), Cisco Systems (CSCO), and Compaq Computer (HPQ) proved adroit at shrinking their tax bills in the '90s through many means. Claiming unfair competition from lower-taxed overseas competitors, manufacturers have taken steps, too. Cooper Industries Ltd. (RD) reincorporated in Bermuda last May. Stanley Works dropped plans to move domiciles to Bermuda last summer after a backlash from lawmakers.

That kind of corporate maneuvering, combined with a long-term trend in Congress of shifting more of the tax burden to individuals, has driven corporate taxes down dramatically over the past four decades. In 1965, U.S. corporate taxes amounted to 4% of gross domestic product, according to the Organization for Economic Cooperation & Development which includes local, state, and federal income and capital-gains taxes in its calculation. By 2000, that figure had dropped to 2.5%. That's the reverse of the OECD nations as a group, which saw aggregate corporate tax receipts climb from 2.2% of GDP 38 years ago to 3.6% in 2000.

What has tax experts and academics puzzled is why the decline has picked up steam in the past few years. In 2002, corporate tax receipts fell to just 1.5% of GDP, far more than any change in the tax rules can explain. Many blame a greater willingness to push the envelope on tax management. "Companies are being much more aggressive," says University of Michigan Business School economist Joel B. Slemrod. "It became more acceptable to play the tax lottery."

So who's to blame? It's hard to fault companies for trying to minimize their tax bills by any legal means. But the system has gotten out of hand. A Byzantine tax code has created endless opportunity for well-financed companies to game the system. Massive resources in the form of tax lawyers, strategists, and lobbyists and shelter-type investments are aimed at nothing more productive than lowering corporate tax bills. That leads to economywide inefficiency and waste. It also leads to basic inequities when tax rates are determined by the ability to fund a sophisticated tax department.

Those inequities become even starker when lobbying is taken into account. Major companies can afford to hire high-powered lobbyists to push for tax breaks, creating yet more complexity with added loopholes and exceptions. In the mid 1990s, for example, Microsoft pushed for a tax break on exports similar to one that had been extended to other intellectual property creators, including movie studios and record companies. After being rebuffed by the IRS in 1995, Microsoft's lobbyists took the issue to Congress. The result: an

86-word provision, shoe-horned into a 1997 budget-reconciliation bill, extending the break to software companies. "Microsoft felt like it should get equal treatment under the tax law," says spokeswoman Caroline Boren, who declined to say how much the legislation saved the company or how much the lobbying effort cost.

The maneuvering by corporations has left the average American with a vastly larger portion of the federal tax burden. In 1940, companies and individuals each paid about half the federal income tax collected; now the companies pay 13.7% and individuals 86.3%. With the scales tipped so far in one direction, the issue of corporate tax avoidance is starting to attract attention in Congress. "If it isn't cut out, it spreads," says Senate Finance Committee Chairman Charles E. Grassley (R-Iowa). "It's much beyond the few obvious cases."

For too many companies, the bull market of the late '90s turned into an extended tax holiday, even as reported earnings soared.

Companies serious about minimizing taxes built powerhouse tax departments staffed with former government tax experts. GE, Ford, and Merrill Lynch have all hired top-flight tax experts from the Treasury Dept. and the IRS. John M. Samuels, hired by GE out of Treasury 20 years ago, went on to assemble an extraordinary team of tax talent. "The best tax law firm in the world," says Timothy J. McCormally, executive director of the Tax Executives Institute, "is the tax department at GE." GE spokesman David Frail says the company hires tax specialists from many places, including law firms, accounting firms, and other companies.

What strategies do those experts pursue? Exploiting low tax rates overseas was and is one of the most common methods of cutting the tax bill. The game has one simple goal and many routes to get there. The aim is to pile up income in low-tax nations while shifting expenses to high-tax nations. The most extreme version of this, and the tactic that has drawn the most fire, is to simply incorporate in a tax haven. Although it cost Tyco International Ltd. shareholders \$1 billion in capital-gains taxes when the company moved to Bermuda in 1997, by 2001 the company was saving \$600 million a year. Cooper Industries, Ingersoll-Rand Co., and a dozen or so others have made similar moves in the past five years. Washington has decried the trend, but Congress has yet to enact curbs.

