

**TAX SHELTERS: WHO'S BUYING, WHO'S SELLING,  
AND WHAT'S THE GOVERNMENT DOING  
ABOUT IT?**

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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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OCTOBER 21, 2003

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# **TAX SHELTERS: WHO'S BUYING, WHO'S SELLING, AND WHAT'S THE GOVERNMENT DOING ABOUT IT?**

**TUESDAY, OCTOBER 21, 2003**

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD-50, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Nickles, Snowe, Bunning, Baucus, and Bingaman.

## **OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. Thank you, everybody. We appreciate very much the kind attendance of people at this hearing, particularly our witnesses, particularly our colleague Senator Levin, who is with us, to look into a very important issue before Congress.

It is not a new issue. It may be new evidence, but it is an ongoing issue that we have. So we are meeting today to provide an update on the issue of tax shelters. My guess is that the first tax shelter was created before the ink on any of the legislation ever became dry in the first Tax Code. So, as I have already indicated, it is a continual and constant effort to fight these shelters.

The administration has taken good steps to address the latest wave of shelters, committing additional resources and looking to using those resources more effectively.

However, it is very clear that we have a long road ahead of us, and we need to give the administration additional power and authority to do its job. The Finance Committee and the Senate have answered the bell.

Several times already we have passed bipartisan legislation that will provide the executive branch the tools that are needed to help address the current wave of tax shelters.

There is hardly a bill passed by this committee that has not contained anti-shelter legislation. I know that the administration supports core parts of our anti-shelter legislation. I would encourage the administration to join us in pressing hard to ensure that the Congress passes this much-needed legislation, and to do it quickly.

The focus of this hearing is on the current situation with tax shelters. We are here today to consider and hear accounts of where we are in the battle against abusive tax shelters.

The hearing today will revisit Enron, but we will also hear similar, equally troubling accounts. Particularly gripping will be the inside account of the abuses in the leasing industry.

This hearing will show that Enron was not an exception, and that Enron did not act alone. Enron was not the “lonely Maytag repairman” when it comes to creating tax shelters and buying tax shelters. Enron had a lot of help from investment bankers, law firms, and accounting firms. These tax shelter hucksters sold tax shelters not only to Enron, but to other companies as well, and they continue to do so today.

I know the administration recognizes that there is work to be done, and has begun the tough job of putting these hucksters out of work. However, my hope is that the Finance Committee’s continued oversight will focus the government’s work and ensure that this remains a top priority with people having that responsibility.

Finally, I say to the hucksters, it is time to find an honest living. The Finance Committee, on a bipartisan basis, remains committed to addressing the issues of tax shelters, and particularly promoters. We will continue to press in this area and to ensure that the government continues to realize results in putting the hucksters out of business.

I now turn to my colleague who has been very cooperative in this effort over a long, long period of time, including the period of time that he was Chairman of the committee, Senator Baucus.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR  
FROM MONTANA**

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, the proliferation of abusive tax shelters has been referred to as “our Nation’s most significant tax compliance problem.” The development, selling, and buying of tax shelters has also been characterized as a “race to the bottom.”

The New York Bar Association said, “The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to extend this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in taxed-advantaged transactions.

Simply put, this is unacceptable. This is why the Finance Committee, under Senators Moynihan and Roth, as well as under Chairman Grassley and myself, have pushed for legislation to put the breaks on these tax-engineered schemes.

The purpose of today’s hearing is to make it clear that the tax shelter problem is not just an Enron/Arthur Andersen problem. The tax shelter problem is widespread, developed and promoted by accounting firms, law firms, investment banks, and purchased by many other corporations and individuals.

Now, as Judge Learned Hand said, “There is nothing sinister in arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor, for nobody owes any public duty to pay more than the law demands. To demand more in the name of morals is mere cant.”

But we are here, not talking about legitimate tax planning. Abusive tax shelters are illegitimate tax avoidance schemes that create a tax benefit without any corresponding economic benefit.

There is no new product, no technological innovation, just a tax break. Those engaged in this tax shelter business are doing this at the expense of those taxpayers who are paying their fair share of taxes.

To give you an idea of the burden they are placing on these honest taxpayers, during the 1990's alone, actions taken to shut down the tax shelters that we knew about saved the American taxpayer \$80 billion.

A recent study commissioned by the IRS estimated that the current cost to honest taxpayers ranged from \$14 billion to \$18 billion a year, and it is up to \$180 billion over 10 years.

Every spring, Americans sit down at their kitchen table at their home computer to figure out their taxes. With quiet patriotism, these Americans step up and pay their fair share. They are counting on us to make sure that sophisticated corporations pay their fair share as well.

I am simply unwilling to tell a schoolteacher in Montana that he needs to pony up a little more because Congress is unwilling to shut down a loophole that is costing tens of billions every year.

Today's hearing is critical, highlighting the magnitude of the problem. Congress cannot ignore the problem any longer. It has been 2 years since the collapse of Enron, yet not one piece of tax legislation to curb tax shelter abuses has been enacted.

I look forward to continuing to work with you, Mr. Chairman, to see the Tax Shelter Transparency Act through to enactment. I also urge all of my Congressional colleagues in the House and the Senate to join forces to send tax shelter legislation to the President for his signature by the end of this year.

Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

Now we have the privilege of hearing from one of our colleagues. We are hearing from him in his capacity as a Senator from Michigan who has been very active in this for a long period of time, and now also is Ranking Member of the Permanent Subcommittee on Investigations, and, when his party was in the Majority, Chairman. He is also very well-known for his activities as spokesperson for the Democratic Party on the Armed Services Committee as the Ranking Member of that committee.

You have been very active, I know, Senator Levin, in working to curb the abuse of tax shelters. So, we look forward to your testimony today. Your entire statement will be included in the record.

I think I should make that announcement for other people as well. So you do not take the time to ask that your statement be put in the record, all statements longer than 5 minutes will be included in the record so that we can keep inside of the five-minute time period.

Senator Levin?

**STATEMENT OF HON. CARL LEVIN, RANKING MEMBER, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, U.S. SENATE**

Senator LEVIN. Mr. Chairman, thank you. Thank you, Senator Baucus and members of the Finance Committee for your determination to try to put an end to tax shelters, the tax shelters which cheat the American taxpayers who are honest of billions of dollars each year need to be exposed. They need to be stopped, and it is going to take legislation, obviously, in order to do that.

One of the advantages of that will not only be additional money coming to the Treasury which is owing the Treasury, but it will be an aid to the honest tax professionals who do not hawk these abusive tax schemes, but have to compete against those who do.

In some parts of the world, tax cheating is a way of life. Some governments do very little to curb that. In this country, however, taxpayers are being asked to pay billions of dollars to strengthen our homeland security, to support our troops, to take care of the sick, to improve our schools, to rebuild Iraq, to look out for our seniors, and the use of these farfetched and abusive tax schemes to avoid payment of tax need to be exposed for really what it is: unfair, and indeed, unpatriotic.

As the Chairman mentioned, last year our Permanent Subcommittee on Investigations opened an in-depth investigation into the development and marketing of abusive tax shelters by professional firms, like accounting firms, banks, investment advisors, and law firms.

This was part of the Enron investigation which, like your investigations, disclosed that one of the things Enron did was to use these elaborate tax dodges. One of the tax schemes that we exposed was a tax scheme called "slapshot," in which J.P. Morgan/Chase—and I emphasize, these are legitimate firms that helped Enron carry out their fraud—designed and sold this tax shelter to Enron for \$5 million. Enron calculated that this tax shelter scheme called "slapshot" would produce tax benefits exceeding \$120 million for their payment of \$5 million to Chase.

As detailed in a subcommittee report, this tax shelter relied primarily on a sham \$1 billion loan that was arranged and financed by J.P. Morgan/Chase. It concealed within a mind-boggling array of loans, stock swaps, structured finance transactions, many of which occurred within minutes of each other. That shelter's complexity was designed to prevent tax authorities from finding out what really happened.

We pierced that veil by subpoenaing hundreds of boxes of documents, reading thousands of e-mails, conducted numerous interviews, and spent months unraveling how that tax shelter worked.

We figured out slapshot, but the larger issue, which we are now investigating with the support of our subcommittee chairman, Norm Coleman, is how respected U.S. financial institutions end up hawking abusive tax shelters and enlisting the help of so many other respected professionals to make them work.

This is a target-rich environment. Numerous respected accounting firms, investment advisors, banks, and law firms spend resources, form alliances, and develop the internal and external infrastructure necessary to aggressively design, market, and imple-



ment hundreds of complex tax shelters that U.S. taxpayers would otherwise be unable, unlikely, or unwilling to employ.

They are doing it in exchange for hundreds of millions of dollars and it cost the Treasury billions of dollars each year.

One of the common features of these tax shelters is the reliance on highly-skilled professionals, these layers of corporations, trusts, special-purpose entities that only a trained financial professional could devise and establish.

Now, some people, Mr. Chairman and Senator Baucus, claim that the tax shelter abuses are already over, that there is no need for further investigations, reforms, or stronger laws.

But our investigation indicates that, while a few promoters are calling it quits, the tax shelter industry as a whole is still going strong, targeting new opportunities and market segments, hawking tax shelters like late-night cut-rate TV bargains, and victimizing honest taxpayers, communities, and honest tax professionals.

Next month, our Permanent Subcommittee on Investigations is going to hold the first in what we hope will be a series of hearings, presenting detailed case histories, demonstrating how respected U.S. tax and financial professionals develop, market, and implement abusive, highly questionable tax shelters.

We are going to present an inside look at the attitudes and operations underlying these tax shelter activities, including documentary evidence illustrating the aggressive approach that some respected firms have taken in selling their tax shelters.

I want to just cite one example for this committee this morning. A leading accounting firm that develops and markets tax shelters, but denies being a promoter of tax shelters, had this e-mail circulating among its tax professionals. This is what the internal e-mail said. This is in a company which denies promoting tax shelters.

"I want to personally thank everyone for their efforts during the approval and process of this strategy." This is a tax shelter marketing strategy. "It was completed very quickly. Everyone demonstrated true teamwork. Thank you. Now, let us capitalize: sell, sell, sell!!!"

What they are selling are these strategies. What they are selling are these tax shelters that are so deceptive, so unfair to the American public.

Finally, Mr. Chairman and Senator Baucus, I commend you for the bill which you have co-sponsored repeatedly, which have passed the Senate twice. We hope that we can get this passed in the House, as well as in the Senate.

I am introducing a companion bill with Senator Baucus and Senator McCain today which will add one additional feature to the bill which you have introduced which tightens up the rules on tax shelters.

What my bill does, is it would bar an accounting firm from auditing the books of any publicly traded company to which it has sold a tax shelter. This has been recommended by the highest authorities, by our most trustworthy authorities. You should not sell a shelter and then audit your own work. It is an inherent conflict of interest. Getting rid of this conflict of interest is what our bill will do.

Getting rid of this conflict has been supported by the Conference Board's Blue Ribbon Commission on Public Trust and Private Enterprise, co-chaired by John Snow before he became Secretary of the Treasury, which says, in summary, "Public accounting firms should limit their services to their clients to performing audits and to providing closely-related services that do not put the auditor in an advocacy position such as novel and debatable tax strategies and products that involve income tax shelters and extensive off-shore partnerships or affiliates."

I want to thank you again, Mr. Chairman, Senator Baucus, and this committee for your leadership. I hope your efforts at both exposing these abusive shelters and getting the bill passed, and hopefully getting our companion bill passed will be complemented by the efforts of the Permanent Subcommittee on Investigations, which Senator Coleman and I lead.

[The prepared statement of Senator Levin appears in the appendix.]

The CHAIRMAN. Senator Levin, you asked me last week if I would take a look at your bill, and I have not completed my study of that yet. But I really compliment you for being out in front and for the very overwhelming testimony that you give.

More importantly, thank you for our committees' working together in mutual support of this effort, because I think it is very mutually supportive. So, I thank you for that.

I do not have any questions, but I want to ask my colleagues if they have any questions. I will go to Senator Baucus first, and then to Senator Bingaman.

Senator BAUCUS. Well, I have no questions, Mr. Chairman, except to very heartily thank our colleague from Michigan. He has done yeoman's work in this area, much more than most members of the Senate.

As you have said, Mr. Chairman, his committee, the subcommittee, has worked very well with this committee also, and that is to be commended. We're not trying to fight each other for turf reasons, or whatnot, but rather are working together. I also thank him for his legislation. I think it is very much needed.

I think the separation of the auditors auditing versus promoting and selling transactions is a no-brainer. Clearly, that is important. I also think it is a good idea to codify the five principles that the Senator codifies in his legislation.

This has got to stop, plain and simple. We have talked way too much and done too little in the U.S. Congress. It has been 2 years since Enron and not one piece of tax shelter legislation has passed.

I think that does not sit too well with the American people. We do a lot of talking, we do not do a lot of acting. I just very much hope that not only the Congress, but the relevant agencies, the IRS, Justice, and the other agencies, will step up their actions, too.

As I said in my testimony, about \$180 billion over 10 years is lost through known tax shelters. \$180 billion over 10 years. That is a lot of money. That is to say nothing about some of the other uncollected tax revenues that we are faced with.

We have got a problem here, a big problem, and we have a huge opportunity. Just think what confidence the American public would have in the U.S. Government if they knew that these shelters were,

in fact, shut down and that unreported revenue was being collected? Basically, that these shelters are being shut down, pure and simple. That they do not exist. Boy, that would be something. It is up to us to try to do something about it.

Thank you very, very much.

The CHAIRMAN. Senator Bingaman, then the Senator from Kentucky.

Senator BINGAMAN. Thank you very much.

Let me thank Senator Levin for his leadership on this. I did want to ask. I obviously strongly support the legislation that this committee has reported several times to deal with the issue.

But to what extent do you believe that the authority currently exists, either with the Internal Revenue Service or with this new, Public Company Accounting Oversight Board, or with any other part of the administration to deal with these problems?

I mean, it does not seem to me that Congress should have to legislate in order to be sure that this kind of thing does not happen. I do not know what your perception of that is. Maybe there is something that could be done, even if the legislation is not fully enacted.

Senator LEVIN. I think it is important that the bill which has been introduced by the leadership of this committee be passed, which will strengthen and simplify the Economic Substance Doctrine that is defined more clearly in that bill. It would increase the penalties for violation of the law's requirements relative to tax shelters, so I very much support the bill.

But in terms of what could be done now, surely one of the things we can do now is give the IRS the tools that they need to enforce the current law. They are able to do enforcement in this area.

It is not as sharp or as strong as it should be, and that is what the bill is introduced for. But it does exist. There is some authority which exists, and they have been able to go after some of these tax shelters.

But they should not be cut in terms of their enforcement personnel. I am afraid that that very well could happen this year unless we act to avoid that happening.

Senator BINGAMAN. Just to follow up. Your view is that there is also a problem of inadequate resources being provided to the folks who are tasked with the job of ferreting out and dealing with these abuses.

Senator LEVIN. I do. I believe they are inadequate. They should be increased and not reduced.

Senator BINGAMAN. All right. Thank you very much.

The CHAIRMAN. The Senator from Kentucky.

Senator BUNNING. Thank you. I am sorry I missed your testimony. I have been involved in certain kinds of tax shelters in the past 25 years of investments. I can only tell you this, that more average people have lost more money in tax shelters than any other investments that they have ever made.

All of a sudden, those tax shelters become phantom income and they are required to pay income tax on money they never earned. Anything we can do to correct that problem, I am going to be for.

Thank you very much.

The CHAIRMAN. Senator Levin, thank you very much.

Senator LEVIN. Thank you so much.

The CHAIRMAN. I am going to ask the next panel to come while I introduce you.

We are going to hear from Michael Hamersley, senior manager at KPMG. Mr. Hamersley is responsible for providing technical guidance at that firm in their tax and audit practice regarding the structuring of proposed corporate transactions in connection with tax provisions reviews performed in the course of their firm's audits.

Our next two witnesses, Robert Schmidt and Thomas Walsh, are former employees who were senior tax counsels at Levi Strauss & Co.

Then we will hear from Mr. Henry Camferdam, Jr., who purchased a tax shelter. Then Mr. Robert Lally. He will share his experience as a partner in charge of tax practice in Hartford, Connecticut for Deloitte and Touche, as well as more recently with his firm in Farmington, Connecticut.

Finally, we are going to hear testimony from a former leasing executive who, in order to protect his identity, will be referred to as Mr. Janet during the hearing. In regard to that, I had an admonition that I wanted to read.

Before our first panel was here, I wanted to inform everybody that, for special security precautions, we are going to take caution to protect the identity of this Mr. Janet. That is not his real name.

In regard to that, we would ask that staff leave the area behind us, except if your member is present. We do have chairs out in the audience reserved for those staff people, because we know you need to hear what is going on here. Everyone else would remain in their seats during the testimony of the first panel, because we do want to protect this witness.

Now, in regard to Mr. Janet, I extend a special thanks to him. He has risked much by appearing here today and by exposing a massive fraud. Mr. Janet has done the Nation a great service. On behalf of the committee, we thank Mr. Janet for appearing.

Again, I would remind everybody to remain seated and keep all cameras pointed to the floor until Mr. Janet has left the room.

Now, in regard to Mr. Janet coming in, are we in a secured position to do that? All right. My staff informs me we are not going to bring him out until we get to the point of his testimony. But I have introduced him, and I am not going to introduce him again, obviously.

So we start, then, with Mr. Hamersley. Would you please start? I think we are going to go in the order as I introduced you, from my left to my right.

I think all of you have been told about the five-minutes, but let me emphasize it, because we have got a lot of witnesses to go through. And, particularly, Senator Baucus and I have a lot of questions that we are going to have to ask. I might ask colleagues to give Senator Baucus and me some leeway in the five-minute rule, because we are working together as a team on this and we would like to complete that.

So, Mr. Hamersley, would you start out?

**STATEMENT OF MICHAEL HAMERSLEY, FORMER EMPLOYEE  
OF KPMG, FAIR OAKS, CALIFORNIA**

Mr. HAMERSLEY. Thank you, Chairman Grassley. Good morning, Senators.

My name is Mike Hamersley. This is a return to DC for me. I graduated from law school here at Georgetown in 1995 and got an MBA and BBA degrees before going to law school.

I joined KPMG, LLP in 1998 in their Washington national tax practice here in town. I relocated to the Los Angeles office in 2000.

I am a mergers and acquisition tax specialist and work in the area of corporate restructuring, acquisitions, dispositions, and corporate restructuring, which is in the environment that many of these tax shelters takes place, the corporate tax shelters.

I was not directly involved in promoting tax shelters, but I was very often contacted by partners who others, including KPMG tax shelter promoters, were selling tax shelters to their clients and they were interested in finding out whether they worked. I also worked in close geographic proximity to some of the most prolific tax shelter promoters in the firm.

While at KPMG in Los Angeles, I received exceptional performance ratings. However, my career came to a sudden end in late 2002 involving a re-audit of a former Arthur Andersen audit client when I raised a number of doubts and concerns about some of the tax shelters, the off-balance sheet transactions, and the conduct of many of the KPMG tax partners that were involved on the audit, particularly on the tax provision work.

I eventually refused to endorse what I believed to be illegal conduct of KPMG tax partners involved in the audit and I was involuntarily placed on administrative leave of absence shortly after confirming that I had communicated with Federal investigators.

There seems to be some confusion about my employment status. I noticed in the program that I am listed as a former KPMG employee. KPMG insists that I am a current employee, despite the fact that I am not allowed to come in the office, and have not been for over a year now. They still list me as a current employee. The only thing that could possibly render me a current employee, is I receive a paycheck.

I would like to just touch upon a few of the major issues that were in my written testimony. Abusive tax shelters. These are really not just a mere contortion of the law. Changing the law to shut them down is a good first step.

But these are contortions of fact. These are lying, deceiving, and concealing true facts and really trying to be taxed on hypothetical transactions that never took place. They are not legitimate business transactions. These are tax benefits that drive the transactions, not vice versa.

Any purported business purpose or economic substance is just a facade. It is economic substance that is engineered in by the tax shelter promoters, not the financial advisors. So, I think that is an important distinction.

In the area of concealment of fact and fact contortion. Most tax shelters include a tax shelter opinion, which include representations from the client. Typically, some of those representations include business purpose and step transaction representations. Were

the many steps of this transaction part of a single plan? And they represent that they were not in order to achieve the tax results.

If you look through that, there are other mechanisms in the transactions. For instance, netting to avoid the detection of the transactions at the taxpayers' level, side agreements, and the like.

There are definitely legislative changes needed to increase the likelihood of disclosure and stiffer penalties for those who intentionally conceal the facts and distort them. Enforcement needs to be aimed at finding more of this concealment and punishing it.

Some of the specific practices that I observed while at KPMG associated with abusive tax shelters were such contortion of the law, contortion and concealment of facts. The transactions that were effective in concealing the facts from the IRS were often referred to by the promoters as having "good optics."

In other words, these are not easily detected, similar to the slapshot transaction that Senator Levin mentioned. I believe in the hearing they referred to that as "not leaving a road map." It is the same concept. There is also some concealment that takes place in the controversy work that may follow not disclosing the facts.

The tax shelter promoters were pretty brazen about this stuff. Some of the quotes that I included in my statement, "it's like stealing candy from a baby," "you'll never pay tax again," "our clients do not pay Federal income tax," "paying Federal income tax is optional," these are comments that promoters made.

The reasoning behind some of this attitude and the favorable cost benefit analysis that these promoters were making was that there is less chance and less penalty of getting caught than there is money to be made by selling these.

They believed the IRS would not discover them, and even if they did, that the enforcement would be prospective, therefore, the penalties would be minimal. There was a "too few to fail" attitude, that "all of the firms, the Big Four and Big Five accounting firms are doing this and they cannot shut down all of us."

I see my time is running out. I did want to touch upon the auditor independence issues. There are four problems which I briefly want to reference.

One, the problem that Senator Levin's legislation addressed, audit firms selling tax shelters to their own audit clients. That is the most abusive situation because the auditor is placed in a position of auditing the tax shelter that was sold by the audit firm, and the benefits on the financial statements were promised when it was sold. How can he not approve it?

The second one is a desire to sell tax shelters to the audit client. The cozying up with the audit client to be able to sell tax shelters in the future is a big problem.

Third. I think this is a problem I think the legislation needs to address. Even if you have not sold the tax shelter to your audit client, you may have sold similar shelters or identical shelters to non-audit clients and have promised financial statement benefit.

You can hardly not sign off on an identical strategy for somebody else's audit client and expect people to believe that your same strategy can be benefitted on the clients that you sold the strategy to.

Finally, in the review of transactions on what is called the tax provision review of an audit, there is a trade-off that goes on in those sign-offs, that very issue I just mentioned.

If another firm has sold a tax strategy to your audit client, there is pressure put on you to sign off because if you do not, they threaten that they will not sign off on yours that were sold to their audit clients.

I am sorry I went over, and I will wrap it up. Thank you.

The CHAIRMAN. Thank you, Mr. Hamersley.

[The prepared statement of Mr. Hamersley appears in the appendix.]

The CHAIRMAN. Mr. Walsh?

**STATEMENT OF THOMAS WALSH, FORMER EMPLOYEE OF  
LEVI STRAUSS & CO., SAN JOSE, CA**

Mr. WALSH. My name is Tom Walsh. I am a Canadian chartered accountant and I have a master's degree in taxation from Golden Gate University.

From September, 1999 to December of 2002, I was employed in the Global Tax Department of Levi Strauss & Co., first as a manager, then as a senior manager, then from February 2001 until my termination in December of 2002, as a director of International Tax.

I was one of five directors who reported to the vice presidents, Ms. Laura Liang and Mr. Vince Fong. My responsibilities as tax director included calculating LS & Co.'s worldwide tax provision for the 2001 and 2002 year.

That process required the calculation of historical data, including the tax accounting reserves established and released, and the availability and prior use of foreign tax credits, and the application of a valuation allowance against those credits.

My efforts began in an unusual context, as LS & Co. had 16 open tax years, meaning the company's consolidated tax returns had not been completely audited by the IRS for 16 years.

With respect to the reserves, I discovered that from 1995 forward, large amounts of tax reserves had been systematically released into earnings. From 1995 to 2001, LS & Co. released approximately \$200 million of tax reserves into its earnings.

Because I was aware that the timed release of reserves violates GAAP and FASB rules, I looked for documentation that would tie the reserve release to the termination of specific tax liabilities. I found no such documentation. I was equally unable to find any lawful justification for the release of the tax reserves.

I concluded that LS & Co. was engaged in systematic time release of tax reserves to lower its effective tax rate, that it was releasing unallocated reserves to lower its effective tax rate and boost its income.

Any doubts I had were removed when I was told by Vice Presidents Vince Fong and Laura Liang that the company set its tax rate targets and it released reserves in order to achieve that particular tax rate.

In addition to releasing the unsubstantiated reserves, LS & Co. failed to set meaningful tax reserves against potential exposures for a number of extremely aggressive tax schemes.

Setting reserves has the effect of reducing the effective tax rate. Approximately \$3 million was set as a reserve against those exposures.

Myself and others in the Global Tax Department, including Mr. Schmidt, had calculated that these reserves should have been at least \$100 million in respect of those aggressive tax positions taken by Levi Strauss during those years.

A similar scenario existed with respect to the foreign tax credits. From 1995 to 2002, LS & Co. claimed the benefit of foreign tax credits and tax on unadmitted foreign earnings on its balance sheet in the aggregate of approximately \$200 million.

Unless LS & Co. can show that it is more likely than not that it will be able to utilize these tax credits in a carry-forward period, valuation allowance should be established to reduce the benefit of those credits on its balance sheet. LS & Co. failed to book any valuation allowance, therefore, on its balance sheets its deferred tax assets were overstated by up to \$200 million.

These issues were deeply troubling to me, as I believed that LS & Co.'s conduct was unlawful. I raised these concerns to the VP of Tax, the CFO, Bill Chasen, and the Human Resource manager, among others.

I also raised my concerns that one of the vice presidents, Mr. Fong, had instructed the leadership team to show the new auditors who replaced Arthur Andersen, KPMG, "we will only show what we want them to see."

When I raised the issues through the chain, the response of the company was to issue me a written warning threatening me with my termination. Ultimately, the threat was carried out 1 week prior to KPMG's arrival to do the field work for their first year-end audit of Levi Strauss' books.

In addition, KPMG had placed several tax partners to do the audit of the tax provision, and two of those partners started to raise issues with regards to the reserves and the foreign tax credits. At Levi Strauss & Co.'s request, KPMG complied and removed those two partners, replacing them with other partners.

The CHAIRMAN. Thank you, Mr. Walsh. I should not assume you were done. You were done?

Mr. WALSH. I was done.

The CHAIRMAN. All right. Thank you very much. Very compelling testimony.

Mr. Schmidt?

**STATEMENT OF ROBERT SCHMIDT, FORMER EMPLOYEE OF  
LEVI STRAUSS & CO., SAN JOSE, CA**

Mr. SCHMIDT. Good morning, Mr. Chairman, Senators. My name is Rob Schmidt. I am an attorney, licensed in California, licensed in 1990. I have an LLM from Georgetown University in tax and international comparative. I think it speaks to Georgetown's ethics policy that both Mr. Hamersley and myself are sitting on this panel today.

I was employed as an international senior manager at Levi Strauss & Company in June of 2001. I was promoted to director of International Tax in June of 2002, and summarily fired on De-



ember 10, 2002 for, among other things, giving the IRS certain pieces of information that they had directly asked me to give them.

Among my responsibilities while I was at Levi Strauss & Company was to be the project leader and issue manager for the technical review and factual review for a Brazilian partnership that the company wholly owned.

The company was held by two U.S. corporations that had no employees, no income, and were established primarily and solely for the purpose of holding a partnership interest with the Brazilian partnership.

The Brazilian partnership was named Levi Strauss Latin America. An investment of \$100,000 was made into the equity of this partnership in 1986. Over the next 8 years, approximately \$138 million in deductions were claimed against Levi Strauss' U.S. income.

The IRS, who had not audited Levi Strauss for 17 years, had commenced an audit in approximately 1999, before I arrived, and had paid particular attention to Levi Strauss Latin America, the Brazilian partnership.

When I arrived, I was taking responsibility for reviewing and answering audit questions. As part of my investigation, I traveled to Brazil on two separate occasions. While in Brazil, I discovered approximately 50 boxes of primary documentation that I had been led to believe did not exist.

In an initial review of those documents, I noticed that much of the information that I was discovering had not been handed over to the IRS in response to information document requests that had been previously asked and answered before my employment.

When I returned from Brazil on my first trip, I informed my superior, Vince Fong and Laura Liang, that there was additional information that was material and Levi Strauss had an obligation and needed to supplement the information document request.

At that time, I was also asked directly by an IRS agent to turn over certain information that she had learned existed. At that point I called a meeting with both of my superiors, Mr. Fong and Ms. Liang.

I told them that I was in possession of this information and that this information was material and relevant and was not privileged, and that there was an ethical obligation to turn this information over to the IRS in response to their request. I was told directly not to turn over any information to the IRS.

I told them that that was a violation of my ethical responsibility and I would be doing so, in which case I was told by Mr. Fong directly that he would go to the IRS "higher-ups" and have the request for the information withdrawn.

The next day, my responsibilities for working with the IRS directly on this issue were taken from me and, within a very short period of time, I was sent back to Brazil for 3 weeks.

While in Brazil, I copied and collected approximately four boxes of primary material documents. I returned from Brazil with those documents. I had them in my office for all of about 4 days, when Fenwick and West law firm, who had been hired to replace me as the direct contact with the IRS, came into my office and took every-

thing that I had as far as relevant material documentation and took it to their office.

I would like to tell you more details about this transaction. However, both Mr. Walsh and myself are in civil litigation on this issue. We have also proceeded under the Sarbanes-Oxley Act for Federal remedy. I know the IRS is continuing to investigate the Brazilian partnership.

Just this morning I received a letter from Levi Strauss counsel threatening me with my bar license and with future financial problems if I say too much and do not assert a privilege, which I believe has been waived by their fraudulent activity.

I would stress, though, that for the partnership in Brazil, the claimed justification for this partnership is, in my opinion, fraudulent.

Let me say one other thing. I have been contacted twice by investigators working for the board of directors of Levi Strauss & Company. In both situations, I cooperated, spoke with them, and told them as much as I knew about these topics.

I also told them quite directly that I was told to withhold documents and information from the IRS, and that that is, in my opinion, fraudulent.

Yet, in a recent press release from Levi Strauss & Company, they claim that these investigations found no evidence of fraud. Now, that astounds me, considering what my experiences were.

With that, I think will pass. Thank you.

The CHAIRMAN. Thank you, Mr. Schmidt.

Now, Mr. Camferdam?

**STATEMENT OF HENRY CAMFERDAM, JR., TAX SHELTER  
INVESTOR, INDIANAPOLIS, IN**

Mr. CAMFERDAM. Thank you, Senator.

I would like to take a few moments to talk about my involvement with the tax shelter COBRA and my relationship with Ernst & Young.

Our first contact with Ernst & Young came in 1995. This was 13 years after I started my business, Support Net, and we were a privately-held, \$200 million company wholesaling computer hardware. We were selling in all the States across the United States and we were having sales tax issues on how to process it.