Concern about these so-called corporate inversions may be taking attention away from a larger, more subtle migration of corporate income and assets toward countries with lower tax rates. Martin Sullivan, a tax economist, recently published a study showing a sharp drop in the foreign tax rates of U.S. multinationals -- from 49.6% in 1983 to 22.2% in 1999. Sullivan found that only half of that came from government tax-rate reductions. The other half was the result of shifting income from foreign countries with a higher tax rate to those with lower rates. "This is the more insidious aspect of corporate

expatriation," Sullivan says. "They're not moving their headquarters offshore, they're moving their assets."

A simple way to milk the system is by setting up transactions between different arms of the company. In one U.S. tax court case that is still pending, the IRS accused hotelier Hyatt International of paying too little for the Hyatt brand and other services provided by its U.S. parent. The IRS alleges that from 1976 to 1988, various Hyatt companies underreported income by \$100 million because of those lowball fees. In an October, 1999, ruling on some aspects of the case, U.S. Tax Court Judge Joel Gerber ruled that the \$10,000 one-time fee International had paid for each hotel bearing the Hyatt name was far too low. Hyatt declined to comment because the broad case is ongoing.

Tax lawyers report a steady stream of technology and pharmaceutical patents being moved overseas. That leaves Boston lawyer Avi M. Lev worried about the U.S.'s stature as a technology leader. "Many countries deliberately tax investment income at a lower rate to attract capital," he says. "We have a high rate because there's lots of good reasons to be here other than the tax rate. But with intellectual property, that tax competition is turned up a notch because intellectual property moves so freely, by the signing of a document."

Pushing even a little income into a lower-tax venue can result in substantial savings for a big company. GE whittled its effective tax rate from 28.3% in 2001 to 19.9% in 2002, paying \$1.5 billion less in taxes on its \$17.9 billion in earnings before income taxes. The single biggest contributor to that decline has been tax credits the company receives on exports and a greater percentage of taxes paid overseas, often in lower-tax jurisdictions. CFO Keith Sherin recently assured analysts that such credits would continue to hold down GE's U.S. tax bill. Within the GE empire, GE Capital enjoys the lowest tax rate. The financing giant paid only 15% in taxes last year, excluding the effect of a reinsurance write-off. How did Capital do it? Good question. Unlike financial statements, tax returns are not public documents. Clearly it benefits from depreciation generated in its huge leasing operations and sizable overseas business. GE declined requests for interviews on the topic and provided only limited answers to written questions.

So much focus on tax savings, critics argue, results in inefficient uses of capital and resources, and some strange business decisions. Compaq Computer Corp., for example, purchased 10 million American depositary receipts of Royal Dutch Petroleum (RD) in 1992 and resold them minutes later at a loss. Its brief ownership, however, earned Compaq a \$22.5 million dividend and a foreign tax credit for the \$3.4 million in taxes it paid on that dividend to the Netherlands. It used the \$20.6 million loss from selling the stock to offset another gain, a benefit worth \$7 million -- thus pulling off a hat trick of tax benefits.

After years of litigation, in 2001 an appeals court ruled against the IRS, determining that Compaq acted within the law.

Another popular tax dodge that has incurred the IRS's wrath: corporate-owned life insurance policies. Companies including Wal-Mart Stores (WMT), Procter & Gamble (PG), and Winn-Dixie Stores (WIN) once took out life-insurance policies on employees designed to yield tax-free income for the company and a corporate tax deduction on the interest. The IRS says such arrangements serve no legitimate business purpose and has disallowed the deductions.

The payoff for such circumlocution is clear -- a low tax bill equals higher earnings, and a higher stock price. David A. Guenther of the University of Colorado and Denise Jones of the College of William & Mary found that a reduction in a company's effective tax rate generally results in a rise in stock price. Two consecutive improvements gives a slightly bigger jolt, and moving income overseas results in the biggest jump of all. Thus, a good tax dodge can boost the stock price -- and the value of executive stock options, which were handed out with such abandon in the late '90s.

Options not only created perverse incentives for executives to lower the tax rate; they also gave them the very tools with which to do so. When stock options are exercised, the employee pays income tax on the gain. The company, however, doesn't book any expense, but gets a tax deduction equal to the difference between the exercise price and the price the stock is fetching in the market. Howard Schilit, president of the Center for Financial Research & Analysis Inc. in Rockville, Md., calls it "winning the lottery" for corporate tax departments.