So one of my partners had a friend at Ernst & Young and we retained Ernst & Young to help us with our sales tax issues. That was 1995.

In 1996, our company grew. We needed a chief financial officer. Ernst & Young recommended a former E&Y employee to be our tax auditor, or tax CFO, and we hired her. Her name was Carol Trigilio. Ernst & Young began doing the personal returns for myself and another one of my partners, so we had a relationship built with them beginning in the mid-1990's.

Around that time, we decided that, as our company grew, we needed additional capital or potentially a partner in our business and we retained Ernst & Young to assist us on that.

In 1997, this resulted in us selling our business to Arrow Electronics out of Melville, New York, a Fortune 500 company. We paid Ernst & Young a fee of \$900,000 to help us do that. The terms of

the sale were, we sold half of our business in the fall of 1997 and we paid capital gains taxes on that sale, with the assistance of Ernst & Young. They were involved, as I mentioned, with the sale. They also represented Arrow Electronics.

Then it was a 5-year agreement to buy the rest of the company. The agreement was accelerated, for various reasons. We sold the remainder of the company in August of 1999.

Ernst & Young assisted us with that, obviously, and we were preparing to pay our capital gains taxes in the beginning of 2000. So, we had a very long relationship and a very trusted relationship with Ernst & Young.

In late October of 1999, Ernst & Young called and said they had a tax strategy that could virtually eliminate our capital gains taxes, and it was called COBRA.

We met with them in early November of 1999 and they gave us a two-hour presentation on COBRA. We had to sign nondisclosure agreements and it was a very secretive plan, primarily, as they described it, because they felt they had a real competitive advantage in developing this plan.

During the meeting it was obvious there was no business purpose for this shelter other than tax reduction. There was no risk possibility. We were not going to lose our money. Ernst & Young helped us determine what our loss would be.

The fees we paid for that transaction were \$3 million to Ernst & Young and a law firm we had never heard of called Jenkins & Gilchrist, who wrote an opinion supporting this transaction.

We paid another \$75,000 to a law firm called Brown & Wood, which we had never met, and still have not met, for a second opinion on this tax shelter. We ended up paying \$3 million to Deutsche Bank to handle this 30-day options transaction. We paid this money to save \$14 million in taxes.

In September of 2000, IRS issued, as you know, 2000-44. We were not notified of this by Ernst & Young. In March of 2002, Ernst & Young sent us a letter suggesting that we might want to consider amnesty.

When we had conferences with Ernst & Young on our particular situation, they encouraged us not to come forward because our tax shelter, in their words, was "different," and that we were only 9 months away from our 3-year statute of limitations.

In June of 2002, we got a form letter from Ernst & Young saying they were in the process of turning our names over to the IRS. We again called and asked what was going on and we asked them not to do this, obviously. They said they would not until they notified us. Then in September of 2002, they did turn our names over to the IRS.

In December of last year, we got audit notification around the same time we got written notification from Ernst & Young that they had, in fact, turned our names over to the IRS.

We, shortly after that, filed suit against Ernst & Young, Brown & Wood, Jenkins & Gilchrist, and Deutsche Bank for various things, and we have since then cooperated with the IRS fully in terms of documents. We have had interviews with both the civil and criminal investigators for the IRS, and we are doing what we can to help them in this process.

I will summarize by saying that Ernst & Young had always been to us the group of people that would say no. When we did a business transaction and opportunity, if it was not above the letter of the law or was not clear to us, Ernst & Young always said, no, do not do it. We had complete faith and trust in what they told us.

When this COBRA transaction came up and we sat in the room with them listening to it, no one in that room said no. They were very high on this strategy. They encouraged us to do it, and we did it.

I thank you, Senator.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Camferdam appears in the appendix.]

The CHAIRMAN. Now, Mr. Lally.

**STATEMENT OF ROBERT V. LALLY, ACCOUNTANT, FEDERMAN, LALLY & REMIS, LLC, FARMINGTON, CT**

Mr. LALLY. Thank you, Mr. Chairman and members of the committee. My name is Robert Lally. I am honored and pleased to be before you today to talk about a subject which has been my life's work and about which I am truly passionate: tax practice. I have practiced tax and public accounting for 27 years.

I am a CPA and an attorney. My comments will be brief. I hope to make three observations to your committee. First, tax law must be the same on Farmington Avenue, our street address, as it is on Fifth Avenue. Tax law must be perceived to be the same everywhere. It is a Federal system. We all read the same cases, we all read the same revenue procedures. An answer in Hartford should be the same as an answer in San Francisco.

It is a self-assessment system. It will not work if clients perceive that in New York they can get a better answer, or worse yet, a magical answer. To us in the field, standards of practice must have some uniformity.

Second, I have seen standards of practice degrade over time. As a former partner in a Big Four accounting firm, I remember days when we had very definite notions of what was and what was not done.

We did not play the audit lottery, although we were certainly aware of its mathematics of chance. We did not rely on hyper-technical interpretations of the code or regulations, even though we were very good technicians. We did not take contingent fees.

Finally, we never, in my 16 years of practice with big firms, structured a transaction around a side agreement, a hidden buy-sell, or disguised ownership. In my detailed text, I have some observations on, I think, some of the causes of this trend.

Finally, tax practice has changed by the introduction of tax products. A tax product is an idea, or a position, or an integrated shelter which seeks to avoid tax with little or no business purpose. It is not a structuring of existing client matters to reduce or to defer tax, but a sojourn into a purely tax-motivated realm.

These products are typified by the following four common features: a confidentiality agreement, because the idea is supposed to be proprietary; contingent fees based on the tax savings; a technical position that is either based on a hyper-technical reading of

the tax law, but which makes little common or economic sense, or in the alternative, a technical position which is based on all of the facts not being disclosed, such as a hidden buy-sell; and, finally, marketing to taxpayers outside of the existing client base.

I have a few suggestions. Regulation. The fact remains that tax practice is largely unregulated and unlicensed. One needs a license in Connecticut to cut hair, but not to prepare a tax return for a fee.

The signature of a CPA or a lawyer qualified to practice in the tax area—and not all are—should mean something about the technical quality and compliance accuracy of a return.

Only by limiting practice can sanctions against unreasonable practice have any meaning. Right now, anyone with a pencil and a photocopier can prepare and sign tax returns.

Enforcement. The IRS audits the same issues time and time again. Agents often avoid the difficult technical areas. I should perhaps be a little careful what I wish for, because, of course, I spend most of my life working the other side of the street.

This lack of enforcement encourages complex, hyper-technical positions, secure in the knowledge that no one is going to challenge them.

In 27 years, I have yet to have an agent raise a LIFO issue, an accounting methods issue, an inter-company pricing issue. It is always the same: lunches and cars.

Only in arcane specialty areas which have dedicated IRS groups—for instance, insurance—do we see substantive technical areas raised.

As a practitioner, the recent IRS efforts at John Doe subpoenas should be applauded. It sounds like I am giving aid to the enemy, but I am actually defending thoughtful clients and practitioners.

It is helpful out in the field to be able to say to clients that some law firm in New York or Washington does not have a magic answer, and that, in fact, far from playing the audit lottery you are about to play the audit certainty. Even the limited activity in John Doe subpoenas so far has actually been very sobering out in the field.

Finally, fees. I do not believe that contingent fees should be permitted in tax practice. The prohibitions in Circular 230 do not appear to be strong enough to stop the practice.

I thank you for this chance to testify.

The CHAIRMAN. Thank you, Mr. Lally.

[The prepared statement of Mr. Lally appears in the appendix.]

The CHAIRMAN. Now we are going to go to a person whose real name is not Mr. Janet, but we are going to refer to him as Mr. Janet. He is over here and he is protected, as I said.

I have already introduced you, Mr. Janet, but I do want to take a second opportunity to thank you for going to this extreme and extraordinary way of giving us very important information for this committee on writing tax policy.

So would you proceed at this point, Mr. Janet?

**STATEMENT OF "MR. JANET," AN ANONYMOUS WITNESS TO  
SPEAK ON SILOs AND LILOs AND ABUSES IN THE LEASING  
INDUSTRY**

Mr. JANET. Good morning, Senators. This morning I will describe a massive scandal that allowed major U.S. companies to have huge tax reductions by pretending to lease the infrastructure of foreign countries such as dams, bridges, and subways, and then pretending to lease that infrastructure back to that country or municipality that owned the infrastructure.

This scheme is so pervasive that much of the old and new infrastructure throughout Europe has been leased to, and leased back, from American corporations. The sole purpose of this scheme is to generate a tax shelter for U.S. corporations that invest in these schemes.

These structures are about the greed of senior management of large U.S. corporations and their financial advisors. The intent is to steal money, just like a bank robber.

I know first-hand what I am talking about. I am a former leasing executive with between 10 and 25 years of industry experience. The best way to explain the scheme is by example of a simple car lease. Under a normal car lease, you pay a set amount of money each month and at the end of the lease you either buy the car or give it back to the leasing company.

In this structure, let us say you are a foreign person who owns the car. An investment bank comes in and says, I will give you \$1,000 if you agree to sign a stack of documents, and then it is leased to an American corporation. You will have no continuing financial responsibility or loss exposure.

You will make no lease payments. You will continue to own the car as you always have. No one can take it from you, and you can dispose of the car as you please once the lease is over. In effect, you are still the owner.

We are just going to pay you a fee to sign some papers that back up our deduction claim to the IRS. What would you say to such an offer? If you are an American taxpayer you might hesitate, but if you were a European or foreign person, what risk do you have? Well, that is the scenario that has played out over the past 10 years on a much larger scale.

The only risk in these transactions is whether the IRS will let tax that have depreciation deductors of the U.S. investors. All too often, the IRS will settle rather than risk loss at trial. Even if settlement requires a U.S. investor to disgorge 50 percent of their tax deductions, they are way ahead of the game by keeping the remaining 50 percent.

What is even more shocking, is that these transactions are arranged by some of the largest, multi-national financial advisors in Europe and the U.S., and investors include major U.S. money center banks and Fortune 500 companies.

There is one more development you need to know about. I said earlier that U.S. municipalities have historically been hesitant to enter into these deals. This is no longer the case.

Faced with local budget deficits, State and local governments are leasing off infrastructure at a record rate. The subway systems of

Boston, Chicago, and Washington, DC have been leased, and leased back to U.S. corporations.

I have reason to believe that the New York and Chicago water authorities are about to engage in a scheme to lease the water lines under their streets. Consider the irony of the situation. Infrastructure is built with taxpayer dollars of working men and women with taxes and bond funds.

They are then leased, and leased back in phony transactions to provide tax deductions for the most profitable companies in America. I cannot believe this is what Congress intended in writing its tax leasing laws.

One final point I want to make. Not all leasing companies participate in this. The leasing industry is represented primarily by the Equipment Leasing Association here in Washington. Not all of their members are doing this. It is mostly ones belonging to the big-ticket leasing group within the ELA.

You will hear a lot of banter about how leasing lowers the cost of capital, stimulates the economy, and drives economic efficiency. In fact, allowing this loophole to stay in place reduces U.S. economic stimulus, and this is why. In doing these deals, U.S. lease companies can shelter income without the risk of having to take possession of leased equipment or without any credit risk.

So why in the world would they take a risk by leasing to a capital-starved U.S. company? There is no incentive whatsoever to take that kind of risk, and they get these juicy, risk-free terms by doing LILOs and SILOs, and they can shelter their income.

Moreover, I fail to see how the U.S. economy is stimulated by giving U.S. tax deductions for assets built by the French, funded by the French, and used by the French. I do not see how the economy is stimulated by taking the subways that are built by taxpayer dollars and allowing corporations deductions for them. These transactions lack canny economic substance or business purpose and should be shut down.

Thank you for this opportunity. I look forward to your questions.

The CHAIRMAN. Thank you, Mr. Janet.

I am going to start with asking you a series of questions, then I am going to turn to Senator Baucus.

Let me make sure I get what you are saying right. If a U.S. city would build a bridge, a subway, or pipes using taxpayers' dollars and exempt bond financing, then a U.S. corporation would pretend to lease the property and will get a tax depreciation deduction, even though the city still owns the property? Is that what you are telling us?

Mr. JANET. Yes. Because in most cases, the bonds are issued on an unsecured basis. So, the ability of the city or State to lease it does not interfere with their bond issuance.

The CHAIRMAN. All right.

Let us talk about the LILOs. There is a chart behind you that shows Germany building a subway with German taxes and German laborers. The Germans use the subway. But under the LILO, a U.S. company gets to depreciate the subway even though they do not own it.

Mr. JANET. That is correct. Yes, that is what happens.

The CHAIRMAN. All right.

You said that most of Europe's infrastructure has been leased through these LILOs. Does that mean that the United States taxpayer is subsidizing Europe's infrastructure costs?

Mr. JANET. Absolutely.

The CHAIRMAN. You said that major banks and corporations are doing these deals. Could you tell me who they are?

Mr. JANET. I feel uncomfortable using their names, but, yes, I could tell you between the two of us.

The CHAIRMAN. All right.

Would you explain why you cannot tell us their names?

Mr. JANET. With the deep pockets these companies have, I am afraid of lawsuits against myself and my family.

The CHAIRMAN. Could you confirm that Washington, DC's subway system has, in fact, been leased out for corporate tax deductions? Do you know who leased it out and who the investors are?

Mr. JANET. Yes. I believe it has been leased out. Again, for my concern over litigation with these large firms, I am concerned about giving you a name.

The CHAIRMAN. You stated that you think our legislation in what we call the FSC/ETI bill will stop these abuses. Do you think that it will impair legitimate leasing and harm the economy?

Mr. JANET. It will not impair legitimate leasing. In fact, it will help legitimate leasing because corporations will have an incentive to enter into real transactions where they take real credit risks and real asset risks.

The CHAIRMAN. You said the companies buy assets instead of leasing them because of low interest rates. What would be the effect of rising interest rates on LILOs and SILOs? Would they go up?

Mr. JANET. In fact, rising interest rates would have the opposite impact. You would have a large growth in these transactions. As interest rates rise, the benefit, the shelter is thrown off and the timing benefits become more valuable. Therefore, the issuer, the municipality, would get a larger up-front benefit.

The CHAIRMAN. You said that we should revisit the treatment of qualified technology equipment. Would you expand on what you said about that?

Mr. JANET. I am not an expert on QTEs, but my understanding is they have been used in the same manner a LILOs and SILOs where the transactions are entered into strictly for the purpose of shelter with no goal of new equipment financing.

The CHAIRMAN. Is that also the way that the Bank of America leased and depreciates the Canadian air traffic control system?

Mr. JANET. That is my understanding from the article that is here as an exhibit.

The CHAIRMAN. Where does the \$20 to \$30 billion estimate of annual leased assets come from?

Mr. JANET. Based on my previous experience, I have looked at the transactions in the marketplace over the years. I think that is a conservative estimate.

The CHAIRMAN. Is there any advice that you could give us to help the Treasurer attack these deals?

Mr. JANET. I think it is quite simple. The Sarbanes-Oxley Act, as it came to accounting fraud, put the CEOs and CFOs having to



sign their financial statements and tell the shareholders those financial statements were honest and fair.

I think if the same CEOs, CFOs, and board members had to sign onto their tax returns that the transactions they enter into have a legitimate economic purpose, not solely in title to avoid paying tax, that would help solve the problem.

The CHAIRMAN. All right.

The leasing industry is opposed to economic substance codification contained in our tax shelter proposals. Do you think that LILOs are the reason that they might oppose it?

Mr. JANET. This is the primary reason they oppose it.

The CHAIRMAN. Do you think that leverage leases have economic substance?

Mr. JANET. Yes, they do.

The CHAIRMAN. Do promoters bribe foreign officials to get these sorts of deals?

Mr. JANET. I am not sure what you call a trip to an island for the summer. There is no cash, but what do you call a trip?

The CHAIRMAN. All right.

Let me see. The next person on the list is Senator Bingaman, since Senator Baucus had to temporarily leave.

Senator BINGAMAN. Thank you very much, Mr. Chairman. Let me ask Mr. Janet a question on his testimony.

You say that all too often the IRS will settle the case rather than risk a loss at trial. If I were the head of the IRS, why would I fear that I would lose this case at trial?

Mr. JANET. These are very difficult transactions for laymen to understand. They have been structured so it makes it even difficult for an IRS agent who is not specializing to understand. If you believe that the best and brightest have structured these transactions, do you really believe that an IRS agent who is doing this part-time is going to keep up with that knowledge?

Senator BINGAMAN. So you are really saying that the IRS is not properly staffed or trained to prosecute.

Mr. JANET. They are being out-gunned by the best and brightest in tax shelters.

Senator BINGAMAN. All right. So we need to hire the best and brightest to work for the IRS to go after these cases. Would that be a reasonable conclusion or not?

Mr. JANET. Well, I think having the best and brightest would be important. But having legislation that completely eliminates these structures would avoid the problem to start with.

Senator BINGAMAN. And you think that the legislation on the books today does not adequately eliminate the possibility of these kinds of abuses?

Mr. JANET. The reason I came forth to this committee was the fact that the Economic Substance Act was pulled out of the last tax bill. That is when I said it was time for me to stand up.

Senator BINGAMAN. All right.

So you think that, clearly, that piece of the legislation that was passed out of this committee needs to become law?

Mr. JANET. Yes, sir.

Senator BINGAMAN.

Mr. Lally, if I could ask you, if we are able to either legislate, or by rule, establish that firms that give tax advice and sell these tax products cannot audit anyone that they have given advice to or sold a product to, how much of the problem will that fix?

Mr. LALLY. The hard part with limiting tax practice, is that it is very hard to draw the line between tax advice and tax compliance work preparing the returns in these more sophisticated products. I am a little concerned that if we further constrain the product line of the industry, that the industry itself may be so impaired.

Accounting firms have a lot of trouble now economically with audit-only services. Typically, the audit is the loser of the practice economically and they hope to recoup that or to have better economic results through consulting and tax work.

So, again, I think it is a definitional problem of, where would we draw that line, what is a product and what is legitimate tax planning? If we completely forbid firms from consulting in tax work, what is going to be left to the industry?

Can the industry really stand on its own if it is an audit-only practice, and would anybody be willing to pay that much for an audit? There are a bunch of tough economic questions for the firms, I think.

Senator BINGAMAN. Clearly, it is appropriate for accounting firms and tax advisors to engage in tax planning and advice to clients about how to structure their business so that they do not pay any more tax than they are required to. So, that is appropriate.

But clearly there is a problem with when you go the next step and say we, as an accounting firm or a tax advisory firm are going to develop products which we then will go out and sell, do you think that there is some way to draw that line or is that a false or impossible line to draw as well?

Mr. LALLY. I think it is going to be a difficult line. I would not say that it is impossible because, again, I think there are characteristic features of products that perhaps, again, someone with careful draftsmanship would delineate.

Some of that is already on the books, again, the economic substance transactions and some of that legislation that is proposed, and the concept of sham transactions. I mean, again, some of that already exists and some of it would turn, as the prior witness just said, on better enforcement and better technical people on the IRS side.

Senator BINGAMAN. Well, thank you very much, Mr. Chairman.

The CHAIRMAN. Before I go to Senator Bunning, I want to re-ask you, Mr. Janet, a question that we asked, because Senator Bingaman touched on it, just to emphasize.

I asked you about whether or not our legislation that is in the FSC/ETI bill would stop these abuses, and at the same time not impair legitimate leasing. I think your answer to me was that that would solve the problem and it would not harm legitimate business activity.

Mr. JANET. That is correct. I want to make sure this committee understands that, in fact, these transactions are harming legitimate economic activity today.

If you are a leasing company and you can enter into a transaction where you take no credit risk, you take no residual risk, the only thing you are betting on is what settlement you can get with the IRS, why would you enter into transactions where you have to make other decisions?

The CHAIRMAN. All right.

Now, Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

I would like to just follow-up on what Senator Bingaman was talking about. In the 25 years that I was in the investing business, there were many tax shelters that I saw come and go. The 1986 tax changes really stung the ordinary investor out of the tax sheltering business.

What you have described as a panel is something that has come after the normal tax shelter that was used for individual investors. In other words, it was done at the corporate level.

My question to all of you is, does the Sarbanes-Oxley legislation address the problems that we are faced with currently? Do any of you care to answer that? In other words, maybe the folks who were formerly Ernst & Young, or whatever you want to call yourselves.

Mr. HAMERSLEY. Yes. I was actually formerly with Ernst & Young and then formerly with KPMG, my most recent employer. Or currently, I guess. I am a little confused on my status as well.

Has Sarbanes-Oxley really hit and prevented the corporate tax shelters as opposed to the individual tax shelters? Do I understand that?

Senator BUNNING. Well, it does not seem like we have, according to our guest behind the screen, addressed the real problem in Sarbanes-Oxley.

Mr. HAMERSLEY. Yes. No, the problems persist. The problem is, Sarbanes-Oxley has, I think, had an impact. It shifted the cost benefit analysis on the problems with financial accounting, the pure accounting scandals.

To the extent that corporate tax shelters, and the reason they are done most of the time, in addition to saving taxes, is the same incentive that the officers and the management of the company has with the financial accounting scandals, financial statement improvement strategies, that that tax shelter will improve their financial statement results and, thus, if they hold stock, will improve their compensation. It is the same kinds of problems.

Senator BUNNING. Mr. Lally, you mentioned the fact of how difficult it might be to draw the line between the auditors and those that are giving financial advice to different corporations. In other words, if I am an investment tax advisor and I also audit, or did audit the same firm, Sarbanes-Oxley has kind of put a damper on and separated that?

Mr. LALLY. I believe drawing the line around the audit services is an easy bright line to draw. Again, my concern is if we draw that line, if we make that line so clear that we do not permit accounting firms to provide the other services, is it really a viable economic business where its only product is the audit?

Senator BUNNING. Fine. I understand that part. But are you telling me that we then cannot create a situation where the Big Four,

or the Big Six, or whatever is left of the auditing firms must do tax and financial advising or they cannot be profitable?

Mr. LALLY. Now, let me be open. I am heading in that direction. It is hard to say for sure.

Senator BUNNING. That is very unfortunate if you are heading in that direction.

Mr. LALLY. Again, it is only my opinion. But I think if all of the accounting firms had to solely rise and fall on audit-only practice, I think they would be very challenged and the prices of audits would go way up, perhaps to the point where society did not want to pay for them any more.

Senator BUNNING. Well, if we are going to have an investing public that has any confidence in what is put down on an audited return or audited financial statement, maybe we have to pay up and make the people that are doing the correct audits accountable for those audits.

I get the feeling that the board of directors and the audit committee of the board of directors are just not really involved in the audit of the company at all, and just kind of sign off on what the public auditors are doing with their firms' statements. Is that a consensus out here?

Mr. LALLY. I would not say that. I think, certainly, Sarbanes-Oxley has brought the quality and technical ability of the audit committee into the forefront. Certainly, we used to see instances where you have whole audit committees, but, for instance, no CPAs on them. I would say that is definitely on the wane.

Of course, if you look at the requirements and the SAS rules on communications between audit committees and the auditor, the responsibilities are actually very specific.

For instance, they are supposed to review all of the major accounting assumptions. They are supposed to review all the past audit adjustments. I mean, there are very definite rules on that communication between the audit committee and the outside auditor.

I think a lot of that architecture is in place and I think we probably have fixed much of that. But, as the other gentleman said, I think we have largely fixed that on the financial accounting side, but this element of tax practice is still, again, a little bit off to the side.

Senator BUNNING. This is my last question. What is the matter with corporations looking at the Tax Code and using the Tax Code as it is written to advantage that corporation by the Tax Code? In other words, to save money.

Mr. HAMERSLEY. That's my point, nothing. They should be doing that.

Senator BUNNING. And you are saying we do not have enough laws right now to prevent them from violating, or enough enforcement?

Mr. HAMERSLEY. I am saying, one, that corporations are not satisfied with fitting—

Senator BUNNING. I understand what you said. But why should I not, as General Motors, or Ford, or whoever I might be, look at the Tax Code and say, you know, here is a legitimate way we can save some money, if it is legal?

Mr. HAMERSLEY. Right. If you have the transaction that is intended by Congress to receive that favorable benefit, absolutely, you should. If you do not, you should not be getting the benefit either.

Senator BUNNING. No, you should not be getting the benefit. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I have some questions, because I asked all my questions of Mr. Janet.

Several of you have talked about the concealment of facts. It is more a question of emphasis than it is to bring out new information. But particularly you, Mr. Hamersley. You indicated that these tax shelters are based not just upon the reading of the law, but on the distortion or concealment of facts.

I would like your, and others', view on that, that tax is being avoided through distortion and concealment and just not some arcane reading of the law.

Mr. HAMERSLEY. Yes. That is the point I was trying to make. I think you see some of that in the Levi Strauss matter as well, that these corporations are not satisfied with the benefits that are clearly intended by Congress.

They cannot do the economic transaction they need to get into that benefit, so you have to lie about the facts and say you did it to get the benefit. There is often a difference between what you want and need or can do economically, or from a regulatory perspective, and the transaction you need to have to get the tax benefits.

The CHAIRMAN. Yes. And to all of you, in your opinion, how widespread is the corporate tax shelter problem, and what makes these tax shelters attractive to public companies? Any of you.

Mr. WALSH. I actually do not think that corporations and accounting firms are afraid of the IRS, so they do not think there is very much to lose from doing it. The up side is, on the individual management level, huge bonuses. So, as was stated earlier, they play the audit lottery.

To the extent that their number does not come up to get audited, or in the event that it is a large corporation that does get audited, whether or not the facts are uncovered becomes the issue. They are just not afraid of the IRS.

Mr. SCHMIDT. In my experience in law firms, accounting firms, and in corporations, it is widespread.

Mr. HAMERSLEY. I agree. Enron is clearly not isolated either on the tax shelter side or the non-tax financial statement improvement strategies. On the cost benefit analysis mentioned, that they do not fear the IRS, they also have mechanisms in place to keep anyone who knows the real facts from coming forward. I think you see some of that testified to here today.

The CHAIRMAN. This is probably a question that is difficult to answer, but what is your gut feeling? Is this a case where one of the Fortune 500's goes out and says to these accounting firms, we are paying too many taxes. You have got to find a way that we are not going to pay taxes.

Or is this where these accounting firms and investment banks, et cetera, et cetera, are going to one of the big Fortune 500's or For-

tune 1,000's and saying, we have got a way here to fix it so you do not have to pay tax?

Mr. CAMFERDAM. I can tell you, Senator, from my experience, Ernst & Young came to us. We were fully prepared to pay our 20 percent capital gains taxes on that. One issue is, big, big corporations can afford to have their own tax people to look at the Tax Code and figure out how things work. But smaller companies like myself, and my understanding is that a large number of these shelters were sold to small companies, the only advice we have is from our tax advisors, and in our case it was Ernst & Young.

For us to figure out the Tax Code and the best way to save tax money is a virtual impossibility. We cannot do it, and cannot afford it. But they came to us, to answer your question.

The CHAIRMAN. Do you have some evidence then that a Fortune 1,000 company has their own insight, counsel and tax advisors that are going this far?

Mr. CAMFERDAM. Do I?

The CHAIRMAN. Well, any of you.

Mr. HAMERSLEY. I think they do, but most of these are so sophisticated. When I saw many of the Enron things, you know right off the bat that they must have had help from an investment banker, lawyers, accountants. They are too sophisticated.

Mr. SCHMIDT. That being said, however, I think that corporations who are looking for ways to lower their effective tax rate or boost their income will go shopping.

The CHAIRMAN. All right.

Now, a question for Mr. Hamersley, and anybody else, for that matter. I sponsored legislation years ago that brought the False Claims Act back into a major tool of the Federal Government to fight fraudulent activity on the use of taxpayers' money.

In a nutshell, the False Claims Act allows certain individuals to bring an action in court to recover, on behalf of the government if the government is not doing it on their own initiative.

If the individual prevails, then they could keep a portion of the recovery. This law has allowed the government to recover billions of dollars from fraud in areas such as health care and defense contracting.

The IRS has the authority to similarly reward individuals who bring to the attention of the government potential tax issues. For a lot of reasons, this program is not nearly as successful as the False Claims Act.

My question is, what financial or personal hardship did you face in coming forward, and do you think that a more vigorous reward system would encourage others to come forward and talk about what they know about tax shelters? I would like to start with Mr. Hamersley, but anybody else that can answer.

Mr. HAMERSLEY. Well, frankly, to whistle-blow, you make the choice that you are almost certainly going to have to leave the industry. Not only will you, with the Big Four, not work for that firm any more, you probably will not work for any others because of the black-balling that goes on in the industry.

My choice was easy. My choice was, participate in what I believed to be a felony, or whistle-blow. In most situations, that is not the case. It is not that cut-and-dried.

The choice you make, you are almost certainly financially ruined. If there were some mechanism, with obvious concerns for the merit of the claim, for people, first of all, have the court, their case see the light of day. There are equal problems of those facts coming to the court as there are with the tax shelter facts.

But if those can see the light of day, and certainly if you have the government helping you make that happen in the discovery process, yes, I think that would increase the incidence of whistle blowing. People are worried that their families will be jeopardized by coming forward.

The CHAIRMAN. Any of the rest of you?

Mr. WALSH. I think the decision on whether or not you are going to whistle blow does not come down the amount of money that you are going to get out of it. It comes down to the morals that you have and the ethics. I am unemployed now, I have been for 10 months.

I do not really have a whole lot of prospects for employment, either. But I knew that when I first started this process to raise the issue and to bring it to light. But it had nothing to do with money, it had to do with right and wrong and, I guess, defrauding the investors.

Mr. SCHMIDT. In my experience, I think that to encourage whistle blowing and people to come forward, rules similar to the Sarbanes-Oxley rules for attorneys representing for the SEC need to be in place for tax issues as well.

Those rules do not exist and, therefore, there is a privilege and confidential issue for attorneys which puts their bar license in jeopardy. But I would concur that my choice was very simple: either participate in a fraud and potentially go to jail or not participate and risk termination and financial ruin. By the way, Mr. Walsh and I are being sued for \$10 million each by Levi Strauss & Company for breach of fiduciary duty.

Mr. CAMFERDAM. From my standpoint, Senator, I would just like to see legislation that would not allow a company like Ernst & Young to sell these tax products. If they had not walked into our office with this, we would not have bought it.

From a whistle blower standpoint, my understanding is it is a fairly complex procedure to go through. The rewards are not very good, but our life would have been better if Ernst & Young had never sold us this, or been allowed to sell us this product.

The CHAIRMAN. Robert?

Mr. LALLY. I have to applaud the courage of my panelists. Again, I am not a whistle blower. It is a remarkable thing to share a panel with gentlemen who have put so much on the line.

The CHAIRMAN. All right. Senator Bingaman had one question. All right. Senator Bunning?

Senator BUNNING. Yes. Given the huge financial gains to be made if illegal shelters are done, not only to those who are selling them but to the corporations that are using them, what type of penalties would be enough to deter these type of things being done?

Mr. LALLY. Well, perhaps I will start. As I mentioned in my remarks, the John Doe summons is an amazing thing. Again, it creates the specter that this product that has been sold, the whole list

of people who have bought it are now suddenly in trouble because they bought it.

Again, I think the IRS has actually used the John Doe summons twice in connection with tax shelters recently. But, again, that is a considerable and very powerful tool, and as I said, kind of very helpful out in the field in creating some sanity and a level playing field between practitioners.

Senator BUNNING. Will you answer my question, though?

Mr. LALLY. I am sorry. I thought I did. I tried.

Senator BUNNING. What type of penalties would be enough to deter both the corporation and the auditor?

Mr. WALSH. One hundred percent of the gain that they have gotten from it.

Senator BUNNING. Well, that is not enough.

Mr. WALSH. If they saved \$10 million in tax, they have to pay back \$10 million.

Senator BUNNING. That could not possibly be enough because they are going to be liable for that anyway if they lose. So what is the penalty?

Mr. WALSH. One hundred percent of the tax that they did not pay. So they would have to pay back the tax. In addition, the penalty would be 100 percent.

Senator BUNNING. Oh, all right. In other words, if it is \$10 million, it would be \$10 million on top of that.

Mr. SCHMIDT. I think the Internal Revenue Code has very aggressive penalties. They just need to be applied.

Senator BUNNING. Well, if we do not have enough players on the Internal Revenue side to compete with the players on the other side, we are not ever going to get a settlement.

Mr. LALLY. I mean, I think the existing fraud penalty is 75 percent, plus all the other ones. I mean, you get to 100 percent pretty quickly.

Senator BUNNING. All right.

Do you think the law as it is written presently, if enforced properly, has enough penalties in it?

Mr. CAMFERDAM. In my opinion, yes.

Mr. SCHMIDT. Me, too. I think it is enforcement and aggressiveness by the IRS.

Senator BUNNING. All right.

Mr. HAMERSLEY. From a taxpayer's perspective. From a promotor's perspective, if he can shift that liability to the taxpayer through representations made by the taxpayer and claim—

Senator BUNNING. Well, any signed document that leaves the person off the hook.

Mr. HAMERSLEY. Yes. Yes. Then the cost benefit analysis is shifted.

Senator BUNNING. Then you had better have good tax lawyers inside rather than just outside. Thank you very much.

The CHAIRMAN. Thank you.

I have no more questions. I should announce to you and the next panel that sometimes members who are here, as well as, more importantly, members that are not here, submit questions for answer in writing. If you get questions like that, we would like to have



those responded to in about 2 weeks, if you would, please. So, consequently, we will leave the record open.

I would ask the second panel to come. You know who you are. But while you are coming, I am going to introduce you.

We are going to have the second panel to get their thoughts about the Federal Government's ability to crack down on abusive tax shelters.

First, we hear from Mr. Philip Cook, from the law firm of Alston & Bird. Mr. Cook represents one of his partners, Neal Batson, who is a court-appointed examiner in the Enron bankruptcy proceeding.

Then we will hear from Mike Brostek, Director of Strategic Issues, U.S. General Accounting Office. Then Pamela Olson, Assistant Secretary of Treasury, Tax Policy, followed by Mark Everson, Commissioner of the Internal Revenue Service.

Then Assistant Attorney General Eileen O'Connor will present testimony on behalf of the Justice Department's Tax Division.

Then Mr. William McDonough, chairman of the Public Company Accounting Oversight Board, which was created by Sarbanes-Oxley.

Then Mr. B. John Williams from the law firm of Shearman and Sterling. Mr. Williams is a former chief counsel at IRS.

I am going to be able to hear just a little bit of the testimony of this panel. Senator Bunning has said that he would chair it for me. I want to explain to you, because you are a very distinguished group of people and your responses are the other half of this problem that we face.

But I want to explain that I, in the capacity of chairman of this committee, am leading Senate negotiations on the energy bill finance portion and we are going to meet from 12:00 to 1:00 on that, continuing a meeting we had last night from 8:00 until 10:15. Then later on, we have to meet with the Medicare prescription drug panel. So, that is why I am not going to be able to hear this testimony. But I will very much, obviously, read the testimony and responses to questions.

So, in advance, I am going to give up the chair now to Senator Bunning and sit here for a few minutes, because I can run over there and be there by 12:00. But I might as well change places with Senator Bunning right now. So, I thank Senator Bunning.

Then we are going to start with you, Mr. Cook, and go across from my left to right.

Senator BUNNING. Go ahead, Mr. Cook.

**STATEMENT OF PHILIP COOK, ATTORNEY, ALSTON & BIRD,  
ATLANTA, GA**

Mr. COOK. Good morning, Senators. My name is Philip Cook. I am a partner in the law firm of Alston & Bird. As the Chairman said, my partner, Neal Batson, was appointed by the U.S. Trustee and approved by the Dr. Bankruptcy Court as examiner in the Enron bankruptcy proceeding.

Because of the restrictions that we are under in reference to our investigation for the Bankruptcy Court, I am appearing here under a subpoena that was worked out with the staff of the committee and that outlines the areas in which I will testify.

Under the Bankruptcy Court's order, the examiner was asked to investigate Enron's numerous and highly publicized transactions

involving special purpose entities, which are sometimes called SPEs.

Among the scores of SPE transactions investigated by the examiner were 11 transactions consummated within Enron's corporate tax department which I will refer to today as the tax transactions. I led the examiner's team who investigated the tax transactions.

The examiner's report shows that Enron's tax transactions may have had some characteristics that are somewhat different from the tax-related transactions entered into by many public companies.

Enron did not need to generate tax deductions on its Federal income tax returns during the years 1996 through 2000 to reduce any current Federal tax bill. In fact, Enron's tax returns for those years showed net operating losses of nearly \$5 billion for tax purposes.

Even though Enron was not paying current taxes, it was required to record a tax expense provision in its financial statements based on its pre-tax book income, or financial accounting income.

The goal of Enron's tax transactions was to generate future tax deductions that could be used to reduce current tax expense for book purposes under the deferred tax accounting rules of FAS-109, and thereby increase Enron's book net income. The tax transactions often would not result in tax deductions for Enron until five or more years following the transaction.

As a general rule, the tax transactions were artificial transactions that had no connection to Enron's ordinary business activities. Instead, they generally involved the transfer of substantial assets already owned by Enron and intercompany instruments, often stock or debt of Enron or one of its affiliates, to an SPE for the purpose of generating current financial accounting income from speculative future tax benefits.

Assets or financial instruments created or acquired in one transaction would be reused in later transactions or sold between structures to trigger reporting of financial accounting gain. An SPE entity created for one structure would be reused in a later structure.

The unusual nature of Enron's tax transactions is illustrated by the Teresa Transaction. This transaction was designed to engineer a non-economic increase of more than \$1 billion and the tax basis of Enron's headquarters office building in Houston, which we refer to as the Enron North Building.

This was to be accomplished by contributing the Enron North Building, which was already owned by Enron and subject to existing financing, to a partnership SPE structure that was also receiving investments from the investment bank that promoted the structure to Enron.

The business of the SPE structure was to lease the Enron North Building to Enron. The only other business activities conducted by the partnership were releasing certain corporate jets to Enron for use by Enron executives and purchasing certain stock interests in various Enron affiliates.

Ultimately, the Enron North Building was to be distributed out of the partnership and Enron would claim a tax basis step-up in the building of more than \$1 billion.

The examiner concluded the transaction had no business purpose other than to achieve the tax and financial accounting results.

The Teresa Transaction did not generate any current tax deductions for Enron. Instead, the deconsolidation of the Teresa SPE entities from Enron's consolidated return caused Enron to incur and pay taxes of approximately \$131 million during the period from 1997 through 2001 that it would not have otherwise paid. However, Enron immediately began recording much greater deferred tax assets related to the expected future basis step-up of the building.

Enron entered into two other tax basis transactions similar to Teresa. In the Condor Transaction, Enron sought to step up the basis of a fully depreciated oil and gas storage facility known as the Bammell facility by approximately \$1 billion.

In the Tammy I Transaction, Enron sought to create a non-economic basis step-up in its new headquarters building, the Enron South Building, which it was then constructing in Houston.

Again, it was contemplated that the basis of the step-up would exceed \$1 billion. These three tax basis step-up transactions were expected to provide a net income boost to Enron's financial statements of nearly \$1 billion over the life of the three transactions.

The examiner found that there is a significant possibility that each of these three transactions ran afoul of various Internal Revenue Code anti-abuse rules. The examiner also concluded that the transactions were accounted for in violation of GAAP.

In terms of the original of the tax transactions, seven of the tax transactions were presented to Enron by investment banking units of major banks. The investment banking firms received fees ranging from \$6 million to \$15 million for advising Enron on the tax transactions.

Three of the tax transactions were brought to Enron by major public accounting firms. One transaction was implemented internally by Enron based on the pattern of a prior transaction that it had implemented on the advice of a public accounting firm.

In order to market the transactions to Enron, the investment banks found that it was helpful to receive an accounting opinion known as a SAS 50 opinion, describing the accounting treatment of hypothetical facts.

The investment banks typically went to Enron's accountants in the transactions that were actually done by Enron for such a SAS 50 letter prior to the transactions. Banks also went to tax firms for "should" level tax opinions in relation to the transactions to establish the accounting requirement that the deferred tax assets were "probable" of recognition.

The examiner found that Enron relied upon a smaller group of law firms to issue the tax opinions and the tax transactions. Several of the firms who gave tax opinions to Enron in the transactions had previously been employed by the investment banking firm that promoted the transaction to Enron.

Certain firms rotated their engagements, representing Enron in one transaction and representing the investment banking firm in the next transaction. In certain instances, Enron paid the tax law firm fixed fees of as much as \$1 million for representing it in a single transaction.

The examiner's report in January expresses skepticism with respect to the conclusion reached in the tax opinions that Enron should prevail in the tax transactions if the tax results were contested by the IRS. Generally, the tax transactions pertained to future tax events that will now never occur because of Enron's bankruptcy.

In summary, the examiner has concluded in his reports filed to date that the tax transactions entered into by Enron distorted its financial statement net income in violation of GAAP.

Enron could not have implemented the tax transactions without the assistance it received from investment banks, from its accounting firm, and the law firms that issued tax opinions.

Thank you.

[The prepared statement of Mr. Cook appears in the appendix.]  
Senator BUNNING. Mr. Brostek?

**STATEMENT OF MIKE BROSTEK, DIRECTOR, STRATEGIC ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC**

Mr. BROSTEK. Good morning. Thank you for inviting me to testify today on IRS's efforts to address abusive tax shelters. I will cover the scope of shelters, IRS's strategy and enforcement mechanisms to combat them, and how IRS has allocated resources to address abusive shelters.

In terms of scope, no entirely reliable measure exists of the extent to which abusive shelters have been used and the amount of tax losses that have been experienced by the Federal Treasury. However, IRS and Treasury have been identifying a growing number of transactions that they believe are abusive, as the chart shows.

This is a chart of the listed transactions that have been discovered by IRS and Treasury over the past several years. You can see the growing trend line.

Several IRS measures suggest that the tax losses from abusive shelters have totaled in the tens of billions over about a decade. In perhaps the most systematic effort to assess the scope of the tax shelter problem, IRS contracted for a study.

That study reported a lower and an upper bound estimate for each year's tax losses between 1993 and 1999. Estimated losses ranged from a low of about \$9 billion in 1993 to a high of about \$18.4 billion in 1999. The average lower amount estimate per year was about \$11.6 billion, and the average upper bound estimate was around \$15 billion.

This study, however, has a number of limitations that cause GAO, Treasury, and IRS concern. Thus, its results are only broadly indicative of the scope of shelters during the 1990's. This study does not estimate the current losses due to tax shelters.

Regarding IRS's strategy, IRS has a broad-based strategy that is comprehensive in the sense of pursuing multiple, simultaneous means of identifying abusive shelters and resolving them. The strategy involves a wide variety of IRS offices, as well as Treasury and the Justice Departments.

Given the efforts of those using abusive shelters to obscure them from view, as we heard earlier, IRS and Treasury's efforts have stressed disclosure by taxpayers and promoters of the tax shelters.

In part, because these cases can be very time-consuming to investigate, IRS has also used various means to expedite closure of cases, for example, through settlement initiatives.

These strategies can facilitate case resolutions, but may work best when a taxpayer sees a record of IRS success against others before a settlement initiative is undertaken. IRS's strategy generally does not include performance goals or measures to track its progress. Officials expect to develop such measures.

Such goals and measures are difficult to establish, given the elusive nature of shelters and IRS's lack of experience in dealing with the current varieties that are now being discovered.

In order to pursue abusive shelters, IRS has shifted, and plans to continue shifting, resources from other enforcement efforts. As this next graph shows, IRS has shifted substantial numbers of examination personnel into abusive shelter work.

Given relatively fixed enforcement resources, these shifts have meant that other examination areas have fewer resources. That is, IRS has reduced staff devoted to examining other taxpayers, including other taxpayers strongly suspected of being non-compliant. IRS hopes to mitigate the effect of diverting these resources by making more efficient use of the remaining resources.

Despite shifting substantial resources to deal with abusive shelters, it is by no means clear that IRS will be able to address all the abusive shelter cases that it is finding.

The uncertainty stems from the lack of experience with these complex cases that complicates predicting how much time its examiners will need to devote to each case, and from uncertainty about the future volume of shelter cases IRS will uncover.

Since calendar year 2000, the database of listed and reportable transactions disclosed by the taxpayers and promoters grew from about 50 to a total of about 2,800 such transactions now.

The total of all listed and non-listed transactions, including those identified by IRS without taxpayer disclosure was about 4,900, as of September 30.

Given that IRS was conducting 98 promoter examinations as of June of this year, it seems likely that IRS will continue, at least for the near term, to identify more abusive transactions that will need to be resolved. Thus, at least for the short term, IRS appears to continue to face a significant challenge in addressing abusive shelters.

We encourage IRS to continue its efforts to obtain a better analytic basis for determining the number of resources it needs to address to shelters, while providing sufficient attention to other tax compliance challenges and to develop goals and measures that it and Congress can use to gauge IRS's progress.

That concludes my statement.

Senator BUNNING. Thank you.

[The prepared statement of Mr. Brostek appears in the appendix.]

Senator BUNNING. Ms. Olson?

**STATEMENT OF HON. PAMELA OLSON, ASSISTANT SECRETARY  
FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY,  
WASHINGTON, DC**

Ms. OLSON. Good morning, Senator. Thank you for inviting the Treasury Department to testify today on the efforts of Treasury and IRS to stem abusive tax avoidance transactions.

I have to begin by thanking the committee for the leadership you have shown on this issue. You have kept a focus on the issue and, in doing so, have lent support to the administration's efforts to put words into action.

Without the committee's unrelenting support for the administration's actions, the aggressive steps the IRS has taken to clamp down on the marketing and sale of dubious tax avoidance transactions and devices would have been more difficult.

I also want to thank the committee for your willingness to work with us as we identify transactions that require a legislative fix and administrative impediments to effective enforcement of the tax laws.

We believe the legislation this committee has approved—several times now, it should be noted—is better legislation for having carefully considered the IRS's experience in stemming the tide of abusive tax avoidance transactions.

We are well aware of the fact that the committee's support for the IRS's actions is dependent on it acting judiciously, using its resources wisely, and treating taxpayers with respect.

The Treasury Department is committed to continuing to work with the IRS to ensure the American public has delivered the service, use of resources, and judicious conduct that will continue to earn this committee's support.

My written testimony and the testimony of Commissioner Everson highlight the actions we have taken since March, 2002 to address abusive tax avoidance transactions and the importance of the legislative proposals made then that have been passed by this committee, but not yet enacted into law.

The IRS's experience since March of 2002 confirms the continuing need for the enactment of that legislation. Let me quickly review why. The IRS's compliance efforts indicated the need for more disclosure. Disclosure brings transactions out of the shadows and into the sunshine, and sunshine, as we know, is a powerful disinfectant.

The cultural laxity of the 1990's, however, left some believing that burying the transactions where the IRS was unlikely to find them was acceptable. As a result, we concluded the IRS needed additional tools to increase the likelihood of it discovering the transactions that taxpayers and promoters did not disclose.

In its audits, the IRS found that the web created by Congress to address tax shelters in the 1980's might serve as that tool. The web, however, was full of holes, holes created by a system that was too complex, holes created by a system with differing rules, holes created by vagueness, and holes created by the lack of effective penalties for failing to follow the rules.

Through regulatory action, we have been able to fill some of the holes that allowed taxpayers to slip through without disclosing. We

have expanded the disclosure rules beyond corporations to individuals, partnerships, and trusts.

This serves three purposes. First, it provides for disclosure for a segment of taxpayers who, the IRS's audit experience confirmed, had become active targets of shelter promotions.

Second, it provides for disclosure for types of returns that some promoters use to further conceal abusive transactions. Third, it increases the likelihood of potentially abusive transactions being disclosed by a participating taxpayer.

On that point, I would note that it takes only one disclosing taxpayer for the IRS to be able to find the promoter of the transaction and, through the customer list-keeping requirement, any other participating taxpayers. In short, a little bit of disclosure can create a lot of transparency.

We have also made the rules for tax return disclosure and customer list keeping uniform, simplifying them and eliminating confusion as a reason for non-compliance. That means that if a transaction is required to be disclosed on a return, the promoter will be required to keep a list of the taxpayers to whom the transaction is sold, and the IRS will be able to locate other taxpayers more readily.

Perhaps most important, we have converted the rules into clear, objective—not subjective—triggers for what must be disclosed to the IRS. In doing so, we have expanded what must be disclosed to the IRS beyond what may constitute a problematic transaction.

That may burden some taxpayers with a requirement to make unnecessary disclosures to the IRS, which is unfortunate. But with it comes clarity and certainty about what must be disclosed to the IRS, and we believe that, in the long run, will better serve the tax system. It may also allow us to more readily identify problems deserving regulatory or statutory correction.

We have also proposed regulations that would increase the cost of non-disclosure. Some tax advisors told their clients to ignore disclosure requirements because there was no up side to disclosure and no down side, since the advisor's opinion would protect them from any liability for penalties, even where the opinion was based on the invalidity of a regulation.

The proposed regulations would eliminate a taxpayer's ability to rely on an opinion as a defense to a penalty if the taxpayer did not disclose the transaction, as required by the regulations.

We expect that this regulation, if finalized, will make tax advisors think twice about counseling their clients to lie in the weeds. But we need the Congress to act to close the web. The information the IRS gathers now tells us what happened last year.

Acting promptly allows Treasury and IRS to close down a transaction before it becomes a bigger problem. But this is a lot like navigating a course through your rear-view mirror: so long as the road does not bend you may stay on it, but if it does you will quickly leave the road.

We need enacted the change to Section 6111 that would conform the registration rules to the rules for tax return disclosure and customer list keeping. We also need enacted changes to the penalties to make clear to taxpayers that the Congress is serious about transparency on the part of taxpayers and promoters.

It seems likely that the cultural laxity of the 1990's has contributed to the problems we have seen. Anecdotal evidence suggests the IRS's aggressive enforcement efforts and sunshine have combined to stem the problem, but we do not, in fact, know whether the problem is abating or whether we are merely at a lull in the action.

Whatever the case, it is clear that some in the tax professional community let us down. We are looking for opportunities to engender a return to the best practices that should define the tax profession.

Additional compliance tools are needed, but they are not enough. In many ways, our actions in the pending legislation are like applying Band-Aids to the problem. As time has passed, we have gotten better at applying the Band-Aids. Indeed, I believe our actions in the legislation will be quite effective Band-Aids. But Band-Aids will not cure the disease.

Moreover, there is no silver bullet, legislative or administrative, that will rid the system of abusive transactions. To cure the disease, we must devote efforts to rationalizing and simplifying our tax laws. Making the necessary changes will not be easy, but it is a task we must begin.

Thank you, again.

[The prepared statement of Ms. Olson appears in the appendix.]  
Senator BUNNING. Mr. Everson?

**STATEMENT OF HON. MARK EVERSON, COMMISSIONER,  
INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Mr. EVERSON. Good morning, Senator. I am pleased to be before the committee today to discuss the IRS's efforts to curb abusive tax shelters.

Since becoming Commissioner this past May, I have set three priorities for the IRS during my 5-year term as Commissioner of Internal Revenue.

The first, is to continue to improve service to taxpayers, helping them to understand their tax obligations and facilitating compliance.

The second area of emphasis, is information technology modernization. The third area of focus, a core element of which is the subject of your hearing today, is to strengthen the integrity of the Nation's tax system through enhanced enforcement activities.

I have said, and firmly believe, that service plus enforcement equals compliance. The IRS must demonstrate and execute a balanced approach if taxpayers are to remain faithful to our system of self-assessment.

As Senator Grassley said in the March, 2002 hearings on the subject of corporate tax shelters, "All taxpayers should be operating under the same set of rules." Or, as Senator Baucus said in the same hearing, abusive tax shelters can cause "serious harm" if they make average taxpayers feel like chumps. I concur with these sentiments and I believe the IRS has made progress in meeting these concerns. Certainly much, however, remains to be done.

Let me also note that expanding efforts to enforce fair tax compliance among high-income taxpayers and businesses is the first



priority of the President's 2004 budget request for the IRS, which is currently before the Congress.

The actions taken by the government over the past two years have established a regulatory scheme which has sent a strong signal of our resolve to choke off these efforts to profit from the complexities of the Tax Code through the creation of products tailored to generate unwarranted tax benefits.

Improved disclosure, registration, and list maintenance requirements, together with prompt, published guidance, are having, and will continue to have, a positive effect.

Where necessary, we have relied, and will continue to depend, on the actions of our colleagues at the Department of Justice to compel production of information which the law requires be shared with the IRS, and to take other actions against those who choose not to comply with our regulation.

The IRS is currently pursuing well over 100 promoter investigations, including accounting firms, law firms, and many boutique promoters. In addition, we have launched thousands of audits of individuals and corporations who have entered into questionable transactions. Many of these are in their early stages.

Beyond these steps, and in order to build upon the work already under way, the IRS needs to do the following. We must re-engineer and improve our enforcement processes, much as we have with our business processes on the service side of the Agency.

Our audits take too long, as do our criminal investigations. While much has already been done, we also need to further shorten the time it takes to identify new abusive transactions and issue appropriate guidance.

We need to appropriately prioritize our enforcement efforts and, where necessary, augment our resources. Our 2004 operating plan devotes more resources to the corporate and high-income areas. I would note that it does so without compromising our service levels.

We need to continue to emphasize and increase our focus on promoters of abusive transactions. We also need to strengthen Circular 230, which sets professional standards, an under-utilized tool in the battle against the creation of abusive transactions.

Under the able leadership of newly-arrived Deputy Commissioner for Services and Enforcement Mark Matthews, I expect the Service to make measurable strides during the fiscal year just started.

Before closing, I do wish to ask for the committee's help in two areas. One, the administration's legislative proposals to address abusive shelters, and others which this committee has actively supported over the previous year and a half, need to be put in place in order to strengthen the hand of the IRS.

Two, I also ask that you help us secure the full funding included in the President's 2004 budget request for the IRS. Thank you.

[The prepared statement of Mr. Everson appears in the appendix.]

Senator BUNNING. Ms. O'Connor?

**STATEMENT OF HON. EILEEN O'CONNOR, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, DC**

Ms. O'CONNOR. Good afternoon, Senator. Thank you so much for the invitation to be with you here today. Thank you for the work of the committee to help in the fight against abusive tax shelters.

My over-arching goal as Assistant Attorney General for the Tax Division of the U.S. Department of Justice is quite simple: to restore respect for the tax laws.

People who comply with the laws and pay the bills of this great Nation should have the assurance that the government is doing something about those who are not, whether they are doing it by simple means or sophisticated means.

Let me begin by a brief description of the work of the Tax Division in tax enforcement generally, and then go specifically to what I referred to as the information litigation and merits litigation that we undertake in the Tax Division.

Under the authority of the Attorney General, the Justice Department's Tax Division is responsible for the conduct of virtually all litigation involving the Federal tax laws. The only exception is cases brought in the U.S. Tax Court. IRS attorneys handle those.

The Tax Division of the U.S. Department of Justice is responsible for all other litigation, trial and appellate, in any other court, Bankruptcy Court, Court of Federal Claims, U.S. District Courts, and U.S. Courts of Appeals. This is affirmative litigation or defensive litigation. Our work in the Tax Division includes appeals from decisions of the United States Tax Court.

We defend Federal tax claims in bankruptcy, we defend IRS agents in suits brought against them for actions they took in the performance of their duties. We bring legal actions to collect taxes due. We bring injunction suits to stop illegal activities before they can do further harm to the Treasury.

The Tax Division also assists the Solicitor General of the United States in Supreme Court cases that involve or affect the administration or enforcement of Federal tax laws, whether or not they actually involve a provision of Title 26.

To promote nationwide consistency and criminal enforcement of the tax laws, Tax Division authorization is required before the Department of Justice investigates or prosecutes a tax charge. We delegate authority to U.S. attorneys to handle most grand jury investigations and criminal tax prosecutions, with Tax Division prosecutors often supervising or assisting.

Tax Division prosecutors also personally litigate a small proportion of tax prosecutions. At any given time, we have about 7,000 civil cases in progress, and about 700 cases before the U.S. Courts of Appeals.

This past fiscal year, we authorized prosecution of more than 1,100 defendants. This was an increase of 17 percent over the prior year, which in itself was an increase of 16 percent over the year before that. To accomplish all this, the Tax Division employs about 550 people, about 350 of whom are attorneys.

Of all the Tax Division activities, the most relevant to the subject of today's hearing are these. We help the IRS obtain information that it needs to accomplish its examination function by obtaining

judicial enforcement of administrative summonses, or obtaining leave of the court for the Internal Revenue Service to serve a John Doe summons. We defend the United States in refund suits, tax claims, and in bankruptcy.

The comments that follow address these two areas of endeavor. Abusive tax shelter cases, as the testimony of the prior panel illustrates, involve both corporations and individuals.

A coordinated and effective effort is essential to prevent substantial losses of revenue to the Federal FSC and to deter other taxpayers from using such shelters in the future.

The Tax Division coordinates very closely at every level within the Tax Division and at every operational and leadership level with the Internal Revenue Service and IRS Chief Counsel's Office.

We, within the Department of Justice, have a summons enforcement team which is engaged in the summons enforcement activity I just mentioned. We also have a tax shelter litigation coordinator who is making sure that the nearly 60 attorneys we have in the Tax Division devoted to the litigation of merits of tax shelters are working together and marshalling our resources effectively so that we win these cases.

The Tax Division has brought summons enforcement actions against some of the Nation's largest accounting firms. The District Courts have enforced orders against BDO Seidman and Arthur Andersen, requiring those entities to turn documents over to the Internal Revenue Service so the Internal Revenue Service could analyze the liability of those firms for promoter penalties, and could commence, where appropriate, examinations of the individuals who engaged in the shelters.

Although we have obtained these court orders, the privileged issues are still being litigated. Mr. Camferdam, earlier, alluded to the fact that Ernst & Young first told him not to cooperate in the voluntary disclosure program, and then told him they were about to turn over their names.

After Ernst & Young agreed to turn over the names, several John Does sued Ernst & Young to prevent just that from happening. So, our victories in the courts are step-by-step, one-by-one.

On the substantive litigation, the Tax Court also plays an important role there because, as I mentioned, unless a case is brought in the U.S. Tax Court, the Tax Division attorneys are going to handle it.

We have had a number of substantive successes on the merits of tax shelter litigation, but there is still very much to do. We presently have in-house about 27 cases in various stages of litigation.

The Tax Division is fully committed to restoring and maintaining the integrity of the Federal tax system. This means succeeding in our summons enforcement litigation and in our tax shelter litigation. We have made progress, but considerable challenges remain.

The IRS has made shutting down abusive tax shelters one of its major strategic initiatives. The IRS cannot do it alone. The Tax Division itself cannot initiate the necessary actions.

Through legal necessity and shared commitment, the Tax Division and the IRS are partners in these efforts. We are very pleased at the committee's interest in this issue, and for your support of the administration's efforts to shut down abusive tax shelters.

Thank you, again.

[The prepared statement of Ms. O'Connor appears in the appendix.]

Senator BUNNING. Mr. McDonough?

**STATEMENT OF WILLIAM J. McDONOUGH, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, WASHINGTON, DC**

Mr. McDONOUGH. Thank you, Senator. I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board.

I would like to begin by commending the committee's thoughtful and deliberative review of the Enron debacle. Your work helped expose Enron's abusive tax shelters and misuse of executive compensation arrangements.

Indeed, the evidence accumulated by this committee and the Joint Committee on Taxation has served as a wake-up call that we all, whether corporate leader, legislator, or regulator, must heed.

The financial scandals at Enron, Adelphia, WorldCom, Health South, and elsewhere left the impression that public company financial reporting is not to be trusted and that professional advisors, including investment bankers, lawyers, and even a company's accountants will help unscrupulous executives cook the books.

Congress responded to that breach of trust by enacting the Sarbanes-Oxley of 2002. The act established the PCAOB and charged it with overseeing the audit of public companies that are subject to the securities laws and related matters in order to protect the interests of investors, and further the public interest, in the preparation of informative, accurate, and independent audit reports.

To carry out this charge, the act gives the board significant powers in relation to the audits of public companies, including to register public accounting firms that audit public companies, to inspect the audits and quality control of such firms, to conduct investigations in disciplinary proceedings concerning such firms' audits, and to establish auditing quality control ethics, independence, and other standards relating to the preparation of audit reports for issuers. Our job, in short, is to oversee the auditing of public companies' financial statements.

The PCAOB will have a variety of tools that may help address problems caused by at least those abusive tax shelters that are designed to make financial statements look better.

First, as part of the board's inspections of registered firms' audits of public companies' financial statements, we will identify and examine how firms audit questionable tax-oriented transactions. We will also look for auditors' involvement in structuring such transactions.

Now, because we are only beginning our inspections program we cannot, today, assess the current extent of promotion and use of corporate tax shelters and products. We will, however, scrutinize the accounting and presentation of the transactions that we discover through our inspections program, including specifically through our reviews of selected audit engagements.

In addition, by looking at auditor compensation, promotion and retention, our inspections will identify a firm's policies and prac-

tices that create incentives for firm audit personnel to promote such transactions to their clients.

Therefore, while existing laws and regulations may not ban auditors from promoting and giving tax opinions on such transactions, at least to their audit clients, both auditors and companies should expect heightened scrutiny of such transactions.

The prospect of that scrutiny may give pause to corporate management, audit committees, and auditors that may consider such transactions. Indeed, some accounting firms have already announced that they will no longer promote or give tax opinions on certain types of structured transactions to their audit clients.

Second, through our authority to discipline registered firms and associated persons, we may impose stiff penalties for failing to adequately and impartially audit such transactions undertaken by public companies. Those penalties may include revocation of a firm's registration and banning individual accountants from working on audits of public companies.

Finally, the board has the authority to commence a standard setting project to address at least a part of the problem. Specifically, the board has authority to add to the statutory list of non-audit services that a registered firm may not provide to audit clients.

Such regulation, of course, would not prohibit a registered firm from selling tax shelters to non-audit clients. That is outside our purview under the statute.

The board also has the authority to develop and impose additional auditing procedures. While ferreting out tax avoidance is not directly within our purview, auditors ought to follow appropriate standards for identifying and auditing transactions whose main purpose is to make financial statements look rosier.