The payoff was certainly Lotto-like. When option exercises peaked in 2000, the 50 companies in the S&P Global 100 that reported exercised stock options lowered their tax bills by a combined \$20 billion, says Charles W. Mulford, an accounting professor and director of the Financial Reporting & Analysis Lab at the Georgia Institute of Technology's Dupree College of Management. A half dozen were able to shave more than \$1 billion off their returns, including Microsoft (\$5.5 billion), Cisco Systems (\$2.5 billion), and Citigroup (C) (\$1.4 billion).

With the stock market decline, this tax bounty has shrunk but hasn't disappeared. The value of the stock-option deduction fell to \$11 billion in 2001 for the companies in Mulford's study. Some companies that had become accustomed to ever-growing stock-option deductions were hit hard. From 2000 to 2002, Microsoft Corp. saw its income-tax bill more than double, from \$800 million to \$1.9 billion. Cisco Systems Inc.'s (CSCO) tax bill nearly tripled during the same period, from \$327 million to \$909 million -- even though net earnings fell from \$2.7 billion to \$1.9 billion. Cisco declined to comment. Microsoft spokeswoman Boren says: "Microsoft works hard to comply with the

tax laws and to pay the legally proper amount of tax....The company claims all deductions to which it is legally entitled."

Companies with aggressive tax-minimization goals invariably claim that their strategies are necessary to compete globally. "The current U.S. tax law is poorly aligned with the tax systems governing our international competitors," says a spokesperson for Cooper Industries. "As a result, U.S. companies are at a competitive disadvantage in pricing their products and in competing for acquisitions."

While it's true some foreign companies, including some of Cooper's competitors, pay lower tax rates, many pay more. The U.S. statutory corporate tax rate of 35% is on the high end, and unlike many countries, the U.S. taxes global income; but foreign companies have other taxes. In France, for example, payroll taxes add significantly to the 30% statutory tax rate, sometimes boosting the tax bill above 60%. In Japan, Sony (SNE), NTT DoCoMo (DCM), and Toyota Motor (TM) all pay more than 40% a year in taxes.

Companies that move to zero-tax havens still operate on an uneven playing field -- it's just that now they have the advantage. Disk-drive maker Seagate Technology (STX) became a Cayman Islands company in November, 2000. It paid an effective tax rate of 3% in the last six months of 2002. (The company operates tax-free in many Asian countries.) And although it was headquartered in Bermuda for only half of last year, Cooper Industries paid an effective tax rate of 24%, down from 35% in 2000. That's on a par with German competitor Siemens and significantly lower than the rates of competitors it left behind like Eaton (ETN) and Emerson Electric (EMR).

While companies were mounting ever greater efforts to avoid taxes, the response from regulators was almost nonexistent. New York District Attorney Robert M. Morgenthau, who is prosecuting former Tyco (TYC) CEO L. Dennis Kozlowski, argues that regulators made a mistake in failing to go after corporations that undertook the most extreme tax maneuvers. Being passive, he says, ensured a growing trend of me-too tax schemes. "Why should I pay my taxes when my neighbor is not paying his or hers?" Morgenthau asks.

The IRS has a good defense. Its budget has been cut in recent years, and with the most aggressive tax shelters structured to involve many layers of transactions and dozens of tax returns, the workload is up. Even without the cutbacks, the rising complexity of the tax code has made enforcement harder than ever, and strategies for skirting the rules ever more plentiful.

There's no doubt that companies with powerhouse tax departments often end up manipulating the tax code in ways lawmakers never intended -- and in many cases end up paying less than anyone ever envisioned. Taken to an extreme, tax games distort the system and

waste resources on investments that serve little purpose beyond financial engineering. There's got to be a better way.

By Nanette Byrnes and Louis Lavelle

With Howard Gleckman in Washington and bureau reports

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MARCH 31, 2003

The Rise of the Wall Street Tax Machine

The shelter game has been hidden and lucrative. Could it be the next big scandal?