Congress gave the PCAOB the responsibility and the tools to build a new future for auditing through independent standard setting, registration, inspection, investigations, and discipline.

My fellow board members and I look forward to a long and constructive relationship with this committee, Senator. Thank you.

Senator BUNNING. Thank you.

[The prepared statement of Mr. McDonough appears in the appendix.]

Senator BUNNING. Mr. Williams, please?

**STATEMENT OF HON. B. JOHN WILLIAMS, SHEARMAN AND  
STERLING, LLP, WASHINGTON, DC**

Mr. WILLIAMS. Senator Bunning, it is a special privilege for me to appear here with you presiding. I wanted you to know that I was an undying fan of the 1964 Phillies. [Laughter.]

Senator BUNNING. So was I!

Mr. WILLIAMS. And Chris Short.

I would ask you to convey my thanks to the Chairman and Senator Baucus for inviting me to testify today on the subject of the government's efforts to curtail abusive tax avoidance transactions.

This is the third occasion on which I have had the privilege of testifying on this subject before this committee. There are two necessary and sufficient parts to interdicting abusive tax avoidance transactions. One, legislation that creates a disclosure regime, sup-

ported by strong penalties. Two, tax administration that pursues promoter audits and income tax examinations strategically.

The committee should be commended for its work on both parts of the solution. On the first part, the committee has marked proposed legislation that adopts an effective information reporting requirement, supported by strong penalties, and significant penalties for taxpayers who fail to disclose reportable transactions and for promoters who fail to maintain lists of investors, and limits the applicability of Code Section 7525, the Tax Practitioners Privilege.

The new information reporting and disclosure requirements would permit the Service to connect either the investor to the promoter, and thus to all other investors, or the transaction to the investor. This web of information should enable the Service to regain credibility that the Service will knock on the door of the taxpayer.

On the second part, the committee enabled Commissioner Rossotti to redesign the administrative apparatus of the Service in a way that permits it to act strategically on a national basis in a way that the old organizational structure never could have.

This strategic use of audit resources, however, requires, one, a new flexibility at the Service, and two, a willingness to reassure taxpayers that the Service is not engaged in chest thumping.

Additional flexibility is needed in both promoter examinations and in follow-up ordinary income tax audits in three important respects: one, in organizing agents to pursue an audit; two, in encouraging examination teams to seek counsel's advice earlier and more frequently; and three, in giving the team time to develop the issues. The foundation for the Service's success is to proceed analytically rather than emotively.

In describing tax avoidance transactions, the term "abusive" reflects the indignation that the Service feels. But the Service's feelings about a transaction do not state a legal basis for determining a deficiency. Abusive is not analytical term, it is an emotive term.

The mission of the Service is to apply the tax law fairly and impartially. I believe the Service has an institutional tendency to apply the law in a manner that is biased toward a result the government wants, based upon their feelings about the transaction.

In this connection, the institution does not need to be reminded that it is an enforcement agency. Instead, the Service needs to be encouraged to use its enforcement tools in a way that helps taxpayers comply with the law.

Taxpayer service is far more than processing returns quickly or answering phone calls pleasantly and accurately. It is the bedrock attitude that the Service should bring to its dealings with taxpayers.

In this respect, as Commissioner Everson just testified, there need to be no pendulum swings between taxpayer service and enforcement.

Taxpayers who do not pay the tax that the government says they owe are not always wrong. Indeed, on occasion the Service has had legal fees imposed on it for taking unreasonable positions.

More to the point, however, is that the complexity and intricacy of the tax law is often murky or uncertain. And even if not unreasonable, the government's position may not be right.

The Service does not always determine a correct deficiency. The deficiencies, as determined by examining agents, may be used to measure compliance, but they are not a fair yardstick.

I would caution the committee against proceeding with strict liability penalties. First, with regard to disclosure, the size and complexity of many businesses and the returns they file will inevitably result in missed items. In my view, the disclosure regimes need some tolerance for inadvertent mistakes.

Second, strict liability penalties tend to suffer one of two extremes in tax administration. Either they are employed too sparingly because they are viewed as too draconian, or they are used as threats to force resolutions that are not appropriate. Neither should be acceptable to sound tax administration.

In particular, the special penalty for engaging in a transaction that lacks economic substance, in my opinion, is fraught with potential arbitrariness.

The proposed changes in penalties, both regarding disclosure and Code Section 6662 penalties, require personal involvement of the Commissioner in those limited circumstances in which a penalty can be rescinded. I think it is a mistake to require involvement of the Commissioner personally in any case.

While the Service still has much work to do, the shelter problem is manageable with strategic use of resources and a disclosure regime in place. The Service must, however, demonstrate a continued respect for taxpayers who disagree with it, or place at risk its credibility with the American public as a fair and impartial tax collector.

Thank you again for the invitation to speak today. I will gladly answer any questions the committee might have.

[The prepared statement of Mr. Williams appears in the appendix.]

Senator BUNNING. Thank you all for your testimony. If, after my first round, we do not get all the questions in, I would like to have the staff submit written questions to each and every one that we do not get in.

So, we are going to start out with Mr. Everson. How do the complex relationships among investment advisors, accountants, lawyers, brokers, and clients complicate your efforts to identify and take action against the abusive transactions? What will you do to address this problem?

Mr. EVERSON. I have a chart, Senator, if I may show it to you. What this depicts is a network of reinforcing commercial relationships amongst investment advisors, CPA firms and law firms, with execution activities by brokers.

Together, what these entities do is create a market and execute abusive shelters. The letters across the top of this chart indicate the players in one shelter, something called Son of Boss, which helps to create a different basis for the taxpayer which comes through three different vehicles which are depicted at the top.

The As, Bs, and Cs here are the names of law firms or accounting firms that you and others will recognize. What it shows, is all the interrelationships in terms of the creation, marketing, and executing of this particular transaction, which is one that the Treas-

ury Department and the IRS have listed as one requiring disclosure. It is one of the 27 where we have serious questions.

The links at the bottom. This shows that these players are actually working on five other products, five other kinds of transactions. The point of showing this gets to what has already been commented on today.

In order for us to address this transaction or others, we need to have the information about what the transaction is. That is what makes it so important for the committee and the Congress to pass into law the proposals that require stiffer penalties for these very entities to register these transactions and to provide lists to us of who is participating in these transactions.

Unraveling the shelters can only be done effectively if we know about player E, or player D, or player C. Unfortunately, some of these entities have demonstrated a tendency in some instances to make business decisions about whether they would give the information to the IRS based on inadequate penalty structures.

Senator BUNNING. Thank you very much. It seems to me, in looking at the chart, that the bottom line, "Other Shelter Products," seems to be, if you do not catch the original Son of Boss promoter relationships, that there are at least 10 to 15 others that are about to begin, or have begun.

Mr. EVERSON. That is a fair observation. One of the problems here is that, as Secretary Olson was indicating, we are looking in the rear-view mirror here. We need to get on these things as the products are created and developed, because everybody is trying to stay one step ahead of the IRS.

Senator BUNNING. Mr. Brostek and Mr. Everson, as we learned so often with Enron, you need to pay attention to what is in the footnotes and in the appendix. That is certainly the case with the GAO report today. The appendix has some very disturbing numbers regarding Schedule K1 and compliance.

The report states the preliminary profiling efforts identify over 227,000 business entities with almost \$64 billion in Schedule K1 income for tax year 2000 that potentially did not file tax returns.

I would like your response to this in more detail, and your views on the matter, Mr. Everson. Well, let me get Mr. Brostek, first.

Mr. EVERSON. Sure.

Mr. BROSTEK. This is coming out of IRS's effort that was begun 2 years ago to reinstitute a process of matching the K1 information document that is generated by a partnership or other flow-through entity to the recipients of that income to see whether the individuals are claiming the income on their tax return.

This is fairly preliminary information. This is the first time IRS has done this in a fair amount of time. But, as indicated, there is a fairly substantial amount of money involved and a fairly substantial number of individuals that IRS has preliminary reason to believe did not file a tax return, and they identified that through this matching process.

Senator BUNNING. Two hundred and twenty-seven thousand, and over \$64 billion?

Mr. BROSTEK. Correct. And there may be some shrinkage in that as IRS gets behind those numbers and tries to understand what really happened.



Senator BUNNING. Mr. Everson?

Mr. EVERSON. The amount of monies that pass through to individual returns that should be depicted or are depicted on these K1s are actually, in total, over \$1.2 trillion a year.

Our indications are that, for the average taxpayer who has an income of \$1 million or more, they actually have 10 to 15 of these pass-through entities that are associated with their return.

What we have started to do, is to compile this information. It was not compiled until 2001 for the 2000 returns. Before that, it would only be looked at if we selected an individual for an audit.

So what we have started to do in the last 2 years, is to enter that information into the system so that we will be able to better match the transactions to the individual.

Because what is happening here in some instances—and I would stress, in some—is that through additional layers of transactions and complexity, individuals can make it harder for the IRS to see the substance of what is going on in their return.

Senator BUNNING. Mr. Cook, what role did Enron's management and compensation incentive pay cause in Enron's decisions to enter into the tax transactions that they entered into, or at least in your opinion?

Mr. COOK. Well, our reports filed to date show that management gave strong incentive to the tax department to originate these transactions. They developed a special unit within the tax department.

The vice president who headed that unit really had significantly higher bonuses than the bonuses received by his contemporaries, indeed, higher bonuses even than the head of the whole department. So, it was clearly a situation where Enron placed a lot of emphasis on obtaining these results and paid its people accordingly.

Senator BUNNING. Well, tell me this, because it has always intrigued me that the tax department would come up with these schemes. But there had to be direct contact with a broker/dealer and a financial institution to make these phantom things work. Did you find that?

Mr. COOK. Well, we did find that most of the ideas were brought to Enron from an outside party. Often it was the investment banking unit of a major bank. We did find that those outside parties would frequently employ accountants and lawyers to develop the structures.

Our report showed that there is evidence that when the investment bank brought the structure to Enron, the tax advisors that had helped develop the structure were present at those meetings.

Our reports show that, on occasion, those tax advisors were ultimately hired by Enron to give the tax opinions and to implement the structure. So, there is the web that really is reflected in that chart very much in play, reflected in the reports we filed to date.

Senator BUNNING. Any one of the three, or all three can answer this, Mr. Everson, Mr. Williams, or Ms. Olson. I asked the earlier panel whether current penalties are sufficient to police the shelters and the tax promoters. What are your views, particularly Mr. Everson and Ms. Olson?

Ms. OLSON. I will go first and let the Commissioner add to my statement. We proposed, in March of 2002, increases to penalties

for promoters. There were two kinds of penalties, one that would increase the penalty for failing to register transactions, and included in that penalty is the fact that we need greater clarity and an expansion of what is required to be registered, and then in addition a time-sensitive penalty for failure on the part of the promoter to turn customer lists over to the IRS.

Recognizing that statutes of limitation can continue to run while the IRS does its investigation, it is really very important that the IRS get its information on a timely basis. So, those are two penalty changes that we think should be made.

We also proposed, on the taxpayer, a penalty for failing to disclose abusive tax avoidance transactions on their returns. So, it would be just a flat penalty for any failure to disclose.

We also proposed an increase in the under-statement penalty that would apply to a taxpayer if the penalty otherwise applied and they had not disclosed on a return.

That is all reflected in the legislation that has been approved by this committee in the past, and we very much appreciate the opportunities we have had to work with the committee staff on that.

Senator BUNNING. Mr. Everson?

Mr. EVERSON. I very much agree with what Secretary Olson just indicated, and support what the committee has already been trying to do over the last year and a half in this regard.

As to the promoters, as I indicated a moment ago, it is very unfortunate. There was an erosion of standards in the professional community, in some instances, in recent years. They have not sought to comply with the law. Therefore, it is clear that penalties need to be increased so that they have a respect for the consequences if they do not comply by their own design.

Senator BUNNING. I have another question for you, Mr. Everson, and for anybody else who wishes to comment. As you well know, the IRS already audits every major corporation.

The problem, as we have heard today, is even though the IRS audits, it always is the same song: travel records, cars, luncheons, things that are not really at the heart of what we are looking at.

In sum, the IRS spends too much effort on the low-hanging, small-dollar fruit. What is the IRS doing to ensure that existing audits' efforts are better focused and targeted for going where the big money is, such as tax shelters and more substantive tax issues?

Mr. EVERSON. Senator, I think that we can, and do need to do more to have our audits be risk assessed. We need to follow the kinds of transactions where the Treasury Department and ourselves have indicated there is higher risk for noncompliance. I think we have been moving in that direction.

I am disturbed to hear that there is a feeling that we are looking more at travel and entertainment expenses in these big companies than the inter-company pricing transactions, and leasing, and some of the other matters that have already been discussed before this panel. There is a constant effort to improve our procedures here.

Debra Nolan is behind me. She is the Commissioner of the Large and Mid-Sized Business Division. We have a number of programs where we have limited issue focused examinations where we are looking at areas of mutual concern. We are doing pre-filing agreements where we have companies come before us with transactions

that are potentially significant. But this is subject to an ongoing set of changes.

The only additional comment I would make, is that I have asked Commissioner Nolan and others to try to bring these audits to conclusion sooner. Several comments have been made today about things being open for long periods of time. I think that this contributes to the efforts on the part of some that they can count on the fact that it will take us a long time to discover potential problems.

Your observation earlier about these other products at the bottom of the chart, well, they can be on to something else by the time we finally catch up with them. So, one thing we are definitely trying to do, is reduce the time that some of these audit issues are open.

Senator BUNNING. Well, if the registration is required on shelters, that would surely help.

Mr. EVERSON. Absolutely, sir. That is very much the intent of everything that the Treasury Department and the IRS are doing together. As we identify these transactions, it is not just a question of registering certain of the transactions we have already identified.

There are criteria that are delineated as to other kinds of transactions or benefit that is provided, or confidentiality. If they follow those guidelines, then we will know where to look.

Senator BUNNING. Mr. McDonough, your written testimony indicates that your board will focus, in its inspections, on partner compensation and promotion. Could you expound on this? How will you examine these issues? How do you expect your findings will impact the firms you are overseeing?

Mr. MCDONOUGH. Senator, the approach that we are taking with the accounting profession is that they have a great deal of work to do to restore the confidence of the American people in their profession.

I believe that they are fully aware that that is exactly what we have in mind, and it is their responsibility, to put it in Biblical terms, to save themselves. If they do not save themselves, we will make sure that they get saved and the approach will not be a pleasant one.

Why are we looking at compensation? If the people at the top of the firm are saying, terrific, we are going to restore the confidence of the American people, we are going to do great audits, but in fact they are paying the super salesman partner three times what they are paying the very good audit partner, then I am not believing it.

So, we will look into the economic reality of how they are running the firm, and I think there is no better indicator of that than relative compensation. If we think that the relative compensation is not what it ought to be, we will sit down with the head of the firm and have some very frank discussions about changing the approach.

It is an interesting business we are in. We have a very limited scope. We have just got the area of the part of an accounting firm that does the audit of public companies. That is a chunk of the firm, but there is a fair bit left.

On the other hand, our approach to the firm is, we are your spiritual guide and we are going to help you turn the firm around. This

is a particular area where I am not sure that they thought that we would look, but we will.

We are. We are conducting inspections, rather thorough inspections of the four big firms right now, and we will wrap up that work about the end of November. Among the very important things we are looking at is the economic reality within the firm, whether they are behaving in the way that they are saying they are behaving.

Senator BUNNING. One more question. I appreciate your testimony and willingness to take the lead in the difficult process for restoring the faith of the public in the accounting industry.

In your testimony, you indicate that the PCAOB plans to examine how a firm audits questionable tax transactions and any involvement the auditors may have in structuring such transactions.

As a member of this committee, I am interested to know whether the board plans to hire personnel with tax expertise to assist in this important function, which crosses both the financial accounting and tax law disciplines?

Mr. McDONOUGH. The way, Senator, that we will see if something is going wrong, is especially when we get into the inspection of particular engagements. We will be looking very closely at the work papers.

Part of the work papers will have to do with the relationship between the tax books and the public books. There should be a discussion in there of the appropriateness of the size of the reserves, and so on.

We think that there will be a fair likelihood that we could spot in there, if the audit partners, the audit people involved, thought that one of the transactions was a bit smelly.

That is not certain that it will be the case, but that will give us an opportunity. Once we get into an investigation, that we really think there is something we need to delve into even more fully than these very thorough inspections, then we can get even deeper in. If we see something that ought to be turned over to the IRS or the Justice Department, we will do so.

You have got a tremendous demand these days by the people on this panel for tax experts. We are a start-up situation. Frankly, I think I would like to leave the tax expertise to the Treasury, the Justice Department, and the IRS rather than be out competing with them in hiring tax experts when, as a 69-year-old head of a start-up, I have an immense amount of work to do to do all the other stuff that we are responsible for.

I think we will try to help all we can in this tax shelter area, because I find it morally, immensely repugnant. But I think that the lead will have to come from our brethren at the table here.

Senator BUNNING. All right. This will be my last question. I want Ms. O'Connor, Mr. Williams, and Ms. Olson to get into this. This question is for Ms. O'Connor, but I would appreciate all others providing input.

Ms. O'Connor, the committee has heard concerns that Justice will at times disregard tax policy and tax administration in making arguments before a court. My understanding is that this will go as far as Justice stating that they are not bound by public's positions

of the IRS. This is very troubling and I would appreciate hearing from you.

Ms. O'CONNOR. Thank you for your question, Senator. It is one I am hearing for the first time, right now, though, so it is coming as a surprise to me that you hear complaints like that.

The Tax Division does not make tax policy. We are, however, part of the Justice Department and in that capacity we are able to see how tax law is a part of law. When we are arguing cases before courts we must make sure that the government, not just in the tax law area, is making consistent arguments.

Having said that, though, while the Attorney General does have the authority for all litigation in all U.S. courts except for the Tax Court, it is our firm belief that the Internal Revenue Service and the Treasury are our clients, that Treasury is responsible for tax policy.

Unless there is some really pressing reason not to, and this would be resolved at the highest levels, our litigating position would be consistent with what the IRS hopes that it would be.

Now, there are times when we are already litigating a certain case and the IRS might wish that it had taken a different litigating posture earlier. Having already made representations before the courts, we cannot then go in the next day and make a different one.

But I would be happy, if you would be interested in giving me any particulars at a time when I am able to reflect on them, to give you a more thoughtful response.

Senator BUNNING. Ms. Olson?

Ms. OLSON. I guess one of the things that has become very clear to me over the course of the last two and a half years, is that relying on the courts to make policy or decide tough issues is a very hazardous way to go.

That is one of the reasons why we have been very aggressive, over the course of the last two and a half years in our published guidance process, to do everything that we can to resolve issues through the published guidance process.

One area where that has proven particularly true, is an effort to determine what expenses in the creation of intangible assets should be capitalized. The IRS, instead of publishing guidance, began litigating some cases and won the first few cases in the Tax Court. Ultimately, many of those decisions were reversed by the appellate court.

In the process, we have a mass of inconsistent rules depending on particular factual situations, particular circuits, and very little clarity for either taxpayers or IRS agents in determining what the rules are.

So what we have determined to do, is to try to identify what those kinds of issues are that really are in need of published guidance where we can provide a consistent answer for taxpayers across the board.

We really think that is the right way to go, and we have worked with the Justice Department on some of those issues where there have been issues that have already been in litigation to make sure that we have the opportunity to do published guidance so that we do get consistent responses for taxpayers and we do have clear guidance for agents about what the rules are.

Senator BUNNING. Mr. Williams?

Mr. WILLIAMS. Senator, I think one of the things I always tried to articulate when I was Chief Counsel, was that litigation does not drive tax policy, tax policy drives litigation. That is to say, litigation must yield to a determination of what the proper rules should be administratively.

The reason for that, is because in administering the tax system we have a nationwide responsibility. We want to make sure that taxpayers all across the country are subject to the same rules.

To the extent that you take positions in cases that differ from that, even if it may win a particular case, it will lead ultimately to a wrinkle at best in administering the system, because if you win the case but it is on the basis of a rule or an articulation of a rule that is different than tax policy promulgated in regulations or rulings, then you will have some taxpayers living under different rules and that is not healthy for the system.

So, I think, to the extent that the Justice Department can reflect the positions of the Treasury Department in moving forward, whether it is in shelter or more general tax litigation, I think the system is better off.

Senator BUNNING. It has come to my attention though that there are certain individuals and certain corporations that would choose a specific place to have a court hear their case rather than another court because the rulings out of a tax court in Cincinnati, or Cleveland, or Los Angeles might be different and be more favorable to the taxpayer than they would in some other areas. I say that only because of experience with the courts.

Mr. WILLIAMS. There is no question, Senator, that that happens. That is a function of two things. One, is the statutes, which provide different routes of appeal depending on whether you litigate it in the Tax Court, the District Court, or the Court of Federal Claims. There are just two separate appellate courts that review those decisions. That is one part of the issue.

The other part is, you have got judges that have different views of the law or of particular cases, which is one of the reasons that litigation should not drive tax policy, tax policy should drive litigation.

Senator BUNNING. Well, even the interpretation of the tax policy by the judges, whether it be in a tax court or an appellate court, differ.

Mr. WILLIAMS. Yes, that is right, Senator. If you are advising a client and you realize that there is a more favorable precedent in one circuit than another, you would be malpracticing as an attorney if you did not advise them of the difference.

Senator BUNNING. To use the right court.

Mr. WILLIAMS. Exactly.

Senator BUNNING. All right. I want to thank you all for your testimony. If there is anybody else that would like to add something, this is the time to do it.

[No response]

Senator BUNNING. If not, we will be adjourned.

[Whereupon, at 12:48 p.m. the hearing was concluded.]

## APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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# Committee On Finance

Max Baucus, Ranking Member

**NEWS RELEASE**

<http://finance.senate.gov>

**For Immediate Release**  
Tuesday, October 21, 2003

Contact: Laura Hayes  
202-224-4515

**Statement of U.S. Senator Max Baucus  
Finance Committee Hearing: Tax Shelters: Who's Buying, Who's Selling, and What's the  
Government Doing About It?"**

The proliferation of abusive tax shelters has been referred to as our nation's most significant tax compliance problem. The development, selling, and buying of tax shelters has also been characterized as a "race to the bottom." As the New York State Bar Association has stated, "the constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions."

Simply put, this is unacceptable. And that is why the Finance Committee – under Senators Moynihan and Roth – as well as under Chairman Grassley and myself – have pushed for legislation to put the brakes on these tax-engineered schemes.

The purpose of today's hearing is to make it clear that the tax shelter problem is not just an Enron – Arthur Andersen problem. The tax shelter problem is widespread – developed and promoted by accounting firms, law firms, and investment banks, and purchased by many other corporations and individuals.

Now, as Judge Learned Hand once said, "There is nothing sinister in arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; for nobody owes any public duty to pay more than the law demands; to demand more in the name of morals is mere cant."

But we are not talking about legitimate tax planning. Abusive tax shelters are illegitimate tax avoidance schemes that create a tax benefit without any corresponding economic benefit. There's no new product. No technological innovation, just a tax break. And those engaged in this tax shelter business are doing this at the expense of those taxpayers who are paying their fair share of taxes.

To give you an idea of the burden placed on honest taxpayers during the 1990s alone, actions taken to shut down tax shelters saved American taxpayers approximately \$80 billion. And a recent study commissioned by the IRS estimated the current cost to honest taxpayers ranged from \$14 billion to \$18 billion a year. That is up to \$180 billion over ten years.

Every spring, Americans sit down at the kitchen table, or at their home computer, and figure out their taxes. With quiet patriotism, these Americans step up and pay their fair share. They are counting on us to make sure that sophisticated corporations pay their fair share as well.

I am simply unwilling to tell the school teacher in Montana that he needs to pony up a little more because Congress is unwilling to shut down a loophole that is costing tens of billions every year. Mr. Chairman, today's hearing is critical in highlighting the magnitude of the problem.

Congress cannot ignore the problem any longer. It has been two years since the collapse of Enron. Yet not one piece of tax legislation to curb tax shelter abuses has been enacted.

I look forward to continuing to work with you, Mr. Chairman, to see the Tax Shelter Transparency Act through to enactment. I also urge all of my congressional colleagues – in the House and the Senate – to join forces to send tax shelter legislation to the President for his signature by the end of the year.

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United States General Accounting Office

**GAO**

Testimony

Before the Committee on Finance, U.S. Senate

For Release on Delivery  
Expected at 10:00 a.m. EDT  
Tuesday, October 21, 2003

**INTERNAL REVENUE  
SERVICE**

**Challenges Remain in  
Combating Abusive Tax  
Shelters**

Statement of Michael Brostek  
Director, Tax Issues



October 21, 2003

INTERNAL REVENUE SERVICE

Challenges Remain in Combating Abusive Tax Shelters



Highlights of GAO-04-104T, a testimony to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Recent scandals involving corporations, company executives, and accounting, law, and investment banking firms heightened awareness of abusive tax shelters and highlighted the importance of the Department of the Treasury and the Internal Revenue Service (IRS) addressing them. During 1999, Treasury issued a report indicating that abusive shelters were a large and growing problem, involving billions of dollars of tax reductions. Treasury was concerned that abusive shelters could ultimately undermine the integrity of the voluntary compliance tax system.

GAO's statement today is based on work done at the request of the Chairman and the Ranking Minority Member of the Senate Committee on Finance to examine IRS's strategy for dealing with abusive tax shelters. In reporting on abusive shelters, GAO is describing

- their nature and scope,
- IRS's strategy and enforcement mechanisms to combat them and the performance goals and measures IRS uses to track its major effort in that area, and
- the decision-making process IRS used and the plans it has to devote more resources to addressing abusive shelters.

[www.gao.gov/cgi-bin/gettrp?GAO-04-104T](http://www.gao.gov/cgi-bin/gettrp?GAO-04-104T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov).

What GAO Found

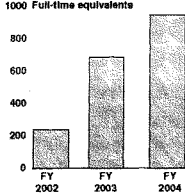
By their nature, abusive tax shelters are varied, complex, and difficult to detect and measure. Abusive shelters manipulate many parts of the tax code or regulations and may involve steps to hide the transaction within a tax return. In recent years, IRS has been accumulating information about them and, although it does not have a reliable measure of the size of the abusive shelter problem, has come to believe that abusive shelters deserve substantially increased attention. IRS continues to gather more information to better define the scope of the problem and has data sources, all with their own limitations, that suggest abusive tax shelters total tens of billions of dollars of potential tax losses over about a decade.

IRS's broad-based strategy for addressing abusive shelters included:

- targeting promoters to head off the proliferation of shelters;
- making efforts to deter, detect, and resolve abuse;
- offering inducements to individuals and businesses to disclose their use of questionable tax practices; and
- using performance indicators to measure outputs and some outcomes and intending to go down the path it has started and develop long-term performance goals and measures linked to those goals. Without these latter elements, Congress would find gauging IRS's progress difficult.

In allocating resources to shelters, IRS used a systematic decision-making process that relied on admittedly limited information. It planned to shift significant resources in fiscal years 2003 and 2004 to address abusive shelters but faces challenges, especially in the near term, in addressing abusive shelters due to a growing workload and limited information on how long it takes to examine shelter cases. IRS's understanding of how many staff will be needed to address the problem over what period will continue to evolve as it gains a better understanding of the problem's scope.

Shift in Examination Resources Allocated to Abusive Tax Shelters



Source: IRS.

Note: Fiscal year 2002 full-time equivalents include actual time spent on the entire returns containing shelters, not on the shelter issues alone. Fiscal year 2003 and 2004 full-time equivalents are planned amounts that are focused more on the shelter issues themselves.

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Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify on the Internal Revenue Service's (IRS) efforts to deal with abusive tax shelters. I am using the term "abusive shelters" to describe very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits. Recent scandals involving corporations, company executives, and accounting, law, and investment banking firms heightened awareness of abusive shelters and highlighted the importance of the Department of the Treasury and IRS addressing the problem. During 1999, Treasury issued a report indicating that abusive shelters were a large and growing problem, involving billions of dollars of tax reductions.<sup>1</sup> Treasury was concerned that abusive shelters could ultimately undermine voluntary compliance by eroding the integrity of the tax system. In response to information pointing to the rapid growth of abusive shelters, IRS formalized a strategic initiative in fiscal year 2000 to strengthen its capacity to deal with abusive corporate shelters. One element of IRS's initiative involved creating a central office within the Large and Mid-Size Business (LMSB) Division to coordinate and guide efforts to curb the growth of abusive shelters.

My statement today is based on work we have done at the request of the Chairman and the Ranking Minority Member. In examining abusive shelters, we focused on (1) their nature and scope, (2) IRS's strategy and enforcement mechanisms to combat them and the performance goals and measures IRS uses to track its major effort in that area, and (3) the decision-making process IRS used to allocate resources to abusive shelters and the plans it has to devote more resources to addressing abusive shelters. We were also asked to provide information on IRS's Schedule K-1 document matching program, which we are including in appendix I.

To do our work, we

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<sup>1</sup>Department of the Treasury, *The Problem of Corporate Tax Shelters* (Washington, D.C.: July 1999).

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- analyzed IRS's and other shelter reports, publications, data, and other documentation providing insight into the characteristics, complexity, size, and type of the problem;<sup>2</sup>
  - reviewed IRS's planning documents with information on its strategies, measures, and resources;
  - compared the contents of IRS's planning documents to Government Performance and Results Act of 1993 (GPRA)<sup>3</sup> criteria for what elements strategic planning should include; and
  - interviewed agency officials about their views on, among other things, the problem's nature and scope and IRS's strategy.

We did our work from September 2002 through August 2003 in accordance with generally accepted government auditing standards. As agreed, we are also discussing the related problem of abusive tax schemes in a report to be released in the near future. Abusive tax schemes are used more by individuals than by large businesses and encompass such distortions of the tax system as falsely describing the law (saying, for example, that the income tax is unconstitutional), misrepresenting facts (for instance, promoting the deduction of personal expenses as business expenses), and using trusts or offshore bank accounts to hide income. The boundary between what we are calling an abusive tax shelter and an abusive scheme is not always clear. Organizationally, although IRS's LMSB Division has lead responsibility for combating abusive shelters, abusive shelters are pursued by IRS's Small Business/Self-Employed Division when they are used by businesses with assets of less than \$10 million or by high-wealth individuals with complicated tax returns.

My statement today will make the following points:

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<sup>2</sup>As part of this work, we tested the tax shelter database maintained by the Office of Tax Shelter Analysis (OTSA) by reviewing related documentation, interviewing knowledgeable agency officials, and doing electronic testing, finding that the required data elements were sufficiently reliable for the purposes of our work. This finding does not mean, however, that the database contains all the information that would be needed to estimate the full size of the abusive shelter problem.

<sup>3</sup>Pub. L. No. 103-62.