In April, 1997, Bankers Trust, now a division of Deutsche Bank (DB), pitched a creative new tax shelter to Enron. After the energy giant expressed interest in the scheme, BT Managing Director Thomas Finley mailed a contract on June 17 to R. Davis Maxey, head of the Structured Transactions Group in Enron Corp.'s tax unit. Buried in the fine print was an unusual provision nullifying the deal "if any law enacted after the date of this letter shall require the Transaction be registered as a 'tax shelter'" with the Internal Revenue Service.

Finley had reason to be concerned. At the time, Congress was debating the Taxpayer Relief Act of 1997, which contained a proposal requiring Wall Street's financial engineers to tell the IRS about the secret tax-avoidance schemes they were machine-vending to companies across the country. The measure would be bad news for Enron, because if the IRS found out about the dubious shelter BT had proposed, it would almost certainly challenge the transaction.

The tax bill passed in August, 1997. But Project Steele, as the Bankers Trust proposal was known, survived nonetheless. That's because Enron, which stood to save \$78 million in taxes from the deal, and BT, which had \$11 million in fees at stake, found a way to salvage it. Salvation came in the form of blue-chip Washington law firm Akin, Gump, Strauss, Hauer & Feld LLP. It was willing to write an "opinion letter" vouching for the legality of the transaction. For a fee of \$1 million, Akin Gump delivered a 12-page opinion on Dec. 16 blessing Project Steele and saying that "the newly added provisions relating to corporate tax shelters should not be applicable" to it.

The participants all say that the deal, which allowed Enron and BT each to claim a deduction for the same pool of money-losing mortgage-backed securities owned by the investment bank, was legitimate. But now that the transaction has seen the light of day, it is being ridiculed by many tax experts. "It is like two families trying to claim the same child as a dependent," says Sheldon D. Pollack, a

professor of accounting at the University of Delaware who is an expert in corporate tax shelters.

The moral of this story is that the tax-shelter business is hard to kill. But there are signs that this lucrative trade could become America's next corporate scandal. The furor that began with the revelation in February that Sprint Corp.'s two top executives attempted to avoid taxes on nearly \$200 million in stock options has intensified with new disclosures about Enron's scams. One highlight: the testimony of Robert J. Hermann, head of the company's tax department, in a Mar. 5 bankruptcy court report that high-ranking officers found the shelters to be "kind of like cocaine -- they got hooked on it."

Thousands of pages of new documents released by the Enron bankruptcy examiner and the Senate, analyzed by BusinessWeek, provide the most detailed view ever of the tax-shelter trade. In particular, they shed light on how the investment bankers, lawyers, and accountants who profited from this business created and marketed their schemes. Now these professionals are in the crosshairs of plaintiffs' lawyers and regulators. Two Democratic representatives from Massachusetts, Richard E. Neal and Edward J. Markey, have asked the Securities & Exchange Commission to investigate the BT-Enron deals. While it has traditionally been hard to pin civil or criminal liability on clever shelter promoters, the Senate's bipartisan Joint Committee on Taxation is promising a regulatory crackdown. "The day of reckoning has come, I think, for shelter promoters," said Senator Charles Grassley (R-Iowa) at a Feb. 13 hearing on Enron's tax schemes. "We have to hunt them down."

The targets of Grassley's wrath are many of the brightest, most highly credentialed investment bankers, lawyers, and accountants in the country. They work in some of America's most prestigious firms, including Merrill Lynch (MER), Bear Stearns (BSC), J.P. Morgan Chase (JPM), Deloitte & Touche, Ernst & Young, Shearman & Sterling, and King & Spalding. The professionals in these firms, of course, all defend what they do. They often point out that companies have a legitimate right to minimize their tax bills, that the law is unclear, and that not all shelters are illegal.

But the one thing these hotshots generally don't like to do is offer any details about the schemes they sell. These transactions are not the type of old-fashioned deals outlawed by Congress in 1986 -- simple partnerships that required a one-time investment in, say, a cattle ranch (table). Rather, they are a revolutionary leap ahead. Enron's shelters, for instance, were complex structured financings involving a wide variety of exotic financial derivatives. They required active management by in-house staff and continuing involvement by the shelter promoter. The only thing new-generation shelters have in common with their single-celled ancestors is the lack of any justification other than avoiding taxes.

While the promoters of these schemes are some of the most highly paid people on Wall Street, they are not nearly as widely known as merger specialists, analysts, or fund managers. That's no accident. Well aware of the bad publicity engendered by successful tax avoidance, shelter dealers keep a low profile. The idea is simple: to prevent the IRS from finding out about the deals in the first place. On the rare occasions when the agency does discover a new scheme -- as often as not because some player has suffered a pang of conscience and anonymously tipped off enforcers by mailing a package of sales materials -- the promoters defend it to the hilt, betting they can win a soft settlement with the IRS years down the road.

Because of the culture of secrecy in the tax-shelter business, it is, by definition, impossible to estimate how big it is. But in 1999, economist Martin Sullivan made a rough estimate that corporate tax shelters cost the Treasury as much as \$30 billion annually. Whether this number is accurate or not, it is clear to most experts that the industry is a big reason companies have been driving down their tax payments in recent years. "Enron is not just one bad apple," says Lee A. Sheppard, contributing editor of Tax Notes magazine.

Prior to the 1986 tax-reform act, most shelters were sold by accounting firms. But investment banks got into the business when their deal work started slowing down in the late '80s. When it came to developing tax schemes, they had two huge advantages over the accountants: the ability to sell securities and the power to raise capital. Hiring the smartest tax minds away from law firms, Wall Street started marketing sophisticated new products. "These people were geeky," says one veteran of a multinational bank's shelter division. "It was not a macho culture like M&A. They didn't hang out with CEOs. These people lived deep in the tax code."

What they lacked in style, they made up for in cash. Tax specialists charged contingency fees of up to one-third of the payments that they saved. One of the pioneers of the business was Merrill Lynch & Co. A corporate finance group led by E.S. Purandar Das, a managing director who has departed the firm, and Arshad R. Zakaria, now president of global markets and investment banking, sold tax-avoidance schemes to Allied Signal (HON), American Home Products (now Wyeth) (WYE), Colgate-Palmolive (CL), and others in 1989 and 1990. The deals enabled the companies to generate huge capital losses on paper to offset big capital gains. A Merrill spokesman says: "We were not in the corporate tax-shelter business." But federal appeals courts have characterized the Allied Signal, Wyeth, and Colgate deals as shelters and rejected them. Both Zakaria and Das declined to comment.

In the early 1990s, many banks passed around nondisclosure agreements when they sold shelters. That came to a halt when Congress, in 1997, required promoters to register shelters "offered under conditions of confidentiality" with the IRS. But even if they

didn't sign NDAs, corporate officers still stayed mum to avoid alerting the IRS. Investment banks, meanwhile, used secrecy as a subtle sales inducement. "We would go to a company's tax manager and say, 'This is brand new,'" says one veteran of the business. "You are one of the first five people that we have shown this to, and we are only going to show it to five more."

Law firms were also key players in the tax-shelter trade. From time to time, partners came up with new ideas and then marketed them with accounting firms or banks. But their primary role was writing opinion letters vouching for the legality of the deals. Under IRS rules, these legal memorandums constituted evidence of corporate good faith -- immunizing companies from penalties for disallowed tax shelters. A small club of partners, many of whom had originally been law enforcers at the IRS, dominated this business, including William S. McKee of McKee Nelson; Fred T. Goldberg and Charles Morgan at Skadden, Arps, Slate, Meagher & Flom; R.J. Ruble of Sidley Austin Brown & Wood; and Robert A. Rudnick at Shearman & Sterling. None of these lawyers agreed to speak to BusinessWeek.

But some lawyers found the whole enterprise -- and the arm-twisting applied by powerful Wall Street clients -- unappetizing. In 1999, the New York State Bar Assn.'s tax committee urged the Treasury Dept. to stop waiving fines for clients with legal opinion letters. Why? Because if the penalties increased, then attorneys would have more leverage to say no to their clients. "Every big firm felt pressure from investment-banking clients to deliver these opinions," says Dana Trier, a partner at New York's Davis, Polk & Wardwell. Treasury never acted on the suggestion.