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- By their nature, abusive shelters are varied, complex, and difficult to detect and measure. Abusive shelters manipulate many parts of the tax code or regulations and may involve steps to hide the transaction within a tax return. In recent years, IRS has been accumulating information about abusive shelters and the extent that they were promoted, and it has come to believe that abusive shelters deserve substantially increased attention. Suffice it to say, although they do not have a reliable measure of the size of the abusive shelter problem, Treasury and IRS believe that tens of billions of dollars of taxes are being improperly avoided and the potential for the proliferation of abusive shelters is strong. IRS continues to gather more information to better define the scope of the problem and has several data sources, each with certain limitations, that point to billions in tax losses. As of September 30, 2003, a database on shelter transactions that IRS has publicly declared to be tax avoidance transactions suggested the potential tax loss to be about \$33 billion, the majority of which was concentrated from tax year 1993 through the present. This database included only transactions disclosed to or discovered by IRS. In addition, an IRS contractor estimating annual tax gaps resulting from abusive shelters estimated that the annual average of foregone taxes between 1993 and 1999 could have been as small as about \$11.6 billion or as large as about \$15.1 billion. However, Treasury, IRS, the contractor, and we all have concerns about the reliability of the contractor's estimates because of methodological and data constraints that the contractor faced.
  - The broad-based strategy reflected in IRS planning documents included various features as well as elements of strategic planning:
    - targeting promoters to head off the proliferation of shelters;
    - making efforts to deter, detect, and resolve abuse;
    - coordinating efforts throughout IRS;
    - offering inducements to individuals and businesses to disclose their use of questionable tax practices; and
    - using performance indicators to measure outputs and some outcomes and intending to continue down the path it has started and develop long-term performance goals and measures linked to those goals. Without these latter elements, Congress would find gauging IRS's progress difficult.

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- In developing this strategy, IRS has had to make decisions about staffing allocations and what can be accomplished on the basis of admittedly limited information. After using a systematic process to determine staffing priorities, IRS planned a significant shift in resources to address abusive shelters in fiscal years 2003 and 2004. However, it faces challenges, especially in the near term, in addressing abusive shelters due to a growing workload and limited information on how long it takes to examine shelter cases. IRS's understanding of how many staff will be needed to address the problem over what period will continue to evolve as IRS gains a better understanding of the problem's scope.

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## Background

Although IRS has no single, authoritative definition of abusive shelters, IRS generally characterizes abusive shelters as very complicated transactions that sophisticated tax professionals promote to corporations and wealthy individuals, exploiting tax loopholes and reaping large and unintended tax benefits. As the Joint Committee on Taxation has said, "taxpayers and tax administrators have struggled in determining the line between legitimate 'tax planning' and unacceptable 'tax shelters.'" Even though, it continued, "there is no uniform standard as to what constitutes a tax shelter ... there are statutory provisions, judicial doctrines, and administrative guidance that attempt to limit or identify transactions in which a significant purpose is the avoidance or evasion of income tax."<sup>4</sup>

Abusive shelters have been promoted by some accounting firms, law firms, and investment banks. Investors in these abusive shelters range from large and small corporations to wealthy individuals. IRS approaches the tax shelter enforcement problem from both the promoter and investor perspectives. IRS promoter investigations are designed to learn (1) what abusive shelters have been promoted, if the shelters are registered,<sup>5</sup> and possibly how much they cost investors, (2) who purchased the shelters and what tax savings the investors expect, and (3) whether promoters should pay penalties for their activities. IRS examines investor and other tax

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<sup>4</sup>Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters*, JCX-19-02 (Washington, D.C.: Mar. 19, 2002).

<sup>5</sup>A promoter or other tax shelter organizer must register a tax shelter with the Secretary of the Treasury by describing it and its tax benefits. The Secretary assigns the shelter an identification number.

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returns to see if income, expenses, taxes, and credits are accurately reported.

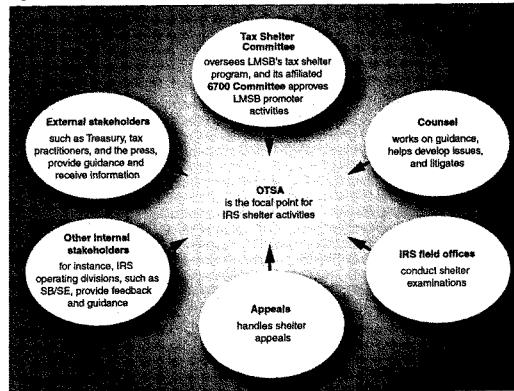
In a June 2002 letter, Treasury responded to congressional questions about whether Treasury had a comprehensive strategy for combating tax avoidance. In his letter to the then Ranking Member of the Committee on Finance, then Secretary of the Treasury O'Neill addressed the actions being taken to combat abusive shelters, referring to Treasury's March 20, 2002, enforcement proposals on the topic. The proposals said that IRS had made significant organizational improvements to coordinate its response to ongoing abusive tax shelters. Treasury, all of IRS's operating divisions, and IRS's Office of Chief Counsel are involved in combating abusive shelter activity.

Within IRS, LMSB has primary responsibility for combating abusive tax shelter activity. LMSB's OTSA was created in February 2000 to centralize and coordinate the IRS response nationwide. As shown in figure 1, OTSA is the focal point for IRS shelter activities, overseeing promoter tax shelter registrations; taxpayer disclosures of tax shelters; hotline tip analysis and referral; and issue coordination and interface between the Office of Chief Counsel, Treasury, the Tax Shelter Committee, the 6700 Committee (referring to section 6700 of the Internal Revenue Code), and external stakeholders.<sup>6</sup> The Tax Shelter Committee oversees LMSB's tax shelter program. The committee is composed of the Commissioner and Deputy Commissioner of LMSB, the Director of Pre-Filing and Technical Guidance, LMSB Division Counsel, five Industry Directors, the Director of International, and the Directors of Field Specialists and Research and Program Planning. The 6700 Committee serves under the Tax Shelter Committee and approves all LMSB tax shelter promoter activities. The financial services' industry director chairs this committee. IRS's appeals function receives and evaluates taxpayer objections to IRS examination determinations and may agree with those determinations or reduce or eliminate changes to tax returns resulting from them. The Office of Chief Counsel plays an integral role in combating shelters through summons enforcement and targeted litigation. By litigating, IRS establishes case law supporting IRS enforcement programs and aims to diminish the incentives taxpayers find for investing in tax avoidance transactions by increasing the risks and costs of IRS discovery.

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<sup>6</sup>Section 6700 covers penalties for promoters of abusive shelters.

Figure 1: OTSA's Role in Coordinating IRS Work on Abusive Shelters



Source: Compiled by GAO from IRS information.

### Nature of Abusive Shelters Is Varied and Complex

Abusive shelters are complex transactions that manipulate many parts of the tax code or regulations and are typically buried among "legitimate" transactions reported on tax returns. Because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters are promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. They may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult.

When a transaction has certain abusive characteristics defined by section 6111 of the Internal Revenue Code, the promoter or other tax shelter



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organizer is required to register it, describing the transaction and its tax benefits to the Secretary of the Treasury. This registration requirement enables Treasury and IRS to identify and evaluate questionable transactions. Under recently issued Treasury regulations,<sup>7</sup> effective February 28, 2003, there are six categories of transactions for which promoters must maintain lists of investors who have entered into the transactions, and investors must disclose the transactions into which they have entered. The rules are designed to allow IRS to use information from investors to identify promoters who do not register transactions and to use promoter registrations and investor lists to identify investors who fail to disclose transactions. The six categories are

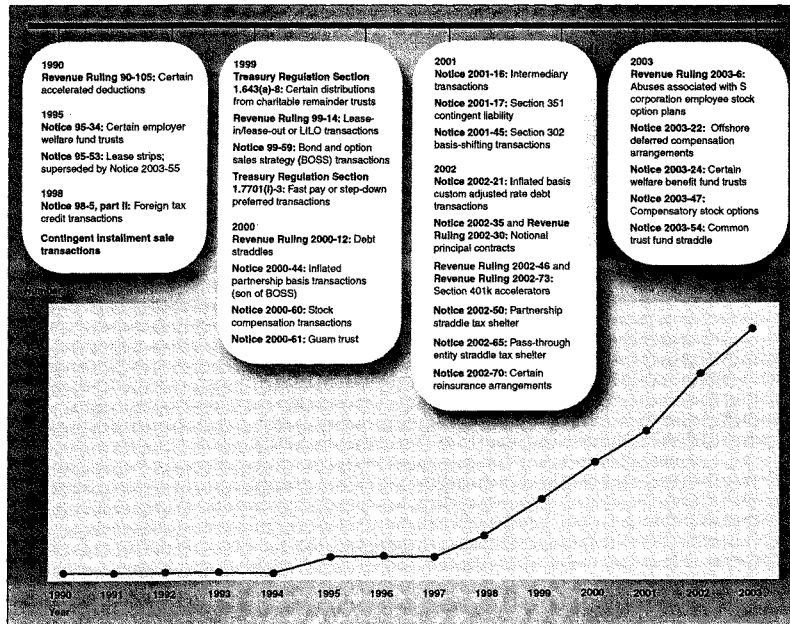
- transactions offered under conditions of confidentiality,
- transactions including contractual protections to the investor,
- transactions resulting in specific amounts of tax losses,
- transactions generating a tax benefit when the underlying asset is held only briefly,
- transactions generating differences between financial accounts and tax accounts greater than \$10 million, and
- "listed transactions."

A "listed transaction" is a transaction that is the same as or similar to one of the types of transactions IRS has determined to be a tax avoidance transaction. For a transaction to be a listed transaction, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. As of mid-August 2003, IRS had listed 27 kinds of abusive tax shelter transactions, a number that, as figure 2 shows, has grown more quickly in recent years than it had grown earlier.

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<sup>7</sup>Treas. Reg. Sec. 301.6112-1 and Treas. Reg. Sec. 1.6011-4.

Figure 2: Cumulative Number of Listed Transactions over Time, 1990–mid-August 2003, and Transaction Descriptions



Source: Compiled by GAO from IRS information.

Disputes between IRS and taxpayers about the abusive nature of a transaction may be litigated. In some, but not all, cases, the courts have upheld the government position. The following cases illustrate features of abusive shelters:

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- In 1993, a corporation began a company-owned life insurance (COLI) program in which the company purchased whole-life insurance on 36,000 employees for which the company was the sole beneficiary. The company then borrowed money against the policies at interest rates that averaged 11 percent and deducted the interest expense and administrative fees from income on its tax returns. Over 60 years, the interest costs and administrative fees would have exceeded the cash surrender value of the policies and benefits paid by several billion dollars. IRS disallowed the deductions and the case was litigated. Despite the fact that the money the company made on this arrangement may have been used to fund the company's benefits program, or for other business purposes, the court found that the function of the program itself was only to generate tax deductions. As a result, the Tax Court sustained the IRS disallowance of deductions and concluded that the COLI program was a sham.<sup>8</sup> The Eleventh Circuit Court of Appeals affirmed the Tax Court's decision.
  - A company had a sizable gain from the sale of a subsidiary and wanted to avoid or minimize paying tax on the gain. An investment bank proposed forming an offshore partnership with a foreign corporation (a tax-indifferent party) for the express purpose of sheltering the capital gains of its corporate client. The partnership purchased and quickly resold notes in a contingent installment sale transaction. The partnership earned a large capital gain, most of which it allocated to the foreign corporate partner. Later, related losses were allocated to the U.S. corporation, generating an approximate \$100 million capital loss for the investment bank's client. The corporation used this capital loss to shelter its U.S.-based capital gains. Both the Tax Court and the Third Circuit Court of Appeals ruled that the transaction lacked economic substance.<sup>9</sup> The Third Circuit, in addition to requiring economic substance, held that a transaction must have a subjective nontax business motive to be respected for tax purposes.<sup>10</sup> For this transaction, the investment bank was to earn a fee of \$2 million. This was one of 11

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<sup>8</sup>*Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313 (11<sup>th</sup> Cir. 2001).

<sup>9</sup>*ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g*, 73 T.C.M. 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

<sup>10</sup>*Id.* at 248.

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such partnerships formed over a 1-year period from 1989 to 1990 by the investment bank.

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**Several Sources Indicate That the Scope of Abusive Shelters Is in the Tens of Billions of Dollars, Though All Are Based on Limited Data**

IRS has information that suggests the scope of abusive shelters totaled tens of billions of dollars over about a decade,<sup>11</sup> but those estimates are based on limited data. This information comes from an OTSA database, examinations of large corporations, and a contractor study. Information contained in the OTSA database includes transactions disclosed to or discovered by IRS and estimates of potential tax losses. The tax loss estimates vary from being IRS officials' recommended taxes based on examining some transactions to taxpayer judgments regarding potential losses in cases where examinations have not been done. In addition to being based on judgments, the database does not include any reductions resulting from examination, appeal, litigation, or other sources. Information from examinations of the largest corporations, which may overlap information in the OTSA database, shows proposed income adjustments in the tens of billions of dollars before reductions, but data were not available from IRS on the results of examinations of smaller corporations, partnerships, trusts, S corporations, or individuals. Information from IRS's contractor study estimates an annual tax gap due to abusive shelters but has data and methodological limitations.

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**OTSA Database**

As shown in table 1, as of September 30, 2003, an OTSA database included estimated potential tax losses of about \$33 billion from investments in listed transactions, before considering any reductions resulting from examination, appeal, litigation, or other sources and another \$52 billion in potential tax losses from nonlisted transactions with some characteristics of abusive shelters. This database contains information on promoters and investors and the amount of potential tax savings resulting from listed and nonlisted transactions. Nonlisted transactions are transactions that needed to be registered because they have some characteristics of abusive shelters but were not, at least yet, determined to be abusive. According to an IRS official, IRS was studying nonlisted transactions with about \$12 billion in potential tax losses for possible listing. The database only

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<sup>11</sup>For the decade from 1993 through 2002, corporations paid almost \$2 trillion in income taxes.

includes information on abusive or possibly abusive transactions that had been disclosed to or discovered by IRS.

**Table 1: IRS's Compilation of Tax Shelter Amounts as of January 14, 2003, and September 30, 2003**

Category of transaction	Number of transactions as of		Potential tax loss (billions) <sup>a</sup> as of	
	January 14, 2003	September 30, 2003	January 14, 2003 <sup>b</sup>	September 30, 2003
Listed	3,423	5,185	\$29.3	\$33.0
Nonlisted	1,334	1,582	44.7	52.0
<b>Total</b>	<b>4,757</b>	<b>6,767</b>	<b>\$73.9</b>	<b>\$85.0</b>

Source: IRS OTSA database.

<sup>a</sup>The potential tax loss covers a multiyear period and does not consider reductions that may result from examination, appeal, litigation, or other sources.

<sup>b</sup>The numbers do not add to the total due to rounding.

The estimated tax losses contained in the OTSA database cover a wide range of years from at least as far back as tax year 1989 and extending even to future tax years since, for instance, improperly claimed deductions may be used in some cases to reduce future taxes. For the \$29 billion in estimated tax losses associated with listed transactions contained in the January 14, 2003, database, about 82 percent of the potential tax losses were concentrated in the period from 1993 through 2002.

According to data IRS provided in mid-October 2003, OTSA had information on almost 300 firms that had possibly promoted abusive shelters as well as other tax planning products that contain at least some features of abusive transactions. It was also aware of about 6,400 investors, including individuals and corporations that bought abusive shelters and other aggressive tax planning products.

#### Examinations of Large Corporations

IRS has proposed shelter-related adjustments to large corporations' income in examinations it has closed and in examinations still open as of early May 2003. In cases closed between October 1, 2001, and May 6, 2003, IRS proposed about \$10.6 billion in abusive shelter-related adjustments to the income of 42 large corporations for tax years 1992-2000. These proposed adjustments would result in about \$3.5 billion in tax revenue if the adjustments were not reduced. The corporations were in what is known as the Coordinated Industry Case (CIC) program, which includes the nation's

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largest corporations.<sup>12</sup> They agreed with about \$1.2 billion of the \$10.6 billion in proposed adjustments to income.<sup>13</sup> As of early August 2003, Appeals research showed that few of the issues comprising the \$9.4 billion unagreed amount had been resolved yet by Appeals or through a settlement initiative, although the database did not track all of them.<sup>14</sup> For the 141 large corporations with cases still open in early May 2003, the amount of proposed shelter-related income adjustments was \$47.6 billion, translating to about \$16 billion in tax if not reduced. IRS did not have similar information for smaller corporations. Also, since one of the sources of information in the OTSA database is shelter-related adjustments proposed in examinations, the proposed adjustments in the CIC program may overlap the information in the OTSA database.

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#### Contractor Study

In July 2003, an IRS contractor estimated the tax gap resulting from abusive shelters for different years. For 1993 through 1999, based on the contractor's estimates, the average annual tax gap could have been as small as about \$11.6 billion or as large as about \$15.1 billion of forgone tax. However, the reliability of the contractor's estimates is questionable because of methodological and data constraints the contractor faced when developing them.

The estimates followed a September 2001 recommendation by the Treasury Inspector General for Tax Administration (TIGTA) that LMSB obtain a more precise estimate of the shelter problem to lay a better foundation for its strategy for addressing abusive shelters.<sup>15</sup> In response, IRS contracted for models to predict the likelihood of finding abusive shelters within

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<sup>12</sup>Under the CIC program, IRS continually audits about 1,100 of the nation's largest corporations, all of which have assets of more than \$250 million.

<sup>13</sup>IRS did not track the additional tax payments these corporations actually made related just to the shelter-related adjustment. However, according to data provided by IRS, they paid about an additional \$552 million in taxes related to all issues raised by IRS, including the abusive shelter issues.

<sup>14</sup>In mid-August 2003, IRS gave us information showing that for the 14 abusive shelter transactions Appeals had closed in fiscal year 2003 for CIC and other cases, Appeals sustained about 71 percent of the dollar amounts proposed as adjustments to income. Similar information was not available for earlier years.

<sup>15</sup>TIGTA, *Management Advisory Report: The Strategy for Curbing Abusive Corporate Tax Shelter Growth Shows Promise but Could Be Enhanced by Performance Measures*, Report Number 2001-30-159 (Washington, D.C.: Sept. 13, 2001).

certain tax returns and to estimate the annual "tax gap" due to abusive shelters. Both IRS and contractor officials believe the contract results are more useful to predict returns with abusive shelters than they are to value the size of the abusive shelter problem.

Nevertheless, as table 2 shows, the contractor produced estimates of the size of the problem for each year from 1993 through 1999. Yearly low-end estimates ranged from \$9.0 billion of foregone tax in 1993 to \$14.5 billion in 1999. On the other hand, the high-end estimates ranged from \$12.1 billion in 1993 to \$18.4 billion in 1999.<sup>16</sup> Averaging the estimates over time results in the \$11.6 billion to \$15.1 billion range cited earlier.

**Table 2: Contractor Estimates of the Size of the Abusive Shelter Problem (Dollars in Billions)**

Year	Lower bound	Upper bound
1993	\$ 9.0	\$12.1
1994	9.5	12.7
1995	10.3	13.6
1996	11.4	14.9
1997	12.7	16.4
1998	13.6	17.3
1999	14.5	18.4
1993-1999 average	11.6	15.1

Source: Report provided by IHS.

Note: As computed by the contractor, the lower and upper bounds are the boundaries of 90 percent confidence intervals associated with the estimates.

The tax gap model used three different kinds of data: (1) IRS's Statistics of Income data for the largest U.S. companies, those with assets over \$250 million falling within the CIC program, (2) Standard and Poor's Compustat financial data, and (3) surveys of IRS field offices. IRS conducted surveys from 1999 through 2001 that asked field managers to identify abusive tax shelters in their open inventory of examinations—

<sup>16</sup>Because the contractor found that estimating the problem's size was difficult and problematic, it applied a statistical technique to the estimates and produced other estimates for each year. However, because it did not believe the statistical technique improved the original estimates, we are not including the second set of estimates here.

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relying on each manager's understanding of what an abusive tax shelter is. Since survey data are included in the OTSA database, some of the same information used by the contractor appears in the OTSA information cited earlier.

Treasury, IRS, the contractor, and we have concerns about the contractor estimates. First, it is difficult to determine whether these estimates might be overstating or understating the true extent of the tax gap because of the uncertainties in the underlying data and the elusive nature of the problem. In identifying abusive shelters in the IRS surveys, field managers might have anticipated that some abusive shelters existed where there were none or where the assertion of abuse might not be sustained. On the other hand, they might not have identified all the abusive shelters in their open inventory of examinations because their definitions of abusive shelters might have differed from each other. Finally, the data might not be representative of all transactions, especially those that closed, because survey responses were only to include open cases.

Second, the Statistics of Income data only included U.S. corporations with assets of over \$250 million falling within the CIC program. Many shelters may be reflected in tax returns of smaller corporations, partnerships, Subchapter S corporations, and wealthy individuals and were not included in this study. Since these transactions were not included in the contractor's estimate, the resulting tax gap estimate is incomplete.

Third, the estimates are based on known shelters. They were developed using 1990s' ideas of what constituted abusive shelters. Since then, more shelters have been disclosed or identified by IRS and still others are under consideration for listing. Since the definition of an abusive shelter can change over time, and the data cannot reflect unknown or unidentified shelters, the operational definition of abusive shelters was a conservative one.

While the last two concerns argue that the contractor's estimates understate the true level of abusive shelters for recent years, the contractor's estimates and other indicators of the problem's size based on past data may also be of limited use as guides to current and future activity for other reasons. According to Treasury and IRS officials, the legal and economic environment has changed since the data for this study were developed. First, they said, IRS has taken many administrative actions to address abusive shelters. For instance, it is their belief that nothing puts more of a damper on taxpayer participation in a particular type of



transaction than IRS listing it. Similarly, although corporate-owned life insurance transactions may heavily influence the contractor's estimates, legislation addressed the problem in 1996 and 1997, and therefore current and future estimates would not reflect that problem—although they could reflect problems not identified in the period covered by the contractor's study. Second, court cases have largely supported IRS's assertions about the need for business purpose requirements and about requirements for economic substance in transactions. Third, today's economy is not as robust as the economy in the late 1990s, generating less profit to protect. Finally, the publicity surrounding numerous corporate scandals may create a chilling effect in the market for aggressive transactions. Countering these points, however, are other opinions appearing in the press that (1) the courts could uphold some tax shelters and (2) IRS's capacity to stem abusive shelters is limited.

**IRS Strategy to Combat Abusive Shelters Is Broad-Based but Generally Has No Long-Term Performance Goals or Measures Linked to Goals**

IRS developed a broad-based strategy for combating abusive shelters that included various features as well as elements of strategic planning. Deeming it a strategic initiative, IRS is executing a strategy incorporating four principal elements: (1) an emphasis on promoters, (2) efforts to deter, detect, and resolve abuse, (3) coordination of efforts throughout IRS, and (4) inducements provided for taxpayers to come forward and expedite case resolution. IRS is implementing a variety of initiatives designed to reduce taxpayer incentives to participate in abusive transactions and discourage promoters from marketing these transactions. Although IRS documents outline an overall strategy for combating abusive shelters, IRS has generally not yet defined long-term performance goals for the effort and the measures it would use to track progress in achieving those goals.<sup>17</sup> However, IRS is planning to establish such goals and measures when it has more information on the abusive shelter activities it is currently tracking.

**IRS Is Actively Pursuing Promoters**

IRS is actively pursuing abusive promoters to ensure (1) that tax strategies containing characteristics of potentially abusive shelters are registered, (2) that information about transactions is disclosed to IRS as required by

<sup>17</sup>Although GPRA is generally applied to agencywide strategic plans, its framework is useful to guide any type of planning. GPRA requires long-term strategic and annual performance goals and associated measures, preferring measures relating to outcomes (results) versus outputs (activities). The Office of Management and Budget says that strategic plans set out long-term goals, outlining planned accomplishments and their implementation schedule.

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sections 6111 and 6112 of the Internal Revenue Code, and (3) that, according to IRS's OTSA manager, those who generate noncompliance change their behavior or go out of business. With 98 abusive shelter promoters approved for investigation as of June 30, 2003, IRS uses investigations to gain access to lists of the clients who buy promoters' products and devise a roadmap to audit shelters included in the tax returns of the investors. IRS is also using promoter investigations to enforce the transaction registration requirements, which, in turn, assist in its efforts to understand, track, and close abusive shelters. IRS announced the completion of three large promoter investigations in 2001 through July 2003. They resulted in, among other things, three substantial payments and promoter promises to work with IRS to ensure ongoing compliance with shelter registration and list maintenance requirements.

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**IRS Efforts Are to Deter, Detect, and Resolve**

IRS focuses its efforts on deterring future marketing and sales of abusive tax shelters and on detecting and resolving existing shelters. TIGTA described IRS's abusive shelter approach along the lines of deter, detect, and resolve in September 2001.<sup>18</sup> IRS considers its efforts to provide guidance as early as possible to taxpayers and promoters in the form of recently proliferating IRS and Treasury determinations, notices, and rulings on abusive transactions and of registration, list maintenance, disclosure, and other requirements to be a key deterrent. (See fig. 2.) Also designed to deter abusive tax shelters, accuracy-related penalties aim at investors who use abusive shelters to substantially undervalue true tax liability. Other penalties are for promoters who market shelters that aid and abet the understatement of tax liability or who fail to register shelters. IRS's Examination Returns Control System showed IRS assessing 21 investor penalties totaling about \$73 million between July 1, 2002, and May 1, 2003, which taxpayers had not necessarily agreed to pay. During our review, Treasury included proposed legislation in the Administration's revenue proposals to strengthen the penalties that could be used in abusive shelter situations.

IRS's ability to detect abusive shelters increased in the last 3 years due to OTSA's hotline, through which callers provide tips about transactions or investors; disclosure, registration, and list maintenance requirements; increased attention by IRS management; and increased use of IRS

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<sup>18</sup>TIGTA, Report Number 2001-30-159.

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examination resources to look for shelter irregularities. For instance, between May 31, 2000, and July 30, 2003, the hotline received 729 shelter-related telephone calls and e-mails, some of them leading IRS to new listed transactions, promoters, and investors. As another example, IRS expanded its disclosure requirements in June 2002 to include noncorporate taxpayers. Finally, as evidence of increased management attention, IRS established a new senior position reporting to the IRS Chief Counsel to supervise staff and lead task force initiatives to more quickly identify and deal with abusive shelters.

Cases may be resolved at the examination level if taxpayers agree with IRS findings. If taxpayers do not agree, cases are resolved at the appeals level, through litigation, or by alternative dispute resolution.

In addition to these detection and case resolution efforts, IRS is using Schedule K-1 data to research better methods of detecting abusive shelters that involve multiple levels of flow-through entities.<sup>19</sup> These complex structures of related entities pose challenges in analyzing tax compliance by creating opportunities for taxpayers to disguise noncompliance. In the future, IRS hopes to use advanced data analysis tools such as link analysis and graph-based data mining to identify potential abusive shelters. Link analysis is the process of building networks of related entities, such as flow-through entities and Schedule K-1 recipients, in order to expose patterns and trends. Graph-based data mining, a form of link analysis, is intended to enable IRS to identify structures of known abusive shelters and find similar patterns in the population of flow-through networks to discover previously undisclosed potential abusive shelter transactions. IRS has paid a contractor \$200,000 so far to assess the feasibility of these technologies and plans to spend \$575,000 over the next 1.5 to 2 years to develop these concepts into models.

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#### IRS Emphasizes Internal Coordination

Coordination within IRS and interface with Treasury on abusive shelters is a core objective in IRS's plans for addressing those shelters. OTSA is the focal point for all shelter-related activity performed in the Tax Shelter Committee, the 6700 Committee, Counsel, Appeals, and LMSB. For example, if a taxpayer discloses an investment in a tax shelter to IRS, OTSA is to enter the transaction into its database, and OTSA reviews the

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<sup>19</sup>Appendix I describes the Schedule K-1, flow-through entities, and other compliance efforts using Schedule K-1 data.

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transaction in collaboration with IRS technical advisors and counsel. OTSA may also forward it to LMSB examiners for compliance action.

At the IRS-wide level, an executive steering committee provides a forum for coordinating work on both abusive shelters and abusive schemes. It meets monthly and includes participants from LMSB, the Small Business/Self Employed Division, Appeals, Counsel, and other organizations. It operates under the auspices of IRS's Enforcement Committee, which was chartered in July 2003. Chaired by the Deputy Commissioner for Services and Enforcement, a new position created in May 2003, the Enforcement Committee is to guide IRS-wide enforcement strategies, focusing on high-visibility issues involving many divisions or potentially having significant compliance impact.

Although we did not systematically measure whether coordination is facilitated by these mechanisms, we did review minutes of selected executive steering committee meetings. In doing so, we saw such evidence of coordination as the discussion of an LMSB and SB/SE working group on who would work a corporate officer case when LMSB works on a corporation.

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**IRS Offers Inducements for Taxpayers to Disclose Shelters and Expedite Case Resolution**

LMSB attempts to leverage its limited resources by using inducements to achieve compliance. These tools include penalty relief, "fast track" issue resolution, and various structured settlement programs that allow participating taxpayers to keep a percentage of a shelter's benefits in exchange for conceding most benefits and expediting case resolution. For example, under a disclosure initiative that expired on April 23, 2002, taxpayers who revealed shelters and their respective promoters avoided accuracy-related penalties. IRS's aim was to more readily identify promoters who had not registered shelters and, through the promoters, find taxpayers who had not disclosed their shelter participation. As a result of this initiative, IRS received 1,664 disclosures from 1,206 taxpayers, disclosing tens of billions of dollars of losses and deductions.

IRS offered taxpayers various alternative dispute resolution mechanisms as inducements to settle abusive shelter issues with IRS, mitigating the hazards of litigation for both sides and moving more cases through the administrative system quickly. For example, from October 2001 through April 7, 2003, 17 taxpayers agreed with IRS on their respective shelter issues in the Fast Track Issue Resolution program, resolving about \$1.6 billion in proposed adjustments to income (potentially about

\$540 million in tax). In another example, IRS announced initiatives in October 2002 to resolve disputes related to three shelters: COLI, basis-shifting shelters, and contingent liability shelters.<sup>20</sup> In these initiatives, if taxpayers agreed to settle their cases with IRS by a certain date, with the last initiative closing March 5, 2003, they would pay a large percentage of the full amount IRS disallowed. A summary as of early May 2003 of the number of investors involved in the three settlement initiatives and the potential tax dollars conceded or to be conceded appears in table 3.<sup>21</sup>

**Table 3: Investors Accepting Abusive Shelter Settlement Initiative Offers and Potential Tax Dollars Conceded or to Be Conceded as of Early May 2003**

Settlement Initiative	Number of taxpayers accepting IRS settlement offer	Number of taxpayers for whom IRS had information on taxes conceded or to be conceded	Potential tax dollars conceded or to be conceded (billions)
COLI	24	14	\$0.2
Basis shifting	267	33	0.6
Contingent liability	62	62	2.8 <sup>a</sup>
<b>Total</b>	<b>353<sup>b</sup></b>	<b>109<sup>b</sup></b>	<b>\$3.6</b>

Source: Compiled by GAO from IRS data.

<sup>a</sup>GAO estimated this number using an average of certain capital loss percentages to be conceded.

<sup>b</sup>We do not know if a particular taxpayer was involved in more than one type of settlement initiative.

### Generally IRS Does Not Have Long-Term Performance Goals or Measures Linked to Goals

Although IRS has outlined and begun to implement a multipart strategy for combating tax shelters, it has not yet generally defined performance goals for the effort and established the measures it would use to track progress in achieving those goals. Performance goals define what an organization is

<sup>20</sup>IRS Notice 2001-51 identifies certain listed transactions. It describes basis-shifting transactions as "certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer." It describes contingent liability transactions as "transactions involving a loss on the sale of stock acquired in a purported [Internal Revenue Code section] 351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes."