In 1995, the tax-shelter juggernaut hit Enron -- a match made in heaven if there ever was one. Its auditor, Arthur Andersen LLP, was promoting a simple and widely marketed type of deal known as the "contingent liability" shelter. For a mere \$500,000 in fees, the company saved \$66 million in taxes in a deal called Tanya. The energy giant declined to discuss its tax transactions with BusinessWeek.

Enron's top management got excited. Tax chief Hermann appointed trusted subordinate Maxey to head the Structured Transactions group, which grew from one person in 1997 to 17 in 2000. Enron's low-visibility tax bureaucrats became dealmaking stars -- with ambitious revenue targets just like the company's energy traders. "Dave [Maxey] was able to build his own world and deal with the big muckety-mucks," recalls one former Enron tax-department insider. Maxey's attorney, Philip H. Hilder, said the company's deals "involve tax planning ideas fully supported by U.S. tax laws."

Like most shelters, Enron's were designed to maximize deductions, credits, and losses -- the currency of the tax-avoidance business. But unlike most other companies, the energy giant did not use the deals to offset current income. It did not really need to, since the company

could already take advantage of immense stock-option deductions. Rather, Enron generated enormous future tax savings and then used aggressive accounting to convert those hypothetical assets into current income.

Because the deals were complex, some of them took more than a year to evaluate and set up. But they were big enough to have a major impact on the bottom line. The 12 tax-avoidance transactions the company did from 1995 to 2001 produced \$2.02 billion in tax savings - - and were then turned into \$2.079 billion in current income. The meticulous Maxey, meanwhile, developed a reputation for secrecy. "He was notorious for handing documents out at meetings and then collecting them back," recalls a former insider.

The first big deal that Maxey did with an investment bank was Project Steele. The key ingredient to the transaction was a pool of mortgage-backed securities owned by Bankers Trust that had lost money -- and therefore could be cashed in for tax deductions. BT transferred these securities, known as REMICs, to a new partnership known as ECT Investing Partners that it jointly owned with Enron. For its part, Enron tossed in some cash and other stray assets such as airplane leases. When these maneuvers were complete, both BT and Enron had rights to the deductions for the REMICs.

Neat trick. This would normally be illegal because the Internal Revenue Code prohibits one company (Enron, in this case) from buying another outfit (ECT) simply to acquire its deductions. To get around this rule, Enron claimed that it had a legitimate business purpose for the deal other than tax avoidance. And what was that? Believe it or not, to inflate earnings -- or, as Akin Gump put it in the firm's opinion letter, to "obtain financial income" benefits from the deal. Both Enron bankruptcy examiner Neal Batson and the Joint Committee on Taxation have criticized this legal alchemy.

In a statement, Akin Gump said that "based upon the information available to us at the time, as well as prevailing legal standards, we concluded that we could [approve] the transactions. Nevertheless, we...are reviewing our records and files to confirm the appropriateness of our advice." BT's Finley, now at Merrill Lynch, declined to speak to BusinessWeek. Deutsche Bank declined to discuss the details of BT's Enron work but said it "is confident [our actions] were lawful."

These are the types of games that lawyers and auditors are supposed to stop. But the outside professionals were making a fortune and often in cahoots on the deals. Akin Gump had helped BT develop the Project Steele shelter -- a conflict of interest that, arguably, made it impossible for the law firm to give Enron objective independent advice about the legality of the scheme. The firm says that it had "the informed consent of both BT and Enron."

Enron auditor Arthur Andersen, whose consent was necessary for Project Steele to succeed, billed a seemingly paltry \$49,600 for reviewing the tax shelter in January, 1998. But it appears that in some other deals Arthur Andersen found yet another way to profit from the shelters. "Andersen's New York office also was frequently engaged by the promoter to opine on the accounting treatment for a hypothetical transaction that [Enron planned on doing], after which Andersen was engaged by Enron to approve the accounting treatment for the actual transaction," says the bankruptcy examiner's report released on Mar 5. Andersen declined to comment on the specifics of its shelter work for Enron, but a spokesman said that "investment banks and law firms were the star players" in this business and the accounting firm's "tax experts were on the sidelines."

A SHORT HISTORY OF THE TAX SHELTER

Shelters used to be sold to the rich. Companies did not really need them, since every industry had its own goodies in the tax code. It all changed after 1986

Data: BusinessWeek



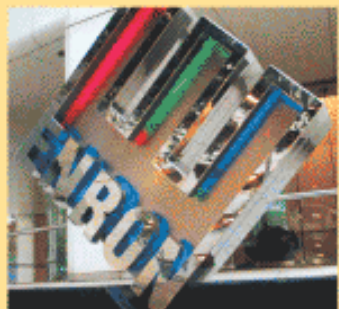
1950s The wealthy get around income taxes by investing in tax-exempt bonds and using trusts to shift income to their children

1970s Accounting firms peddle cattle-ranching and oil-field shelters



1986 Congress pushes back with the Tax Reform Act of 1986, which kills many of the games

LATE 1980s Investment banks, including Merrill Lynch, enter shelter business



1995 Enron does its first deal, a widely marketed shelter promoted by Arthur Andersen

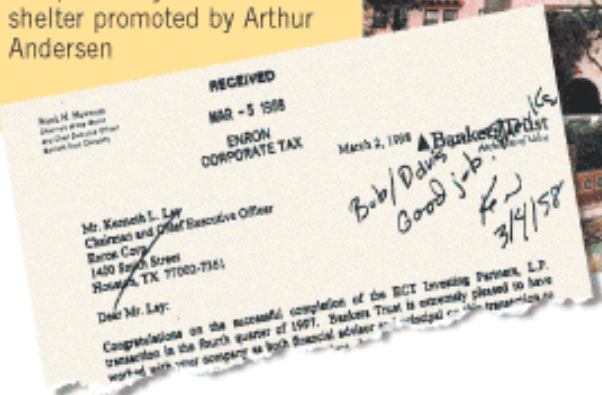


1997 Congress cracks down by requiring shelters to be registered—a measure that's largely ignored

1998 The spoils of the tax trade: Enron tax chief R. Davis Maxey is jetted to Florida resort on Bankers Trust's corporate plane and gets handwritten praise from CEO Kenneth L. Lay



2003 Revelations about Enron's deals prompt new calls for reform from Senator Charles Grassley, among others in Washington



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IN THE CROSSHAIRS

A hit list of firms that helped Enron construct its tax shelters. All defend their actions, but the deals have been attacked by the Senate Joint Committee on Taxation

BANKERS TRUST

The most active promoter of tax shelters to Enron —earning total fees of more than \$40 million. Now part of Deutsche Bank Group.

DELOITTE & TOUCHE

Investigators say the firm earned \$8,325,000 pitching a shelter in 1999. D&T says it did not “sell” the schemes to Enron.

SHEARMAN & STERLING

The big New York law firm became a powerful adviser to investment banks promoting shelters in the 1990s. Advised on the Chase deal.

CHASE MANHATTAN

Earned \$11.25 million in fees in 1998 by selling Enron a tax shelter known as Apache, named after a golf course in Arizona.

McKEE NELSON

A unique law firm that at one point formed a strategic alliance with the accounting firm Ernst & Young. Approved a complex 1998 deal.

AKIN, GUMP, STRAUSS, HAUER & FELD

Powerhouse D.C. firm gave a green light to Enron's 1997 Steele transaction, while earning \$1.1 million in fees.

For its part, BT collected a fee of \$8.5 million on Project Steele. In January, 1998, BT invited Maxey on a jaunt in the investment bank's plane to the Boca Raton Resort & Club. A few months later, BT Chairman and CEO Frank Newman mailed a letter to Enron CEO Kenneth L. Lay celebrating the successful completion of Project Steele. The Enron chief forwarded the note to Herman and Maxey with a handwritten notation: "Good job. Thanks, Ken."

The rewards in the tax-shelter business were obviously rich. The risks, on the other hand, were minimal. Enron inundated the IRS with 2,486 tax returns in 2000. Naturally, none of these documents advertised the fact that many of Enron's deductions, and much of its income, came from tax-driven transactions. To find that out, an agency auditor would have had to request backup documentation from the company -- and then embark on a long investigation. That rarely happens. And it's rarer still for an IRS agent to uncover a sophisticated corporate tax shelter. Until the agency starts digging deeper -- or Congress helps out with new regulations -- there's little reason to believe the shelter business will disappear.

By Mike France

With Emily Thornton, Heather Timmons, and Louis Lavelle in New York

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