<sup>21</sup>Some of these investors are also included in the fast track program just described.

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trying to achieve over time, preferably focusing on the outcome desired rather than activities or outputs. To date, according to IRS officials, their shelter-related goals cover the number of staff years to be devoted to shelter examinations and the number of shelter examinations to be closed. Also, LMSB planning documents have a few short-term goals. For example, LMSB had a short-term goal to begin compliance actions on all voluntary shelter disclosures by June 30, 2003, a goal IRS officials told us was met. IRS management officials recognize that developing other performance goals and associated measures to track progress is desirable but point to challenges they face in assessing the scope of the abusive shelter problem. Nonetheless, IRS intends to establish such goals in the future when it has more information on activities it is currently tracking.

IRS has already started down this road by developing several measures that, while not tied to longer-term performance goals, are to be used in tracking its progress in combating abusive tax shelters. It devised these measures for fiscal year 2003 responding to a September 2001 TIGTA recommendation to develop performance measures so managers could better target problem areas, highlight successes, evaluate alternatives, and track whether OTSA is achieving desired outcomes. IRS is mostly tracking outputs related to case management, such as the number of tax shelter examinations closed and tax shelter return cycle time, and is using output measures of IRS program activities, such as published guidance issued and hotline contacts. IRS is also using some measures that track tax enforcement outcomes, namely adjustments proposed to tax returns from disallowing abusive shelters and tax shelter penalties proposed.<sup>22</sup> Since fiscal year 2003 was the first year IRS used these measures, it had no baseline data with which to evaluate its performance measures. However, LMSB plans to evaluate its measures over time to assess their usefulness.

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<sup>22</sup>LMSB called the tracking of adjustments a "record of tax enforcement results." IRS does not use performance measures for outcome measures like these because the IRS Restructuring and Reform Act of 1998 prohibited it from using tax enforcement results to evaluate any employee or to impose or suggest production quotas or goals.

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**Resource Shifts Are Significant but IRS Faces Challenges in Addressing Abusive Shelter Workload**

Using admittedly limited information, IRS used a systematic decision-making process in deciding to shift a large portion of LMSB examination staff resources toward addressing abusive shelters. From fiscal year 2002 through fiscal year 2004, LMSB expected to increase the portion of its examination resources devoted to combating abusive shelters from 3 percent in 2002 to 20 percent in 2004. In doing so, it will have shifted resources out of examining the category of cases including such areas as net operating losses and claims for refunds. Even so, IRS faces challenges, especially in the near term, in addressing expected increases in its shelter workload because of the growing number of shelter cases and limited information it has on how long it takes to conduct shelter examinations. As will be described, GAO has previously raised questions about IRS's ability to shift compliance resources as planned.

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**IRS Used Systematic Planning and Budgeting Process to Determine Staffing Priorities**

At an agencywide level, IRS decided staffing resource levels to be devoted to addressing abusive shelters through a systematic planning and budgeting process based on experience and professional judgment because IRS did not and does not have a reliable measure of the abusive shelter problem. Early in calendar year 2002, IRS's divisions completed strategic assessments in which they studied trends, issues, and priorities affecting their operations. In April 2002, IRS's senior management team, including the Commissioner, Deputy Commissioner, division heads, and others used two rounds of considering IRS's programs to rank the needs for new or redirected funding for fiscal year 2004. Of 33 programs considered, the program including tax shelters received the third most votes. According to an IRS official, this process also informed how funds already requested for fiscal year 2003 would actually be spent. After the senior management team reached consensus, the Commissioner issued overall planning guidance for fiscal years 2003 and 2004 to reflect the jointly set strategic direction, and the divisions wrote fiscal year 2003 and 2004 "strategy and program plans" outlining staffing resources needed.

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**IRS Shifts Significant Levels of Examination Resources to Shelters**

In 2002, LMSB put forward plans to increase its work on abusive shelters from 3 percent of its examination resources to 20 percent between fiscal years 2002 and 2004, assuming congressional funding. To support this shift in examination resources, LMSB needed to allocate examination resources away from other areas. One area to receive less audit coverage was

industry audits.<sup>23</sup> As shown in table 4, from fiscal year 2003 to fiscal year 2004, IRS planned to move resources away from specific types of mandatory examinations and from some high-risk nonmandatory returns.<sup>24</sup> IRS's strategy is to mitigate the impact of resource reallocations away from nonshelter areas by using such issue management strategies as fast-track resolution and prefiling agreements, thereby requiring less staff time to close cases and freeing staff to be used in other areas.

**Table 4: Percentage of LMSB Examination Resources in Different Examination Areas**

Examination area	FY 2002 <sup>a</sup>	FY 2003	FY 2004
Shelters	3%	15%	20%
Other mandatory examinations (including coordinated industry, <sup>b</sup> claims for refunds, net operating losses, compliance initiative projects, and flow-through entities related to wealthy individuals)	N/A	55%	54% <sup>c</sup>
Related returns	N/A	5%	4% <sup>c</sup>
High-risk, nonmandatory returns	N/A	15%	13%
Nonreturn examination activities	N/A	10%	10%
<b>Total</b>		<b>100%</b>	<b>100%</b> <sup>d</sup>

Source: LMSB September 20, 2002, presentation to the IRS Oversight Board, as amended after the presentation.

<sup>a</sup>Information for most of the rows in this column was not available, as the presentation to the Oversight Board did not include it.

<sup>b</sup>Coordinated industry cases are examinations of the nation's largest corporations, those under continual IRS audit.

<sup>c</sup>At the time of the September 20, 2002, presentation to the Oversight Board, the 54 and 4 percent were 52 and 5 percent, respectively.

<sup>d</sup>The column does not add to 100 percent because of rounding.

<sup>23</sup>IRS defines an "industry" case return as the return of an organization with assets of more than \$10 million but without being part of the largest corporations that are under continual IRS audit.

<sup>24</sup>According to LMSB officials, mandatory examinations are those LMSB knows it will do, such as those for abusive shelters and promoters. Nonmandatory examinations are what remain after mandatory work is accommodated. High-risk nonmandatory examinations are those in the nonmandatory category that have the highest probability that a taxpayer needs compliance activity.



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In addition to LMSB examination staff, IRS has managers, attorneys, and others who work on abusive shelters. For instance, in February 2003, OTSA and its parent body, the Office of Pre-Filing and Technical Guidance, had 39 full-time and 34 part-time technical experts, program analysts, and managers. Also at that time, a contact list for listed transactions included 17 attorneys. These numbers did not include many of the IRS legal resources involved with abusive shelters. In addition, as of September 30, 2003, LMSB had assigned about 1,900 abusive and potentially abusive shelter transactions involving non-LMSB taxpayers to IRS's Small Business/Self-Employed Division, which supplies examination staff resources of its own.

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#### IRS Faces Challenges in Addressing Increasing Shelter Workload

Although IRS appeared to be on track to shift planned resources to shelter work in fiscal year 2003, it faces challenges in addressing the abusive shelter workload, especially in the near term. This is because of (1) the growing numbers of transactions and promoters to be examined and (2) limited information on how long it takes to conduct shelter examinations.

From fiscal year 2002 through fiscal year 2004, LMSB planned to use 1,879 full-time equivalents (FTE) to address abusive shelters. During fiscal year 2002, LMSB used 239 FTEs to address tax returns that included abusive shelters.<sup>25</sup> According to IRS's fiscal year 2004 congressional budget justification, LMSB planned to allocate 691 and 949 FTEs in fiscal years 2003 and 2004, respectively. In a draft strategy and program plan dated September 2003, LMSB projected it would actually use 615 FTEs for shelter work in fiscal year 2003, or 88 percent of the planned amount and an increase of 157 percent over the fiscal year 2002 FTE level including this work.

Because (1) the known abusive shelter workload has increased, (2) IRS has limited experience to judge how many resources will be needed to work the cases for how long a period, and (3) the workload may continue to increase, it remains uncertain whether the substantial shift of resources to shelter work will enable IRS to examine in a timely manner the growing workload associated with shelters. For instance, the number of potential

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<sup>25</sup>According to LMSB officials, the fiscal year 2002 FTEs include time spent on the entire returns containing shelters, not on the shelter issues alone. The estimates for fiscal years 2003 and 2004 are focused more on the shelter issues.

examinations of listed transactions disclosed has grown since the inception of OTSA, adding significantly to IRS resources required to address the problem. Table 5 shows the number of listed transactions disclosed by taxpayers grew from 51 to 2,182 between December 31, 2000, and September 30, 2003, and other transactions disclosed to IRS grew from none to 663. The total of all listed and nonlisted LMSB-related transactions in the OTSA database, not only those disclosed by taxpayers, as of September 30, 2003, was 4,897.

**Table 5: Taxpayer Disclosures of Listed and Other Reportable Transactions between 2000 and September 30, 2003**

Section 6011 disclosures	Calendar year (CY) 2000	CY 2001	CY 2002	CY 2003 through September 30	Total
Listed transactions disclosed	51	63	1,251	817	2,182
Other reportable transactions disclosed	0	214	308	141	663

Source: IRS.

IRS workload from promoter investigations has also grown since May 2002. At that time, IRS planned that 7 promoter investigations would be ongoing in fiscal year 2003. As of June 30, 2003, IRS had 98 promoter investigations approved. Based on early promoter investigations, an IRS official stated that promoter investigations can take thousands of hours to develop, and several have been litigated, each requiring a large expenditure of resources.

LMSB has limited information on the amount of time required to examine abusive shelter cases. LMSB developed estimates of the amount of examination time required for such cases based on its experience examining various types of shelters but acknowledged that examiners can spend hundreds or thousands of hours depending on the type of shelter examined and the facts and circumstances of the case. For example, according to an LMSB official, based on personal experience, OTSA estimated that it would take about 800 hours to examine a potentially abusive transaction reflected in the return of a CIC corporation although LMSB had little data to support the estimate. During fiscal year 2003, IRS began collecting data on examination time that it plans to use for estimating the resources needed to address its abusive shelter workload.

The future abusive shelter workload also could increase, at least in the short term. For example, as IRS learns more about the use of shelters, it may identify and list new kinds of transactions as being abusive. As IRS

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conducts the 98 promoter investigations approved as of June 2003, more investors are likely to be identified, and investor cases could lead to identifying more promoters. In addition, IRS expanded the types of taxpayers subject to disclosure requirements to include taxpayers like individuals, partnerships, and S corporations. According to IRS officials, disclosures from these types of taxpayers are first due to IRS for filing year 2003 and generally do not yet appear in the OTSA database.

In the longer term, what happens to the abusive shelter workload is less certain. To the extent that IRS actions and other factors reduce the size of the abusive shelter problem, IRS might not need to continue devoting as large a percentage of its examination resources to abusive shelters. How much and how soon such a drop may occur in abusive shelter cases is uncertain.

We have previously raised questions about IRS's ability to shift compliance resources as planned. We recently testified that many parties have expressed concern about declining IRS compliance—especially audit—and collection trends for their potential to undermine taxpayers' motivation to fulfill their tax obligations.<sup>28</sup> Concerned about these trends, IRS has sought more resources, including increased staffing for compliance and collections since fiscal year 2001. Despite receiving requested budget increases, staffing levels in key occupations were lower in 2002 than in 2000. These declines occurred for reasons such as unbudgeted expenses consuming budget increases and other operational workload increases. Based on past experience and uncertainty regarding some expected internal savings, fiscal year 2004 anticipated staff increases might not fully materialize. Thus, if IRS carries through with its intentions to increase resources devoted to abusive shelters, it may not have the desired level of resources in other areas of compliance.

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## Concluding Observations

Abusive tax shelters represent a potentially significant, although imprecisely understood, loss in tax revenues. IRS developed and is following a broad-based, multifaceted strategy to combat abusive shelters even though it had limited data on the full scope of the problem. IRS's strategy generally does not contain long-term performance goals and

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<sup>28</sup>U.S. General Accounting Office, *Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives*, GAO-03-732T (Washington, D.C.: May 7, 2003).

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associated measures that can help Congress evaluate IRS's progress. Although establishing performance goals and measures is inherently difficult since the scope and nature of abusive shelters is elusive, the need for such goals and measures is heightened because IRS is shifting large amounts of examination staff resources to support combating abusive shelters. IRS's initial decisions on shifting resources might need to be reevaluated as IRS develops better information on the size of the abusive shelter problem and the amount of time it takes to examine abusive shelter cases. We encourage IRS to continue its efforts to obtain a better analytic basis for determining the resources needed to address schemes and shelters—while providing sufficient attention to other tax compliance areas—and to develop goals and measures that it and Congress can use to gauge IRS's progress.

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Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

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### Contact and Acknowledgements

For further information on this testimony, please contact Michael Brostek at (202) 512-9110 or [brostekm@gao.gov](mailto:brostekm@gao.gov). Individuals making key contributions to this testimony include Ralph Block, Elizabeth Fan, Amy Friedheim, Lawrence Korb, Signora May, and James Ungvarsky.

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## IRS Compliance and Research Programs Using the Schedule K-1

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Schedule K-1s are information returns that link flow-through entities with their income recipients and therefore can be used for various compliance and research purposes, such as the automated underreporter (AUR) program<sup>1</sup> and profiling potential nonfilers.

Partnerships, S corporations, trusts, and estates are collectively known as flow-through entities because they can legally pass net income or loss through to their partners, shareholders, and beneficiaries. Flow-through entities are required to provide IRS and each partner, shareholder, or beneficiary with a Schedule K-1 stating the individual share of net income or loss to be reported. These individuals are then responsible for reporting this income or loss on their individual income tax returns and paying any applicable tax. According to IRS in tax year 2001, over 9 million flow-through entities reported passing through almost \$1 trillion to approximately 24 million partners, shareholders, or beneficiaries. IRS research efforts suggest that 6 to 15 percent of the K-1s attached to flow-through returns are currently being omitted from beneficiary, partner, and shareholder returns. To better detect such noncompliance, IRS began transcribing nonelectronically submitted Schedule K-1s for tax year 2000 at a cost of about \$20 million.

In 2001, IRS added Schedule K-1 document matching to its AUR program. It began matching Schedule K-1 data to individual tax returns to identify taxpayers who had underreported flow-through income and had consequently underpaid their taxes. IRS estimated that K-1 matching program costs would be about \$23.5 million total for both K-1 transcription and AUR program operations and that program yield would be \$36 million in direct tax assessed. IRS also estimated that if voluntary compliance improved one percent due to the matching program, approximately \$1.23 billion of additional tax would be generated annually. In the first year of the program, IRS issued about 69,000 notices to taxpayers and assessed about \$29 million in additional taxes directly attributable to Schedule K-1 underreporting.<sup>2</sup> GAO estimates that when program assessments are compared to the costs of the program's AUR operations, the return per

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<sup>1</sup>The AUR program matches information return data, such as Forms W-2 and 1099 and Schedule K-1, with individual tax return data to verify that all income is reported.

<sup>2</sup>IRS began notifying taxpayers of potential discrepancies between income reported on the K-1 and individual tax returns in April 2002. However, after receiving complaints that notices were being sent to compliant taxpayers, IRS stopped issuing notices in August 2002. IRS data on number of notices sent and tax assessed were provided in August 2003.

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Appendix I  
IRS Compliance and Research Programs  
Using the Schedule K-1

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dollar of the K-1 matching program was about \$9.31. If the cost of transcribing the K-1 data is included, the return per dollar decreases to about \$1.25.<sup>3</sup> Both of these assessment-to-cost ratios are substantially lower than that for the AUR program as a whole.<sup>4</sup> The AUR program returned about \$25 for every dollar spent in tax year 2000.<sup>5</sup>

IRS has also used Schedule K-1 data to determine characteristics of potentially noncompliant taxpayer populations. Its preliminary profiling efforts identified over 227,000 business entities with almost \$64 billion in Schedule K-1 income for tax year 2000 that potentially did not file tax returns. As of September 2003, IRS had begun to discuss ways of analyzing these cases to determine whether these businesses were required, but failed, to file returns, or whether inaccuracies in Schedule K-1 data produced false nonfiler leads. In addition, in response to a Treasury Inspector General for Tax Administration report issued in September 2002,<sup>6</sup> the agency has begun to research the effectiveness of using information returns, such as the K-1, to identify business nonfilers.

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<sup>3</sup>To increase efficiency and improve the accuracy of K-1 data, IRS is exploring two-dimensional bar coding of Schedule K-1s. Instead of transcribing K-1 data, IRS would scan a bar code on the K-1 and electronically upload the information.

<sup>4</sup>Because the Schedule K-1 document matching program is new, its return on investment may be low compared to mature AUR programs.

<sup>5</sup>Information about the AUR program is based on IRS data from December 28, 2002.

<sup>6</sup>Treasury Inspector General for Tax Administration, *The Internal Revenue Service Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns*, Report Number 2002-30-185 (Washington, D.C.: Sept. 18, 2002).

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## PREPARED STATEMENT OF HON. JIM BUNNING

Thank you, Mr. Chairman.

We have before us today an interesting array of witnesses as this committee continues to examine the issue of abusive tax shelters.

In recent years, the U.S. Congress and the U.S. Government have paid a lot of attention to the issue of tax shelters and many changes have been made in this area through both legislation and regulation. Many of those changes and many current proposals focus on requiring more taxpayer disclosure with a goal to make such transactions more transparent.

I understand that more aggressive enforcement action has been seen coming from the Department of Justice and the I.R.S. recently. In particular, I have read of the "John Doe" summonses that have been issued in recent weeks and months.

I look forward to hearing the testimony of our witnesses today. In particular, I will be listening for insights and opinions from our panels regarding the various proposals in this area that this committee is still considering.

## PREPARED STATEMENT OF HENRY CAMFERDAM

1. Good Morning. My name is Henry Camferdam. I live in Carmel, Indiana. I appreciate the opportunity to talk to you today. I have been looking forward to this opportunity for quite awhile.

2. I want to talk to you about two areas:

a. My involvement in what I was told was a legal tax savings strategy known as "COBRA;" and

b. what action I would like to see taken against the people who designed, promoted and sold me this tax strategy.

3. In the early 1990s, I started a company called Support Net, Inc. ("Support Net"). Over time, this company became a tremendous success. In 1995, Support Net hired Ernst & Young ("E&Y") to work on various state sales tax issues.

4. In early 1996, Jeff Adams and I, on behalf of Support Net, hired E&Y to do Support Net's audit & tax work. E & Y designated Jay Heck as the lead audit partner and Wayne Hoeng as the senior tax manager.

5. On or about February 26, 1996, Carol Bockelman Trigilio was hired as Support Net's CFO on the suggestion and /or reference of Jay Heck at E&Y, where she formerly worked in their Entrepreneurial Audit Services Group.

6. In the summer of 1996, Support Net, because of its capital needs due to its rapid growth, began discussions with E&Y about E&Y assisting Support Net with finding potential investors or a buyer.

7. This culminated on or about August 26, 1996, with Support Net signing an engagement letter agreement for E&Y to prepare a Senior Offering Memorandum.

8. In October 1996, E&Y began soliciting potential buyers/investors with the Senior Offering Memorandum it had prepared. Support Net initially went to market to raise capital to grow the business, because it was, at that time, one of Indiana's fastest growing companies. Support Net went from \$50 million to \$500 million in sales in 3 years.

9. The process, however, culminated not just in raising capital but rather in a sale of the business to Gates/Arrow Distributing, Inc., a division of Arrow Electronics, Inc ("Arrow"). On or about June 9, 1997, Support Net received a Letter of Intent from Arrow.

10. On or about October 16, 1997, a definitive Agreement between Arrow and Support Net was announced on Wall Street, followed by a sale in December of that year of 50.12% of Support Net to Arrow. E&Y received a commission for this sale of approximately \$900,000.00.

11. E&Y was also the audit/tax professionals for Arrow. The local E&Y office in Indianapolis (Jay Heck and Wayne Hoeng) continued to perform the audit and tax work for Support Net, in conjunction with their peers in New York assigned to Arrow.

12. All amounts from the sale of Support Net received by Jay Michener, Jeff Adams, Carol Trigilio and me (collectively, the "Partners") in 1997 and 1998 (and these amounts were in the millions) were duly reported on both federal and state tax returns, and tax was paid. E&Y prepared the tax returns for me, Jeff Adams, Support Net, and BAMC, LLC (which held the Partners' interests in Support Net). Prior to the COBRA tax strategy sold to us by E&Y, none of us had ever been involved in a tax shelter of any sort, and we had always reported and paid the taxes we owed.

13. Unfortunately, a business dispute arose between Arrow and BAMC, LLC. In March 1999, BAMC, LLC and the Partners filed a lawsuit in federal Court in New York against Arrow and others for, among other things, breach of contract and fraud.

14. In the late summer of 1999, we at Support Net worked with Wayne Hoeing of E&Y and tax professionals at Arthur Anderson to evaluate the tax and business impact of settlement offers we received from Arrow.

15. In August 1999, we received and accepted a settlement offer from Arrow for in excess of \$70 million cash, in exchange for a sale to Arrow of the remainder of Support Net not previously sold. E&Y was aware of this settlement, as we had been staying in touch with them frequently to consider the tax impact of any settlement offer.

16. In addition, all four of the Partners had consulted with Wayne Hoeing of E&Y during this same time frame as to what tax payments should be made (and when). Wayne advised us that Federal estimated taxes were to be paid by January 15, 2000, and state estimated taxes were to be paid prior to December 31, 1999, so they could be itemized on our 1999 Federal returns. Also, in September 1999, we consulted with Wayne and worked through Third Quarter estimated taxes and again confirmed tax payments for the Support Net sale. The four of us fully intended to report and pay the taxes owed, as we had always done in the past. We had actually set aside the money we needed to pay the taxes and the rest was invested.

17. In late October 1999, Wayne contacted Carol about a potential tax saving strategy to benefit me due to my large capital gain on the sale of Support Net. Carol informed me that Wayne briefly presented the idea to her: for gains over \$50 million in 1999, worked whether the gains were ordinary or capital, involved foreign currency options, and took advantage of a "tax loophole" that he did not specifically describe. According to Wayne, the strategy would eliminate all capital gains taxes, thus saving me millions. Carol suggested that he call me directly. After I spoke with Carol about her conversation with Wayne, I told Jay Michener and Jeff Adams generally about my conversation with Carol.

18. As suggested by Carol, Wayne called me about the potential tax saving strategy. During our discussion, I suggested to Wayne that all four of the Partners meet with E&Y to see their presentation of the idea, since all of us had gains on the sale. Wayne told me then of the urgency: that we needed to start the transaction within the next week to ten days because the transaction took about 6–8 weeks to complete and that it needed to be completed prior to the end of 1999. As a result, we agreed to meet with E&Y on or about November 5, 1999, to hear the details of the strategy.

19. On or about November 5, 1999, the Partners met with Wayne Hoeing, Brian Upchurch, and Carl Rhodes of E&Y at E&Y's Indianapolis office. There was no one else present (i.e., no one from Jenkins & Gilchrist or Brown & Wood). With the exception of having to sign a short confidentiality agreement as soon as we arrived (before anything else took place), it was a typical casual meeting for us with Wayne, with whom we had a long-standing relationship. Carl was there at the suggestion of our broker, Dave Knall. Dave had known Carl for years and felt his judgment was conservative and could be trusted. Wayne and Carl brought Brian to the meeting: Brian actually conducted the meeting and seemed to be the most knowledgeable about what was being discussed; it appeared that Wayne and Carl were really present more for client relations, than for any substantive knowledge they might have.

20. The meeting on or about November 5, 1999, lasted one to two hours. Primarily, it was a PowerPoint presentation presented by Brian Upchurch. Brian appeared to be the lead contact in Indianapolis for the COBRA transaction; according to the Power Point, COBRA stood for "Currency Options Bring Reward Alternatives." Wayne and Carl, to a lesser extent, assisted with answering our questions and in giving their take on the strategy. We asked many types of questions, because none of us understood the deal. In response, Wayne and Brian stated, "That's why you have us." I depended on Wayne to tell us if this transaction was valid and appropriate for us. Wayne advised us that they could make this transaction work for us. Wayne told us this was a valid tax shelter; that the tax shelter would be upheld if we were audited; and that Ernst & Young would defend us up to Court. They also showed us an opinion letter from Jenkins & Gilchrist during the presentation, which we were told was "insurance" in the event of an audit. They also suggested we obtain a second legal opinion just to make sure. They informed us they had another law firm, Brown & Wood, which could provide us with a second legal opinion. We weren't allowed to keep any of the materials discussed in this meeting.

21. During the November 5, 1999, meeting, we contacted Steve Humke, our attorney at the Ice Miller firm in Indianapolis and requested he join us in the meeting. He could not join us at that time. Carl and Brian later visited Steve's office. I spoke

with Steve after their meeting. Steve told me that the meeting lasted almost one hour. Steve also told me that Carl and Brian would not permit him to bring in an Ice Miller tax expert or any other attorney. Steve had to sign the same confidentiality agreement we did. They let him briefly look at the Jenkins opinion. According to Steve, the meeting was “rushed.” Steve told me that he could not render an opinion on the transaction, as Carl and Brian wouldn’t even let him keep the opinion to review. Steve advised me that Jenkins & Gilchrist was a large, reputable firm and that we would have to rely on our relationship with E&Y for direction.

22. Following the meeting on or about November 5, 1999, Wayne picked the “loss” I needed to generate. The loss was almost in alignment with the prior ownership of BAMC, LLC (which had held the shares of Support Net and was owned by the Individual Plaintiffs).

23. Wayne told me they were in a hurry to get the deal done. As a result, a few days later, I believe on or about November 9, 1999, the four of us met Wayne Hoening and several other individuals at Twin Lakes Golf Course before Jeff, Jay, and I were to play golf. Because of the urgency, Wayne wanted to squeeze the meeting in before our tee time. The purpose of the meeting was to sign all the paperwork to start the implementation of the tax strategy, including transactional documents and a two page engagement agreement (the “Engagement Agreement”) between each of us and E&Y. The meeting only lasted 30 minutes or so. No copies of the documents were given to us at that time—Wayne said they would be mailed to us later. Although the transactional documents were later sent to us in a binder, the Engagement Agreement and the promotional materials used during the meeting were never sent to us. I did not understand the transaction. During this meeting, Jay asked Wayne, “What is this strategy?” Wayne responded by saying, “It is already done, don’t worry about it.”

24. No time was spent at this meeting on or about November 9, 1999, discussing the documents, as Wayne continued to tell us that we needed to go forward with the strategy immediately to have it completed by the end of the year. He appeared to be in a hurry to get the deal done, and, in fact, acted as though the deal was done. Trusting Wayne, I quickly signed the voluminous documents, which included documents for the formation of limited liability companies for each of the four of us, a partnership known as Carmel Partners, and an S-corp called BAMC, Inc. I viewed it as like closing a mortgage loan, where it was sign the documents or go to another lender, except that in this case E&Y was the only party we knew of who could eliminate our taxes, in their words, “legally and conservatively.” I also knew that I didn’t have the time to show the Engagement Agreement to Steve Humke or another lawyer, and was led to believe that because of all the confidentiality surrounding the strategy that wasn’t really an option anyway.

25. Through the rest of November and December of 1999, we did as instructed by E&Y to implement the tax strategy known as “COBRA.” I also had a brief conversation with David Parse at Deutsche Bank at which time David Parse picked the options for us (the “Euro” for me, the “Yen” for the others) because I had no idea what to do. We also signed and sent Deutsche Bank accounts forms on which they had already filled in information about our supposed investment experience before sending them to us.

26. In early December 1999, the four of us received engagement letters from Jenkins and Gilchrist. I signed and returned mine. I never talked to anyone at Jenkins and Gilchrist, and this is the only agreement we had with them about the work they were doing for us.

27. On or about December 22, 1999, we sent, as directed, a wire to E&Y from Carmel Partners’ account for \$1,056,000. On December 29, 1999, we sent, as directed, a wire to Jenkins & Gilchrist from BAMC, Inc.’s account at Duetsche Bank for \$2,012,000.

28. On or about June 20, 2000, we received a letter from Brian Upchurch of E&Y transmitting to us a package containing the Brown & Wood opinion (dated March 9, 2000), a request for each of us to sign an engagement letter with Brown & Wood, other materials, and a request for us to send payment to Brown & Wood. I never talked to anyone at Brown & Wood. In fact, all of their documents were sent to us via E&Y—not directly to us. I never intended, expected, or contracted to arbitrate with Brown and Wood regarding the COBRA transaction. We initially didn’t want to pay Brown & Wood because their opinion letter was received so late; however, Brian Upchurch with E&Y told us if we didn’t pay Brown & Wood they would probably “turn us in” to the IRS. On October 2, 2000, we mailed a payment of \$75,000 to Brown & Wood.

29. In March 2002, E&Y sent me a letter informing me about a “Tax Amnesty Program” offered by the IRS. This letter was followed-up by a telephone call with E&Y wherein E&Y advised me not to participate in the “Tax Amnesty Program.”

During the discussions where E&Y told me not to participate in the Tax Amnesty Program, E&Y did not inform me about the existence and implications of IRS Notice 2000-44, which I later came to understand was directed at COBRA and similar transactions that indicated the IRS did not believe those transactions were lawful. Following the advice of my accountants, I did not enter the Tax Amnesty Program.

30. On approximately June 6, 2002, Wayne Hoeing of E&Y informed me by letter that the IRS was investigating E&Y and was demanding the production of broad categories of documents and other information with regard to the COBRA transaction I did.

31. E&Y informed me that E&Y had received administrative summons from the IRS and that in the opinion of E&Y, documents and information in their files pertaining to the professional services they had rendered to me in connection with the COBRA transaction were responsive to the summons.

32. In a letter dated June 6, 2002, signed by Wayne Hoeing of E&Y, I was informed that E&Y would produce documents and information regarding the transaction I had done if no objection was received. I informed E&Y the same day that I objected to the disclosure of any information about me, including my name and any documents related to the transaction I had done.

33. In September 2002, E&Y informed me that, on the advice of their outside counsel, they planned on disclosing my name to the IRS but promised that no documents would be produced and that E&Y would notify me if the IRS required production of my documents.

34. On approximately September 5, 2002, a suit was filed in the Northern District of Illinois seeking to prevent E&Y from disclosing to the IRS the identify of individuals that had completed the COBRA transaction. There were several hearings in connection with this lawsuit. E&Y at no time informed me that they believed the Court had permitted them to disclose my name to the IRS or that they intended to do so immediately. Unfortunately, on approximately September 24, 2002, E&Y voluntarily disclosed my name to the IRS. E&Y's disclosure of my name to the IRS was done in express violation of the instructions I had given to E&Y not to disclose my identity, documents, information, or any communications to the IRS without my consent, which was never given. No Court ever ordered E&Y to disclose my identity to the IRS. The bottom line is that E&Y was more worried about protecting themselves and currying favor with the IRS than protecting the rights of their clients.

35. I want to emphasize the following points to the Committee:

a. E&Y and Jenkens & Gilchrist took advantage of a long-term relationship I had with E&Y. E&Y and Jenkens & Gilchrist took advantage of the trust and confidence I had for E&Y. E&Y and Jenkens & Gilchrist took advantage of E&Y's knowledge of my financial condition. I did not approach E&Y for this tax strategy; rather, they approached me. I fully intended to pay the taxes I owed on the gain from the sale of my company.

b. I was never made aware of the actual relationships and roles of E&Y, Jenkens & Gilchrist, and Deutsche Bank with respect to COBRA. For instance, E&Y informed me that COBRA was an E&Y tax strategy. I now know that COBRA was a Jenkens & Gilchrist tax strategy. E&Y informed me that Jenkens & Gilchrist was an "independent" law firm that would review the tax strategy and write an opinion letter supporting the strategy, which would protect me from penalties in the event of an audit. This was untrue. I now know that Jenkens & Gilchrist was not an "independent" law firm since Jenkens & Gilchrist designed, created and promoted this tax strategy. Finally, I was not aware that E&Y, Jenkens & Gilchrist, and Deutsche Bank met before marketing COBRA to determine how to split the fees up among them.

c. E&Y told me not to enter the IRS Amnesty Program. However, a short time later E&Y turned my name over to the IRS without my permission.

d. Neither E&Y nor Jenkens & Gilchrist explained to me that existence and significance of various IRS Notices, which indicated that the IRS would disallow COBRA. If I had been informed of the existence and significance of this information, I would not have done the tax strategy to begin with and certainly would have entered the Amnesty Program when it was offered by the IRS.

e. E&Y and Jenkens & Gilchrist used high pressure sales tactics to sell me the COBRA. E&Y also emphasized the need for me to "trust them." My trust in E&Y resulted in this ordeal I am now in.

f. I have always paid my taxes. In fact, I paid the taxes I owed from the initial sale of part of Support Net. I would have paid the taxes I owed on the gain from the sale of the rest of Support Net; however, my trusted legal and tax advisors placed me in a tax savings strategy that they represented was completely legal. Since I had never entered into a tax shelter and had never been audited, I relied on the advice and recommendations of E&Y and Jenkens & Gilchrist.

36. In closing, I have several questions for the Committee:

a. While I and other taxpayers in this situation have been subjected to tough talk about penalties and interest, E&Y, Jenkins & Gilchrist, and Deutsche Bank have not come under scrutiny for their conduct. Why have you not brought action against E&Y, Jenkins & Gilchrist, Deutsche Bank, and others that marketed these tax shelter products to trusting individuals like myself?

b. Why are E&Y, Jenkins & Gilchrist, and Deutsche Bank allowed to keep hundreds of millions of dollars in fees that were paid for these transactions, while the participating tax payers are currently undergoing extensive and expensive audits?

c. What is being done to make E&Y, Jenkins & Gilchrist, and Deutsche Bank accept responsibility for their conduct?

d. What can be done to protect future taxpayers from being in the position I and many others are in: having to pay one group of lawyers to defend me from the IRS, and another group of lawyers to assert my civil claims against the promoters who talked me into this strategy?

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## PREPARED STATEMENT OF PHILIP C. COOK

My name is Philip Cook, and I am a partner at the law firm of Alston & Bird LLP. One of my partners, Neal Batson, was appointed by the U.S. Trustee and approved by the Bankruptcy Court as the Examiner in the Enron bankruptcy proceeding. Our firm represents Mr. Batson in conducting his examination. I am appearing before you today in response to a subpoena to testify regarding matters that Mr. Batson found in his examination and included in certain portions of his January and June 2003 reports that were filed with the Bankruptcy Court.<sup>1</sup>

Under the Order of the Bankruptcy Court, the Examiner was asked to investigate Enron's numerous and highly publicized transactions involving Special Purpose Entities, which are sometime called SPEs.<sup>2</sup> Among the scores of SPE transactions investigated by the Examiner were 11 transactions consummated within Enron's corporate tax department during the 1995-2001 time period, which I will refer to today as the Tax Transactions.<sup>3</sup> I led the Examiner's team of lawyers who investigated the Tax Transactions.

I have been asked to describe today what the Examiner learned about Enron's Tax Transactions and about the roles of law firms, accounting firms and investment banks in facilitating the Tax Transactions.

Enron's Tax Transactions appear to have been somewhat different from tax-related transactions entered into by many public companies for a number of reasons:

- ? Enron did not need to generate tax deductions on its federal income tax returns during the years 1996 through 2000 to reduce any current federal tax bill.<sup>4</sup> In fact, Enron's tax returns for those years showed net operating losses of nearly \$5 billion for tax purposes.<sup>5</sup>

- ? Even though Enron was not paying current taxes, it was required to record a tax expense provision in its financial statements based on its pre-tax book income. The goal of Enron's Tax Transactions was to generate future tax deductions that could be used to reduce current tax expense for book purposes under the deferred tax accounting rules of FAS 109<sup>6</sup> and thereby increase its book net income.<sup>7</sup> The Tax Transactions often would not result in tax deductions for Enron until five or more years following the transaction. The Examiner's reports indicate that the accounting treatment employed by Enron in many of the Tax Transactions did not comply with GAAP.<sup>8</sup>
- ? As a general rule, the Tax Transactions were artificial transactions that had no connection to Enron's ordinary business activities.<sup>9</sup> Instead, they generally involved the transfer of substantial assets already owned by Enron and liabilities (often stock or debt of Enron or one of its affiliates), to an SPE for the purpose of generating current financial accounting income from speculative future tax benefits.<sup>10</sup> Assets or financial instruments created or acquired in one transaction would be reused in later transactions or sold between structures to trigger reporting of financial accounting gain.<sup>11</sup> An SPE entity created for one structure would be reused in a later structure.<sup>12</sup>

The unusual nature of Enron's Tax Transactions is illustrated by the Teresa Transaction. This transaction was designed to engineer a non-economic increase of more than \$1 billion in the tax basis of Enron's home office building, which we refer to as the

Enron North Building.<sup>13</sup> This was to be accomplished by contributing the Enron North Building, which already was owned by Enron and subject to existing financing, to a partnership SPE structure that also received investments from the investment bank that promoted the structure to Enron.<sup>14</sup> The business of the SPE partnership structure was to lease the Enron North Building to Enron.<sup>15</sup> The only other business activities conducted by the partnership were leasing certain corporate jets to Enron for use by Enron executives and purchasing certain stock interests in various Enron affiliates.<sup>16</sup> Ultimately, the Enron North Building was to be distributed out of the partnership, and Enron then would claim a basis “step-up” in the building of more than \$1 billion.<sup>17</sup> The Examiner concluded that the transaction had no business purpose other than to achieve the tax and financial accounting results.<sup>18</sup>

The Teresa Transaction did not generate any current tax deductions for Enron.<sup>19</sup> Instead, the deconsolidation of the Teresa SPE entities from Enron’s consolidated return caused Enron to incur and pay taxes of approximately \$131 million during the period from 1997 through 2001 that it would not otherwise have paid.<sup>20</sup> However, Enron immediately began recording much greater deferred tax assets related to the expected future basis step-up in the building.<sup>21</sup> During the period from 1997 through September, 2001, the Teresa structure decreased Enron’s book tax expense and thereby increased its net income for financial reporting purposes by \$229 million.<sup>22</sup> The Examiner’s report concludes that the accounting treatment for the Teresa Transaction did not comply with GAAP.<sup>23</sup>

Enron entered into two other tax basis step-up transactions similar to the Teresa Transaction. In the Condor Transaction, Enron sought to step-up the basis of a fully



depreciated oil and gas storage facility known as the Bammell facility by approximately \$1 billion dollars.<sup>24</sup> In the Tammy I Transaction, Enron sought to create a non-economic basis step-up in its new headquarters building, the Enron South Building, which it was then constructing in Houston.<sup>25</sup> Again, it was contemplated that the basis step-up would exceed \$1 billion dollars.<sup>26</sup> These three tax basis step-up transactions (the Teresa, Condor and Tammy I Transactions) were expected to provide a net income boost to Enron's financial statements of nearly \$1 billion dollars over the life of the three transactions.<sup>27</sup> The Examiner found that there is a significant possibility that each of these three transactions ran afoul of various Internal Revenue Code anti-abuse rules.<sup>28</sup> The Examiner also concluded that the transactions were accounted for in violation of GAAP.<sup>29</sup>

As a further illustration of the Tax Transactions, Enron also engaged in two transactions involving acquisition of REMIC Residual Interests that had the effect of distorting Enron's financial statements.<sup>30</sup> As this Committee knows from other hearings, a REMIC is a tax vehicle created by Congress to permit bona-fide investment in mortgage securities.<sup>31</sup> REMIC Residual Interests are securities issued by REMICs that generate so-called "Phantom Income" for tax purposes in the early years of a REMIC and "Phantom Loss" in the later years of the REMIC.<sup>32</sup>

Enron entered into the Steele and Cochise Transactions to acquire REMIC Residual Interests in transactions in which it could take advantage of future Phantom Losses from the REMICs without ever having reported the related Phantom Income.<sup>33</sup> More importantly, the transactions were designed to record deferred tax assets related to the future losses and to reflect the recognition of offsetting deferred credits as pre-tax

book income.<sup>34</sup> The Examiner concluded that an existing Internal Revenue Code anti-abuse provision probably can be relied upon by the IRS to disallow the tax benefits of the transaction.<sup>35</sup> The Examiner also concluded that portraying the income from the transactions as pre-tax income (rather than a reduction of tax expense) without disclosure of the nature of the purported pre-tax income was misleading and violated GAAP.<sup>36</sup> During the period from 1997 through September, 2001, Enron amortized \$144 million of pre-tax income through its reported financial statements, which amounts actually were items reflecting the anticipated future tax benefits from acquired REMIC Phantom Losses.<sup>37</sup>

In total, Enron created \$886.5 million of net income benefits from the Tax Transactions through September 2001, and it was projecting in excess of \$1.7 billion of net income benefits over the lifetime of the transactions.<sup>38</sup> In addition, these transactions were disclosed in Enron's financial statements in a misleading manner.<sup>39</sup>

Seven of Tax Transactions were promoted to Enron by investment banking units of major banks.<sup>40</sup> The investment banking firms received fees, ranging from \$6 million to \$15 million dollars, for advising on the Enron Tax Transactions.<sup>41</sup> Three of the Tax Transactions were brought to Enron by major public accounting firms.<sup>42</sup> One transaction was implemented internally by Enron based on the pattern of a prior transaction that it had implemented on the advice of a public accounting firm.<sup>43</sup>

In order to market the transactions to Enron, the investment banks found that it was helpful to obtain the opinion of a major accounting firm that the expected accounting treatment complied with GAAP. In certain circumstances, accounting firms will issue so-called SAS 50 letters describing the applicable accounting treatment of a hypothetical

transaction to an investment banking firm that is promoting a transaction.<sup>44</sup> In many of the Tax Transactions, Andersen had been separately engaged by the investment banking firm that was promoting the transaction to develop the SAS 50 letter on the underlying hypothetical transactions, and then advised Enron on the accounting treatment of the transactions as actually implemented.<sup>45</sup>

To record the accounting benefits, Enron and Andersen generally relied on a “should” level tax opinion from a law firm.<sup>46</sup> Accounting literature does not permit the recognition of a deferred tax asset unless it is “probable” that the tax position will be sustained.<sup>47</sup> Accounting literature indicates that the term probable implies a higher likelihood of success than the 51% probability of success implied by a “more likely than not” tax opinion.<sup>48</sup> As the Joint Committee on Taxation has noted in the past, the standard required to conclude that tax results “should” prevail in a tax dispute is somewhat uncertain. Generally, professional tax advisors believe that the standard is in the range of 70% to 90% likelihood of success.<sup>49</sup>

The Examiner found that Enron relied upon a small group of law firms to issue the tax opinions in the Tax Transactions.<sup>50</sup> Several of the firms who gave tax opinions to Enron in the transactions had previously been employed by the investment banking firm that promoted the transaction to Enron.<sup>51</sup> Certain firms rotated their engagements, representing Enron in one transaction and representing the investment banking firm in the next transaction.<sup>52</sup> In certain instances, Enron paid the tax law firm fixed fees of as much as \$1 million for representing it in a single transaction.<sup>53</sup> The Examiner’s January Report expresses skepticism with respect to the conclusion reached in the tax opinions that Enron should prevail in the Tax Transactions if the tax results were contested by the

IRS.<sup>54</sup> Generally, the Tax Transactions pertained to future tax events that will not occur because of Enron's bankruptcy.<sup>55</sup>

In summary, the Examiner has concluded in his reports filed to date that the Tax Transactions entered into by Enron distorted its financial statement net income in violation of GAAP.<sup>56</sup> Enron could not have implemented the Tax Transactions without the assistance it received from investment banks, its accounting firm and the law firms that issued the opinions.<sup>57</sup>

<sup>1</sup> See Second Interim Report, Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates); Subpoena of Philip C. Cook, A&B, by U.S. Senator Chuck Grassley, Chairman, before the United States Senate Committee on Finance, Oct. 15, 2003.

<sup>2</sup> Order of the United States Bankruptcy Court for the Southern District of New York, Apr. 8, 2002 (appointment of an examiner pursuant to 11 U.S.C. § 1104(c)).

<sup>3</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*.

<sup>4</sup> See Second Interim Report, Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>5</sup> See Second Interim Report, *Tax Transactions*, at 89, fn. 176. Enron did not need current tax deductions in those years because of employee stock option deductions and because much of the income it was reporting to its shareholders for financial accounting purposes under its mark-to-market accounting was not considered taxable income for tax purposes under applicable law. See Second Interim Report, *Tax Transactions*, at 89.

<sup>6</sup> Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109 (Financial Accounting Standards Bd. 1992) ("FAS 109").

<sup>7</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions* see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates). In some instances, Enron also reflected amortization of deferred credits related to expected future tax deductions as pre-tax income. See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-3 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 27-42.

<sup>8</sup> See Second Interim Report, Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>9</sup> See Second Interim Report, *Tax Transactions*, at 87-94; Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>10</sup> *Id.*

<sup>11</sup> See Second Interim Report, *Tax Transactions*, at 87-94; Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>12</sup> *Id.*

<sup>13</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions).

<sup>14</sup> *Id.*; see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48 and 72. The charge for the capital contributed by the investment bank was not economic for Enron if the fees charged by the investment bank were taken into account. See Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 20-21.

<sup>19</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*, at 52; Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 3; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-43.

<sup>20</sup> *Id.*

<sup>21</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 42-48.

<sup>22</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9; Second Interim Report, Annex 4 to Appendix J (Tax Transactions), at 27; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 43.

<sup>23</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 4 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>24</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions). The partnership transaction causing the tax basis step-up was designed to be part of the Whitewing financing, but played virtually no role in actually facilitating that financing. See Second Interim Report, Appendix G (Whitewing Transaction).

<sup>25</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions). Although the partnership transaction was nominally linked to Enron's Zephyrus financing, the assets of the partnership did not provide meaningful credit support to the Zephyrus financing. See Second Interim Report, Appendix I (Minority Interest Transactions); Second Interim Report, Annex 4 to Appendix I (Minority Interest Transactions).

<sup>26</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annex 5 to Appendix J (Tax Transactions).

<sup>27</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*; Second Interim Report, Annexes 4-6 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>31</sup> The REMIC structure has been important to the improvement in the ability of capital markets to finance residential real estate. See Second Interim Report, Appendix J (Tax Transactions); see generally James M. Peaslee & David Z. Nirenberg, *The Federal Taxation of Mortgage Backed-Securities* (rev. ed. 1994).

<sup>32</sup> See Second Interim Report, Appendix J (Tax Transactions), at 2-4.

<sup>33</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1-2 to Appendix J (Tax Transactions); see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 28.

<sup>38</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 8-9.

<sup>39</sup> See Second Interim Report, *Tax Transactions*, at 87-94.

<sup>40</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 102-108.

<sup>44</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 15-16.

<sup>45</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 9-11; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 15-20 and 27-57.

<sup>46</sup> See Second Interim Report, Appendix J (Tax Transactions), at 16-17; see also Second Interim Report, Annex 3 to Appendix J (Tax Transactions), at 1-2; Second Interim Report, Annex 6 to Appendix J (Tax Transactions), at 26.

<sup>47</sup> See Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109*.

<sup>48</sup> *Id.*

<sup>49</sup> See Second Interim Report, Annex 3 to Appendix J (Tax Transactions), at 1, fn 1.

<sup>50</sup> See Second Interim Report, Appendix J (Tax Transactions).

<sup>51</sup> See Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 30-36, 38-42 and 45-48.

<sup>52</sup> See *id.* at 27-42.

<sup>53</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*, at 11.

<sup>54</sup> See Second Interim Report, Appendix J (Tax Transactions).

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*; see also Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates).

<sup>57</sup> *Id.*

**RESPONSE OF  
PHILIP C. COOK  
ALSTON & BIRD LLP  
ATTORNEY TO ENRON EXAMINER, NEAL BATSON**

to

**WRITTEN QUESTIONS  
SUBMITTED BY  
MEMBERS OF SENATE COMMITTEE ON FINANCE**

November 4, 2003

**Question 1:** You were personally involved with your firm's report on Enron. Based on your understanding of the Enron transaction, can you [ . . . ] educate the committee on the roles of the various law firms, accounting firms, investment banks and other financial institutions. In other words, who came up with the ideas for some of those code-named transactions such as Apache, Condor, and Cochise, and who wrote the tax opinions?

**Response 1:** BT/Deutsche designed and promoted the Teresa, Steele, Tomas, Cochise, Renegade, and Valhalla Transactions.<sup>1</sup> Andersen promoted the Tanya Transaction.<sup>2</sup> Deloitte and Touche developed the strategy used in the Condor and Tammy I Transactions.<sup>3</sup> Chase Securities designed and promoted the Apache Transaction.<sup>4</sup> Enron patterned the Valor Transaction after the Tanya Transaction that had been promoted by Andersen.<sup>5</sup> The law firms or accounting firms engaged to issue tax opinions to Enron for the Tax Transactions were as follows:<sup>6</sup>

Transaction	Firm
Tanya Transaction	Arthur Andersen LLP
Valor Transaction	Arthur Andersen LLP
Teresa Transaction	King & Spalding LLP
Steele Transaction	Akin, Gump, Strauss, Hauer & Feld, L.L.P.
Tomas Transaction	Akin, Gump, Strauss, Hauer & Feld, L.L.P.
Cochise Transaction	McKee Nelson, Ernst & Young LLP King & Spalding LLP

<sup>1</sup> See Second Interim Report, Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates). BT/Deutsche also solicited Enron's involvement in the Renegade and Valhalla Transactions as accommodation parties. *Id.*

<sup>2</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 9, fn. 49.

<sup>3</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Tax Basis Step-Up Transactions*, at 53 and 58; Second Interim Report, Annexes 5 and 6 to Appendix J (Tax Transactions).

<sup>4</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 89.

<sup>5</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 9, fn. 49.

<sup>6</sup> See Second Interim Report, Appendix J (Tax Transactions).

Apache Transaction	Shearman & Sterling LLP
Condor Transaction	Vinson & Elkins LLP
Tammy I Transaction	Vinson & Elkins LLP
Renegade Transaction	None
Valhalla Transaction	Vinson & Elkins LLP

**Question 2:** Can you elaborate on why Enron required “should” level tax opinions from law firms in order to record the financial statement benefit from these tax transactions? In other words, why were these law firm opinions needed?

**Response 2:** Enron’s Tax Transactions were aimed largely at generating accounting income from projections of future tax savings.<sup>7</sup> These financial statement results were accomplished through aggressive interpretations of both the Internal Revenue Code and GAAP, with a particular emphasis on FAS 109<sup>8</sup> and its deferred tax accounting principles.<sup>9</sup> Under FAS 109, Enron is required to recognize the estimated future tax consequences of certain events that have been recognized in Enron’s financial statements or tax returns by recording a “deferred tax asset” or a “deferred tax liability.”<sup>10</sup> Over future periods, these assets or liabilities will reverse and create a taxable or deductible amount on Enron’s financial statements.<sup>11</sup> The Tax Transactions were structured to create reported net income in current periods based on tax deductions that would occur at some time in the future, often years or decades later.<sup>12</sup> Enron, however, could not record the accounting benefits associated with the Tax Transactions unless it was “probable”<sup>13</sup> that the future losses would be realized (i.e., would be deductible for federal tax

<sup>7</sup> *Id.*

<sup>8</sup> Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109 (Financial Accounting Standards Bd. 1992) (“FAS 109”).

<sup>9</sup> See Second Interim Report, Appendix J (Tax Transactions).

<sup>10</sup> See Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109*. A deferred tax asset or deferred tax liability is recognized for the estimated future tax effects attributable to “temporary differences,” which result from differences between the tax basis in assets or liabilities and the reported amounts of such assets or liabilities in a company’s financial statements. *Id.* For example, a deferred tax asset is recognized if the asset has a lower book basis than tax basis or if a liability has a higher book basis than tax basis, while a deferred tax liability is recognized if an asset has a higher book basis than tax basis. *Id.*

<sup>11</sup> *Id.* In addition, if a transaction is treated as a “business combination” under Business Combinations, Accounting Principles Bd. Opinion No. 16 (Financial Accounting Standards Bd. 1970), and the sum of the net assets exceeds the purchase price, “negative” goodwill (the presumed discount or bargain on net assets acquired) is created. *Id.* Under GAAP, the negative goodwill is treated as a proportionate reduction in non-current assets other than long-term investments in marketable securities. *Id.* If the book value of these assets is less than the negative goodwill, the remainder is required to be recorded as a “deferred credit” in the liability section of the balance sheet. *Id.* Income is then generated by the reversal or amortization of the deferred credit. *Id.*

<sup>12</sup> See Second Interim Report, Appendix J (Tax Transactions).

<sup>13</sup> Under GAAP, a “probable” event is one that is likely to occur, i.e., it can reasonably be expected or believed but is neither certain nor proved. Elements of Financial Statements, Statement of Financial Accounting Concepts No. 6, nn. 18 and 21 (Financial Accounting Standards Bd. 1985); Accounting for Contingencies, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975), ¶3. Probable is a higher level of certainty than “more than likely,” which refers to a probability of more than 50%. FAS 109, ¶ 17e; see also Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109*.



purposes).<sup>14</sup> Enron used the tax opinions to support its financial accounting treatment of the Tax Transactions.

**Question 3:** Why was Enron not reporting taxable income during the 1996 to 2000 period in which it was reporting billions of dollars of income for financial accounting purposes?

**Response 3:** Under FAS 109, Enron was required to recognize income tax expense based on the amount of pre-tax income reported for GAAP purposes, and not the amount of income reflected on Enron's consolidated federal income tax return.<sup>15</sup> As a result, Enron reported large annual tax expenses for GAAP purposes.<sup>16</sup> However, due primarily to book-tax differences arising from the use of mark-to-market accounting for its trading operations, exclusion of income earned by certain foreign subsidiaries, and compensation deductions from the exercise of employee stock options, Enron had large tax net operating losses from 1996 onward.<sup>17</sup> On its consolidated federal income tax returns, Enron reported ordinary losses of \$399 million in 1996, \$581 million in 1997, \$813 million in 1999, and \$3.023 billion in 2000.<sup>18</sup>

**Question 4:** The Examiner's reports and your testimony indicate that Enron moved assets such as the leased aircraft in the Cochise transaction from one tax shelter to another. It seems as if Enron recycled these planes through multiple tax shelters. Could you elaborate on that?

**Response 4:** As described in the Examiner's Second and Third Interim Reports, two leased commercial aircraft (the "Cochise Planes")<sup>19</sup> were among the assets transferred between the structures created by Enron's Tax Transactions.<sup>20</sup> The Cochise Planes were transferred three times over an 18 month period among affiliates of BT/Deutsche and Enron in connection with the Cochise and Tomas Transactions as follows.<sup>21</sup>

On January 28, 1999, Enron obtained the Cochise Planes in connection with the Cochise Transaction, which also involved the transfer of REMIC Residual Interests and mortgage-backed securities to a REIT in exchange for common and preferred stock held by Enron

<sup>14</sup> See Second Interim Report, Appendix J (Tax Transactions), *Accounting for Deferred Taxes Under FAS 109*.

<sup>15</sup> See Second Interim Report, *Tax Transactions*, at 89.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 89 n. 176.

<sup>19</sup> The leased aircraft included a Boeing 747-238B aircraft leased to United Airlines, Inc. and a McDonald Douglas DC-9-82 aircraft leased to Continental Airlines Inc. See Second Interim Report, Appendix J (Tax Transactions), *Enron's Other Tax Transactions*, at 84-85; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 11-12.

<sup>20</sup> See Second Interim Report, Appendix J (Tax Transactions), at 33-35 and 84-85; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 11-12; Third Interim Report, Appendix C (Role of Enron's Officers), at 53-57; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 51-57.

<sup>21</sup> *Id.*

and BT/Deutsche affiliates.<sup>22</sup> More specifically, ECT Investments Holding Corp. (“ECT Holding”), an Enron affiliate, purchased the Cochise Planes from BT Ever, Inc., a BT/Deutsche affiliate for \$46.7 million (including brokers fees).<sup>23</sup> These planes were purchased for the purpose of accelerating the recognition of pre-tax income.<sup>24</sup> Enron offset the deferred credit arising from recording deferred tax assets in the Cochise Transaction against the book basis of the Cochise Planes, which immediately reduced the planes’ book basis from \$46.7 million to zero.<sup>25</sup> Then, upon the subsequent sale of the Cochise Planes described below, Enron would recognize the full amount of the sale proceeds of the Cochise Planes as pre-tax income.<sup>26</sup>

On June 28, 2000, ECT Holding sold the Cochise Planes to BT Leasing Corp. (“BT Leasing”), an affiliate of BT/Deutsche, for an aggregate purchase price of \$36.5 million.<sup>27</sup> Because the purchase accounting adjustments described above had reduced its book basis in the Cochise Planes to zero, Enron reported the entire sale proceeds of \$36.5 million as pre-tax income in the second quarter of 2000.<sup>28</sup>

Approximately one month later, on July 27, 2000, BT Leasing sold the Cochise Planes to Oneida Leasing, Inc. (“Oneida”) for \$36.0 million (the same purchase price, but adjusted for lease payments made in the interim).<sup>29</sup> Oneida was distributed to an Enron affiliate soon thereafter as part of the redemption of the Enron affiliate’s interest in the Tomas structure in a transaction that again triggered recognition of book gain.

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<sup>22</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*; Second Interim Report, Annex 2 to Appendix J (Tax Transactions); Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 36-38.

<sup>23</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 33; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 11-12; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 37-38.

<sup>24</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 33; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 17-18; Third Interim Report, Appendix C (Role of Enron’s Officers), at 54; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 38.

<sup>25</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 33-34; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 17-18; Third Interim Report, Appendix C (Role of Enron’s Officers), at 54; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 38.

<sup>26</sup> *Id.*

<sup>27</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 34; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 12; Third Interim Report, Appendix C (Role of Enron’s Officers), at 55; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 51.

<sup>28</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 34; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 18; Third Interim Report, Appendix C (Role of Enron’s Officers), at 55; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 52.

<sup>29</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron’s REMIC Carryover Basis Transactions*, at 34 and 84; Second Interim Report, Annex 2 to Appendix J (Tax Transactions), at 12; Third Interim Report, Appendix C (Role of Enron’s Officers), at 55; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 52.

**Question 5:** What is the significance of Enron's assertion that the Steele and Cochise transactions produced pre-tax income on Enron's financial statements to its shareholders? The Examiner seems highly critical of that aspect of certain transactions.

**Response 5:** The Steele and Cochise Transactions were designed to record potential future tax benefits as pre-tax income rather than as after-tax income resulting from reduced tax expense in the tax provision of Enron's income statement.<sup>30</sup> The characterization of those items as pre-tax income was materially misleading because readers of Enron's financial statements were unaware that \$144 million of pre-tax income arose from tax-related transactions.<sup>31</sup>

**Question 6:** What role did Enron's management and compensation incentives play in causing Enron to enter into the tax transactions?

**Response 6:** The Tax Transactions were largely completed by a subgroup of individuals within Enron's tax department that ultimately became known as the Structured Transactions Group.<sup>32</sup> Over time, Enron's management came to rely on Enron's tax department and, more specifically, its Structured Transactions Group to fill the annual "stretch"<sup>33</sup> to produce additions to net income that could not be accomplished by other business units through ordinary operations.<sup>34</sup> The tax department employees were required to quantify the value of their activities on a pre-tax, after-tax, and cash basis through monthly, quarterly, bi-annual, and annual performance reports.<sup>35</sup> The annual performance report was submitted to management in December, just prior to the bonus allocations.<sup>36</sup> In addition, the financial accounting benefits generated by the Tax Transactions frequently were the subject of PowerPoint presentations supervised or presented to senior management in an effort to obtain increased compensation for the Structured Transactions Group.<sup>37</sup> Although bonuses were not directly determined in relation to the income generated, Dave Maxey who was the Vice President of the

<sup>30</sup> See Second Interim Report, Appendix J (Tax Transactions), *Enron's REMIC Carryover Basis Transactions*; Second Interim Report, Annexes 1 and 2 to Appendix J (Tax Transactions); Third Interim Report, Appendix C (Role of Enron's Officers), at 18; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 31 and 39.

<sup>31</sup> See Third Interim Report, Appendix C (Role of Enron's Officers), at 18; Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 28.

<sup>32</sup> See Second Interim Report, Appendix J (Tax Transactions), *Introduction to Enron's Tax Transactions*; Third Interim Report, Appendix C (Role of Enron's Officers), at 19 n. 77.

<sup>33</sup> Management prepared an annual plan that included Enron's target to maintain the effective tax rate under 35% for the upcoming year. See Third Interim Report, Appendix C (Role of Officers), at 17 n. 71. Through the planning process, each business unit would inform management with their expected earnings (e.g., \$100 million) and management would then include a target (e.g., \$120 million) in the budget, with the additional amount (e.g., \$20 million) representing the "stretch." *Id.*

<sup>34</sup> See Third Interim Report, Appendix C (Role of Officers), at 17.

<sup>35</sup> *Id.* at 21, n. 85.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 21.

Structured Transactions Group received a larger bonus (e.g., \$800,000 for 2000) than other vice presidents at Enron.<sup>38</sup>

**Question 7:** Could you give the Committee an understanding of the typical manner in which one of these transactions was developed and marketed? For example, could you walk us through briefly the development and marketing of one of the transactions, such as Project Steele?

**Response 7:** The Steele Transaction was developed within BT/Deutsche's structured transactions group.<sup>39</sup> The transaction was developed because BT/Deutsche was looking for an efficient way to sell or monetize REMIC Residual Interests that it had acquired in the course of its business.<sup>40</sup> The transaction that it developed could be used to generate significant accounting benefits for its counterparty.<sup>41</sup> BT/Deutsche used both internal and external advisors in developing the transaction.<sup>42</sup> BT/Deutsche engaged both King & Spalding and Akin Gump to review the tax consequences of the transaction.<sup>43</sup> BT/Deutsche engaged Andersen (New York) to issue a SAS 50 letter on the accounting treatment of the transaction.<sup>44</sup> BT/Deutsche then promoted the Steele Transaction to Enron in June 1997.<sup>45</sup>

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<sup>38</sup> *Id.*

<sup>39</sup> *See* Third Interim Report, Appendix G (Role of BT/Deutsche and its Affiliates), at 15.

<sup>40</sup> *Id.*, at 30.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 15-16 and 30.

<sup>43</sup> *Id.* at 30.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

**PREPARED TESTIMONY OF  
COMMISSIONER OF INTERNAL REVENUE  
MARK W. EVERSON  
BEFORE THE  
SENATE FINANCE COMMITTEE  
HEARING ON CORPORATE TAX SHELTERS  
OCTOBER 21, 2003**

**INTRODUCTION AND OVERVIEW**

Mr. Chairman, Senator Baucus and Members of the Committee, thank you for inviting me to discuss the subject of abusive corporate tax avoidance transactions with you. I mentioned to you at my confirmation hearing in March that enhancement of the IRS' enforcement activities would be one of my priorities, and your invitation to join you today to discuss corporate tax shelters illustrates the Committee's keen interest in a subject that raises significant compliance issues. I welcome the opportunity to speak to you about it today.

I would like to begin my comments today by describing for you how I view abusive transactions from the standpoint of the position I have occupied since this past May.

A theme I have emphasized since assuming my role as Commissioner of the IRS is that "Service plus enforcement equals compliance." To me, this means that, in order for the IRS to pursue the goal of compliance with our tax laws, the IRS must provide a level of service to taxpayers that merits their respect and cooperation. I want to be clear that the overwhelming majority of taxpayers, whether individuals or businesses, are honest and law abiding. Taxpayers deserve efficient, professional and fair tax administration, for this will enhance compliance. Enforcement similarly must reinforce taxpayers' trust that their own good faith in complying with our tax laws is matched by that of their fellow citizens. That is, we need to strike the right balance.

My intention in bringing this message to the Service's employees is to emphasize that both providing service and ensuring compliance are vital to the Service's success in the era after the 1998 IRS Restructuring and Reform Act (RRA 98). The importance of not sacrificing one for the other must mark our approach. My conviction on this point has only grown in the nearly six months I have been at the Service.

Consistent with the clear statutory mandate and strong legislative message of RRA 98 to improve service to taxpayers and to protect taxpayer rights, the IRS has demonstrated unmistakable progress in improving customer service and incorporating and increasing its recognition and respect for taxpayer rights. The

Service will continue to strive to improve service to America's taxpayers building on the important foundation established by Commissioner Rossotti. At the same time, we will make sure that the improvements in the Service's enforcement capabilities continue, as well.

Work needs to be done by the IRS to ensure that all taxpayers pay their fair share of taxes and to support best practices among tax professionals. The Treasury Department has asked Congress to assist in this effort by passing legislation to strengthen certain provisions of the Internal Revenue Code to make them more effective in curtailing abusive transactions. We appreciate this Committee's efforts to secure passage of that legislation, and hope that its enactment will soon occur.

Before discussing what the Service has done with respect to abusive tax avoidance transactions and what I see the Service doing in the future, I want to emphasize several considerations that I believe ought to be taken into account in considering and evaluating the IRS' approach to abusive transactions.

First, abusive tax transactions are a product of the structure and complexity of the Internal Revenue Code. While I do not plan to address technical and definitional issues about abusive tax transactions today, I want to state my belief that many abusive tax transactions are fashioned in the likeness of legitimate transactions that are permitted under the Code. Others are the beneficiaries of the Code's length and complexity, which provide fertile ground for the creativity of tax planners and provide camouflage that the Service's agents must pierce in order to determine that a particular product or transaction is in fact abusive. The latest generation of abusive tax transactions has been facilitated by the growth of financial products and structures whose own complexity and non-transparency have provided additional tools to allow those willing to design transactions intended to generate unwarranted tax benefits.

Second, abusive transactions that are used by corporations and individuals present formidable administrative challenges. The transactions themselves can be creative, complex and difficult to detect. Their creators are often extremely sophisticated, as are many of their users, who are often financially prepared and motivated to contest the Service's challenges.

Third, because of these factors, the Service will always face a variety of tax avoidance products and structures. Some will constitute abusive transactions and will merit Service challenge. Some will come close to that line but not go over it and will not merit enforcement. Still others will straddle the line and will have to be assessed on a product-by-product basis.

The Service will continually evaluate the initiatives and steps that we have taken and that we plan to undertake with respect to abusive tax transactions in light of

the foregoing factors. I expect our decisions going forward to be subject to the following standards.

First, our efforts must be balanced. We must present a real and credible risk of detection and audit for those considering selling or entering into abusive transactions. At the same time, however, we must not emphasize this to the detriment of other priorities.

Second, enhancements to the Service's compliance efforts must be matched by continued improvements in service to taxpayers. Service enhancements will benefit not only the taxpayers but also the Service itself. Better service to taxpayers results in better compliance. For those taxpayers who are the subject of Service compliance efforts, improved service can still result in mutual benefits. Decreasing audit-cycle times, for example, will benefit both the Service and taxpayers because both suffer when audit cycles are prolonged.

Third, we must continue our efforts to ensure that the right resources and tools are being applied to the right problems. This can be achieved through the careful identification of priorities and through the more efficient allocation of resources to meet those priorities. We must look for ways to use additional administrative guidance to decrease controversy if the controversy results from a lack of clear rules. This is important for taxpayers, and it is important for the Service because it allows resources to be focused on other priorities. We must look for ways to continue working with the Justice Department to ensure that the right types and volume of cases are being selected for litigation. Finally, to preserve the balance between compliance, service, and enforcement, we must continue to improve compliance through service initiatives.

Mr. Chairman, the IRS, the Treasury and Justice Departments and the Administration are firmly committed to curbing abusive tax transactions. They are an affront to honest taxpayers and practitioners and undermine confidence in the fairness of our tax system. The Congress and our taxpayers have every right to expect diligence, care and professionalism from the IRS in this effort, and I will do my utmost to see that those qualities are applied to our effort, without compromising taxpayer rights.

#### **LEVERAGE**

Faced in recent years with growth in the volume of abusive transactions, including abusive tax shelters, a discernible increase in the variety and non-transparency of financial products and transactions that could be vehicles for abusive tax shelters, and a disturbing decline in corporate conduct and governance, the IRS has undertaken efforts to enhance its response to abusive transactions.

An important criterion in the Service's selection of responses to this enforcement challenge is leverage. Leverage is desirable in order to obtain the maximum effect, relative to the Service's available resources, in ensuring compliance by collecting revenues owed by taxpayers to the Treasury from abusive transactions already in existence, and in influencing current and future taxpayer behavior with respect to abusive tax shelters.

The Service has selected, among the enforcement alternatives identified below, tools that provide good leverage. I believe that the leverage the Service gains from disclosure and other information gathering techniques and from targeting of promoters of tax shelters, including abusive transactions, is particularly effective.

#### **EARLY IDENTIFICATION**

Early identification of questionable transactions permits the IRS to gather information and issue guidance. Notifying the public of the IRS's position with respect to current transactions, coupled with a vigorous enforcement of the disclosure, registration and list maintenance requirements discussed below, deters taxpayers from playing the audit lottery and participating in abusive transactions.

There are three ways the IRS finds out about questionable transactions. One, taxpayers and promoters are required to disclose or register questionable transactions and maintain investor lists under sections 6011, 6111 and 6112 of the Code. Two, the IRS identifies questionable transactions through the examination process. Three, the IRS and the Treasury Department occasionally find out about transactions through anonymous tips, such as through the Office of Tax Shelter Analysis ("OTSA") Hotline.

Once the IRS finds out about a new potentially abusive transaction, the promptness of the Service's response is important. Prompt action, such as through the issuance of public guidance with respect to a new potentially abusive transaction, can be effective in limiting the spread of that shelter. Failure to identify and react to abusive transactions quickly, on the other hand, can allow the transaction to spread, for several reasons.

First, absent prompt challenges to these transactions, taxpayers may assume, incorrectly, that the IRS has tacitly approved the transaction or simply may not catch up with it. A "follow the crowd" mentality can set in. Other taxpayers begin to think that they might as well enter into aggressive transactions themselves. They may perceive a loss of opportunity or a competitive disadvantage if they do not enter into these aggressive transactions and little risk if they do. Indeed, when the IRS finally takes action to shut down the transaction, taxpayers and promoters may have moved on to the next generation of the abusive transaction.



Second, when the IRS is slow to uncover new potentially abusive transactions and loses the opportunity to react quickly to them because of delays in obtaining information about their existence, it must address more cases through audit and litigation. Litigation, for example, will always be necessary to demonstrate to taxpayers that the Service will hold them accountable when other methods have failed. Both audit and litigation are, however, slower processes than published guidance and hence less effective in containing the spread of new tax avoidance transactions.

We want to address the problem of abusive transactions at the front end, and we want to stay apace with the market, in order to retard and curtail their spread.

#### **DISCLOSURE**

In February 2003, the IRS issued final regulations under sections 6011, 6111 and 6112 to improve and enhance the disclosure of potentially abusive transactions by taxpayers, the registration of those transactions by "material advisors" (also sometimes known as "promoters"), and the maintenance of customer lists by those advisors. These regulations are designed to improve our information about potentially abusive transactions, about those promoters who market them and about those taxpayers who invest in them, by requiring taxpayers to disclose "reportable transactions" on their returns and to the OTSA, by requiring promoters to register their tax shelters with the IRS, and by requiring promoters and other persons to maintain lists of investors in their tax shelters and furnishing those lists to the IRS upon its request.

A reportable transaction may or may not be an abusive transaction. But by subjecting a range of transactions that should include most abusive transactions to a much greater likelihood of detection by the IRS, we believe these provisions shift the risk/reward calculus of entering into abusive transactions substantially in the government's favor.

The number of disclosures received from taxpayers has been increasing significantly and we expect to receive more taxpayer disclosures in calendar year 2003 than in any previous year.

#### **IRS RESPONSE TO DISCLOSED AND IDENTIFIED TRANSACTIONS**

Early identification is only as valuable as the IRS response to the transactions that have been identified. To avoid the delays that had previously hampered our efforts, the IRS has launched efforts to ensure a coordinated approach and response as quickly as possible to questionable transactions once they are identified.

We believe that, once a transaction becomes listed, taxpayers are reluctant to enter into it. By deterring taxpayers, we save audit resources. In addition,

agents in the field know to focus on these transactions both in promoter and taxpayer audits, and we are better able to assure a coordinated response to these transactions, consistency across the country and fairness. We must identify these transactions more quickly, and I will be working with the IRS' Chief Counsel and Treasury to identify ways to do that. One idea I know Assistant Secretary Pam Olson has mentioned publicly is "yellow light" rulings – where we issue a public announcement that we are aware of and evaluating a transaction even though our analysis may not be complete. There are pros and cons to this idea, but this is an example of the type of idea that we should consider to advance our progress on this front. Signaling the Service's interest or focus can be appropriate even if our conclusion is not fully developed.

The Office of Chief Counsel and the Large and Mid-Size Business Division have implemented transaction-specific task forces to address tax shelters. The task forces are formed for specific transactions or a group of transactions, and include attorneys from the appropriate operating divisions of Chief Counsel, attorneys from the technical divisions of Chief Counsel, the Treasury Department and OTSA. In addition, revenue agents may be assigned to each task force.

Use of such task forces allows the Service to distinguish between sound and problematic transactions and to determine the kind of guidance appropriate to the transaction, and permits both follow-up on the transaction and prompt issuance of guidance. Decisions on whether to issue a notice alerting taxpayers that the IRS will challenge a transaction are made early and jointly with the Treasury Department.

Through improved disclosure and registration regimes, the Service intends to become aware of these transactions earlier, and to be able to address them closer to the start of their life cycle. The task forces will achieve consistency through the system. Furthermore, cross-checking of issues identified on audit with disclosure and registration will become easier. This increases the likelihood that taxpayers who have invested in questionable transactions will be identified and subject to examination.

## **GUIDANCE**

The published guidance program is an important tool that the IRS can use to increase disclosure and compliance. The IRS has in recent years made significant progress in accelerating and increasing its issuance of published guidance and our intention is to continue to improve our performance in this area.

Informing taxpayers through published guidance that we are aware of abusive transactions and who has invested in them will discourage participation in them. And there is another side to the coin – a very positive one that is sometimes forgotten. Some transactions that are worthy of IRS scrutiny may nevertheless prove to be sound under the law. Our willingness to indicate transactions that

the Service believes are permitted under the tax law should encourage promoters and taxpayers to come to us with transactions that they believe are technically sound. In addition, through published guidance in non-shelter areas we can save audit resources that we can then devote to areas with higher risk of noncompliance.

I would like to point out that the Service made great strides in the area of public guidance under the tenure of B. John Williams, the IRS's former Chief Counsel, who left the IRS this summer. I would like to thank B. John for advancing the Service's performance in this key area and I intend to build on those advances.

### **FOCUS ON PROMOTERS**

A significant priority in the Service's efforts to curb abusive transactions is our focus on promoters.

Initiatives focused on promoters can provide a number of benefits. Promoters are required to maintain investor lists that identify taxpayers who participate in or purchase tax shelters that are "reportable" or "listed" transactions under the Service's rules. Such shelters can be and sometimes are abusive. By auditing the promoters and obtaining investor lists and following up with audits of those investors, we can deter the promotion of as well as the thirst for such products.

The IRS has focused its attention in the area of tax shelters on accounting and law firms, among others. The IRS has focused on these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers.

Where the IRS believes a firm has failed to comply with the rules, the Service will not hesitate to audit, whether the firm is a prestigious and well-known organization or a lesser known firm. I believe that validation of the IRS' position in these actions will draw the attention of professional firms and prospective tax shelter purchasers alike.

### **Promoter Audits and Examinations**

Examination and audit of promoters' compliance with the registration and list maintenance requirements of sections 6111 and 6112 are very important tools to combat abusive transactions.

The IRS conducts promoter examinations to determine whether a promoter has complied with regulations requiring identification of potentially abusive transactions by registering such transactions and maintaining and providing investor lists to the IRS upon request. As discussed further below, some promoters have cooperated by giving the IRS the information to which it is entitled; however, others have not.

The IRS has currently approved 112 entities for promoter examinations under sections 6111 and 6112, compared to 22 entities approved by December 2001. There are currently 94 active audits; 12 are approved but not yet started; and 6 examinations have been closed or discontinued. We have issued 305 summonses to 35 promoter entities. Promoters under examination include accounting firms, law firms, insurance companies, brokerage companies, banks and other boutique and mid-size promoters. The Tax Division of the Justice Department has filed summons enforcement actions against 6 promoters to date, and more enforcement actions are likely. We appreciate the strong actions of the Justice Department in this area.

We have shown that we are willing to use the tools at our disposal to obtain the information promoters are obligated to provide to us. Through the web of information, including transactions and investor identities, generated by these efforts, we are demonstrating that there is a credible risk of detection and audit that should be factored into the risk-reward calculus by promoters and investors alike. Mr. Chairman, we believe we can do a lot more in this area and you can expect us to continue our efforts.

#### **COORDINATION OF IRS EFFORTS**

I have asked our new Deputy Commissioner for Services and Enforcement, Mark Matthews, to assess our current structure and to assist me to prioritize enforcement initiatives and reengineer processes to enhance compliance with our tax laws, in particular with respect to tax shelters. As some of you may know, Mark comes to us with a distinguished record as a prosecutor, an IRS executive, and a private sector executive. I am also pleased to report that the Service has just recently enlisted John C. Klotsche, a former chairman of the international law firm of Baker & McKenzie, to join the IRS to help coordinate the agency's efforts to combat abusive transactions and improve enforcement processes. John will serve as Senior Advisor to me and will also work closely with Mark. Mark and John will target intra-agency coordination with respect to tax shelters as one of our priorities.

Mark's and John's efforts will build upon the efforts that have already taken place. These include OTSA, which the IRS established in February 2000. OTSA operates under the umbrella of the Large and Mid-Size Business (LMSB) Division. OTSA plans, centralizes and coordinates LMSB's tax shelter operations and collects, analyzes, and distributes within the IRS information about potentially abusive tax shelter activity. It plays a vital role supporting our frontline examiners. OTSA also maintains a Tax Shelter Hotline to which interested persons can submit information on abusive transactions by phone, e-mail, letter or fax.

#### **COORDINATION WITH JUSTICE DEPARTMENT**

We have developed a strong working relationship with the Department of Justice. Deputy Attorney General Larry Thompson provided a great deal of support during his tenure with the Department. I am very pleased with the efforts being provided by Eileen J. O'Connor, Assistant Attorney General of the Justice Department's Tax Division, and her staff, and I can testify that the Tax Division is partnering effectively with respect to abusive transactions. IRS Counsel meets regularly with the Department of Justice to assist in litigation of abusive tax avoidance cases and to provide a coordinated process on promoter cases. Counsel attorneys serve too on DOJ trial teams for selected abusive tax avoidance cases. In addition, Counsel regularly coordinates with DOJ regarding issuing and enforcing promoter summonses.

#### **COORDINATION WITH THE STATES**

The IRS recently entered into a nationwide partnership agreement with 40 state tax agencies and that of the District of Columbia to combat abusive tax avoidance. Under agreements with individual states, the IRS will exchange information about abusive transaction leads with participating states. This will allow the IRS and state agencies to avoid duplication and to piggyback on the results of each other's work. The states and the IRS will then share information on any resulting tax adjustments, reducing the need for duplicating lengthy taxpayer examinations by both a state and the IRS.

#### **SIGNIFICANT RECENT IRS ACTIONS**

Over the recent past, the IRS has taken a number of noteworthy actions to combat abusive transactions. You are probably familiar to varying degrees with most or all of these actions. They all center on the themes of greater transparency and developing and using a web of information curb these transactions at the front end.

##### **Disclosure Initiative**

The IRS continues to obtain benefits from its tax shelter compliance efforts as we evaluate information produced by the 120-day disclosure initiative that ended on April 23, 2002. The initiative provided taxpayers an opportunity to disclose questionable transactions to the IRS. Under the terms of the initiative, if taxpayers provided all relevant information about the disclosed transactions or items, the IRS would waive certain accuracy-related penalties that may apply to tax shelters and other questionable items that resulted in an underpayment of tax.

OTSA has recorded 1,689 disclosures from 1,206 taxpayers who disclosed their questionable transactions. These disclosures are assigned to field agents who

are contacting taxpayers to determine appropriate resolution of their various issues.

Importantly, the IRS is using the disclosures to identify tax shelter promoters. We are aggressively examining the activities of these promoters to determine whether they complied with their legal obligations to register certain shelters and maintain investor lists. Upon receipt of the investor lists from promoters, the IRS will be able to identify other taxpayers who participated in tax shelters and failed to disclose them.

### **Settlements**

In November 2002, The Treasury Department and the IRS announced that taxpayers involved in three types of tax shelters would have limited times to accept IRS offers to resolve their tax issues. After the settlement periods ended, the IRS began pursuing the remaining cases through its usual compliance processes, including litigation when appropriate.

The settlement offers require taxpayers to pay significant amounts of tax, plus interest. Both the government and the taxpayers avoid expensive litigation on these issues. The specific settlements depend on the merits of each transaction and each case. The IRS will also consider whether penalties should apply where taxpayers did not previously disclose their abusive transactions.

Through this type of initiative, we can solve cases without months or years of costly litigation while making it clear to taxpayers who may consider participating in abusive tax shelters in the future that they will end up in a bad deal.

The IRS identified two of the shelters – known as the Section 302/318 basis shifting and the Section 351 contingent liability – as listed transactions in notices issued in 2001. The IRS has not previously offered any settlements related to these transactions. Participants in the basis shifting transaction had until December 3, 2002, to notify the IRS of their decision to take advantage of this settlement initiative. Those participating in the contingent liability transaction had until January 2, 2003, to apply for resolution of their tax liability under one of two settlement processes. Over 90% of the known participants applied for the 302/318 settlement and the IRS is working with taxpayers to enter into closing agreements to resolve these cases. Of 126 known participants in the 351 contingent liability shelter, 62 applied for resolution under the settlement process.

The third shelter – highly leveraged corporate-owned life insurance (COLI) – has been found to be abusive by the courts. Since August 2001, the IRS has offered those taxpayers with leveraged COLI plans a settlement in which they retain 20 percent of the claimed benefits. This offer is being discontinued because, after several court victories, it was considered appropriate to give taxpayers a deadline to decide whether to accept the offer or litigate. Taxpayers received

letters giving them 45 days to accept the offer before it ended. Twenty-five taxpayers participated in this resolution process.

### **Workpapers**

To help the IRS shut down abusive transactions, the Service may now request tax accrual workpapers when we audit returns that claim a tax benefit from listed transactions.

This limited expansion of when the IRS will request tax accrual workpapers is critical to our ongoing effort to curb abusive tax avoidance transactions and to ensure compliance with the tax laws.

In all other cases, the IRS is continuing to apply its current policy of requesting tax accrual workpapers only when unusual circumstances warrant such a request. Tax accrual workpapers normally are prepared by taxpayers and their independent auditors to evaluate the taxpayer's tax reserves for financial accounting purposes.

### **KPMG/BDO Seidman**

In July 2002, the Justice Department, on behalf of the IRS, filed suit in federal court in Washington, D.C. against KPMG LLP, asking the court to compel the public accounting firm to disclose information to the IRS about all tax shelters it has marketed since 1998.

In a similar suit filed in Chicago, the Department asked the federal court there to enforce summonses issued to the public accounting firm, BDO Seidman, LLP, for information related to its marketing of tax shelters since 1995.

According to the court filings, KPMG has failed to provide all the documents the IRS had requested in connection with its probe into KPMG's compliance with these requirements and its potential liability for penalties. Although KPMG has produced many documents to the IRS, it has also withheld a substantial number of documents that the government has requested.

Similarly, the court papers filed in the case against BDO Seidman seek to obtain information concerning tax shelter transactions that the Government believes BDO Seidman has marketed. BDO denies that it has promoted any such transactions. This summer the Seventh Circuit upheld our right to obtain the investors' names.

### **Jenkins & Gilchrist**

Earlier this year, the Department of Justice on behalf of the IRS petitioned the United States District Court, Northern District of Illinois, for enforcement of five

administrative summonses and a John Doe summons served on Jenkens & Gilchrist. The summonses ask the law firm to provide information on certain listed transactions or other potentially abusive transactions organized or sold by the firm's Chicago office and identify taxpayers who may have invested in them. This is the first case of its kind involving a law firm.

#### **Grant Thornton**

On September 17, 2003, the Department of Justice, on behalf of the IRS, filed a petition in the U.S. District Court, District of Columbia, to enforce nine administrative summonses issued to the accounting firm, Grant Thornton LLP.

The summonses were issued as part of an IRS examination to determine Grant Thornton's compliance with tax shelter registration and list maintenance requirements, including identifying taxpayers who may have invested in potentially abusive transactions organized and sold by the firm.

#### **Ernst & Young**

Finally, on July 2, 2003, the IRS announced a closing agreement with Ernst & Young, LLP, resolving issues relating to an examination of Ernst & Young's compliance with the registration and list maintenance requirements regarding the firm's marketing of tax shelters. The agreement requires Ernst & Young to make a non-deductible payment of \$15 million.

In addition to the payment, Ernst & Young agreed to work with the IRS to ensure ongoing compliance with the registration and list maintenance provisions of the Internal Revenue Code and regulations. To this end, Ernst & Young agreed to implement a Quality and Integrity Program to ensure the highest standards of practice and ongoing compliance with the law and regulations. The IRS may, upon its request, review documents prepared as part of this program.

Ernst & Young also agreed to our disclosure of its settlement and certain of the terms of the settlement. I mention this settlement last because I consider it important in spreading our message to other firms in the marketplace.

We are pleased that Ernst & Young has cooperated fully with the IRS in resolving these matters. This represents a real breakthrough and is a good working model for agreements with practitioners.

#### **Differentiation in Approach**

Mr. Chairman, looking at the big picture, we are trying to differentiate between those who cooperate with the IRS, who try to remedy past mistakes and who seek transparency in their dealings with the Service, and those others who



simply refuse and continue to peddle abusive transactions. Our intention is to differ in our approach to them based on their behavior.

I also hope that the marketplace will differentiate between those who provide legitimate tax planning advice and those who sell abusive transactions. We question whether most investors want to buy tax products from firms whose professional standards cross over the line.

### **GOING FORWARD**

The challenges presented to the IRS by abusive transactions continue to call for a greater and more effective response from the Service, whether or not the future volume of abusive transactions were to decline. Given the complexity and size of the Code, opportunities to create abusive tax avoidance transactions will always exist. The growth in the use and variety of complex financial products and structures will provide more vehicles for the creation of tax shelters.

Given these factors, how should the Service respond?

First, we must do better with the existing tools at our disposal.

Second, we must consider what additional tools the Service and the Treasury can reasonably ask Congress to provide.

Third, we must weigh what others outside the Congress, the Treasury and the IRS can do to address this problem.

### **Using Existing IRS Tools**

I discussed above the various initiatives and tools that the IRS already has used in trying to address the problem of abusive transactions. It is my responsibility as Commissioner to ensure that the Service uses these tools as effectively as possible. As I indicated above, it is also my responsibility to ensure that, in doing so, the Service does not compromise service, and that indeed service continues to improve.

I regard the areas in which the Service has the greatest potential for improvement in the fight against abusive transactions to be the following:

Prioritization. The Service needs to prioritize its audit focus and apply proportionately greater resources to areas where we believe there are, or where we expect to find, compliance issues. Advances have already been made in this regard by LMSB through the use of pre-filing agreements and limited issue focus examinations, and these efforts must continue and expand.

Transparency. The Service must continue to seek the prompt collection of information about abusive transactions, both actual and potential, through examinations, the registration rules of Sections 6011, 6111 and 6112 and third party contacts. We must then produce published guidance regarding those transactions quickly without compromising the quality of analysis.

Reduction of Audit Cycles. The Service needs to reduce the audit cycle time of corporate and other non-individual taxpayers. An audit duration of 5 years is too long. Audit issues, including those that might arise in connection with abusive tax shelters, often do not become clearer as they age, but rather less clear. Reduction in cycle time is also a worthy goal from a service standpoint. We also need to get more current with the marketplace; that is, audit returns as soon after they are filed as possible, and not 5 or 10 years later. This requires us to take a closer look at a number of alternatives in order to reduce audit cycles: encouraging greater use of electronic filing, reexamining and reengineering the audit process, and more effective use of technology, in particular.

Focus on Promoters. The focus on promoters to date has generated valuable gains to the Service's compliance efforts and shown the promise of generating even more gains. Particular tools that can be utilized with respect to promoters include audit and enforcement of the registration and list maintenance requirements under Sections 6111 and 6112 of the Code. The Service should continue to emphasize and increase this focus.

Increase Allocation of Resources to Enforcement. The IRS must allocate additional resources to enforcement. It must do so in a way that will not impede the continuing increase in the IRS' service levels. I have asked all the Divisions to take a hard look at this to enhance our enforcement performance without jeopardizing improvements in service.

Regulatory Changes. One step the IRS can take is to aim for clear and prompt guidance concerning potentially abusive transactions. The Service needs to answer the tough questions in published guidance before a transaction is entered into and not after an audit or through litigation. I have been advised both by responsible outsiders and by my own personnel that clear and prompt guidance can be an extraordinarily useful resource. It can serve to alert professionals and taxpayers that a transaction has, in the Service's view, crossed the line or merits particular attention from us. Such a message can significantly limit the spread of an abusive transaction, and this benefit is greater the earlier that guidance is issued. The Service also owes the professional and taxpayer communities guidance when the Service determines that a transaction does not cross the line and is in our view permissible under the law.

I am convinced that effective use of clear and prompt guidance will pay substantial dividends in the battle against abusive tax avoidance transactions. In

order to provide such guidance, of course, we must continue to make effective use of the disclosure, registration and list-maintenance requirements.

#### **Obtaining Additional Tools**

The Treasury Department has solicited support for a number of legislative proposals intended to curb abusive tax shelters. My colleague Pam Olson will discuss those proposals with you. We appreciate that these proposals have been included in legislation passed by the Committee. In addition, if we identify the need for additional legislation, we will work with the Treasury to bring those areas to the Committee's attention promptly.

#### **Assistance from Outside the Government**

Mr. Chairman, at my confirmation hearing last March, I stated that "attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention." Six months later, I believe as strongly as ever in that statement.

I do not believe that most tax professionals are personally engaged in the generation or promotion of abusive tax avoidance transactions. Indeed, I believe that most tax professionals have viewed the marketing of such transactions to taxpayers with dismay and alarm. Some have urged us to pursue promoters and investors in these transactions because they undermine the tax system.

Tax professionals who advise against abusive transactions can be criticized as being too conservative by their clients and potential clients and by the promoters who take business from such honest practitioners. These actions should instead be encouraged.

In that regard, we are working both inside and outside the Service to improve best practices among tax practitioners. On the regulatory side, Circular 230 establishes standards of ethical conduct required of professionals who practice before the IRS. The Treasury and the IRS believe that changes should be made to Circular 230, pursuant to our existing authority, to help curb abusive transactions. Among the subjects we are closely examining in this regard are the standards employed in legal opinions that are used by taxpayers in support of abusive transactions. I have asked Mark Matthews, the new Deputy Commissioner for Service and Enforcement, to make the strengthening of the Service's regulatory authority under Circular 230 one of his priorities.

The Service's Office of Professional Responsibility, which is charged with enhancing the oversight of tax professionals, also is working with associations of tax professionals in dealing with representatives who fail to meet the standards of professional conduct. Tax professional organizations are close working partners with the IRS and they understand the problems that result when members abuse

the tax system. The creation of this office is a direct result of the concerns of the professional organizations. Our goal is to encourage best practices that rise above minimum standards, and these organizations are well positioned and interested in bringing about such a change.

#### **RESOURCES AND BALANCE**

Mr. Chairman, concern has been expressed in some quarters that the IRS does not have the resources to deal with the problems that I have described. Clearly, we must provide *both* quality customer service and enforcement, based on a foundation of taxpayer rights, if we are to achieve compliance. There is no question that the IRS has poached resources from enforcement to boost customer service in the wake of RRA 98.

The difference now is that times and conditions have changed. The IRS is continuing to improve its service. Now, the IRS must bring the same focus and energy to improving its compliance efforts as it did to improving the service side.

Our sharpened focus must not come at the expense of taxpayer rights. Quite the contrary, our program will be built on a sound foundation of taxpayer rights.

We will not sacrifice quality standards in casework. We will not relax standards of professional conduct. We will not use statistics to evaluate employees. We will not establish quotas for personnel.

And we will not reduce our commitment to continued quality customer service. We can and must provide customer service and enforce the law. In other words, we can and must have balance. Enhanced compliance and improved customer service are not mutually exclusive. They are the two interlocking pieces that make up compliance. We must succeed at both to succeed in our larger mission.

#### **CONCLUSION**

Mr. Chairman, abusive transactions can and will continue to pose a threat to the integrity of our tax administration system. We cannot afford to tolerate those who willfully promote or participate in abusive transactions. The stakes are too high and the effects of an insufficient response are too corrosive. We have put in place the foundation and structure to begin to attack these transactions in a systematic way. Certainly we will need to do more and we will need to do it better.

We have begun to hear suggestions that the use of abusive transactions among some groups may already have begun to ebb. If this is true, we believe that IRS efforts may have played a significant role in this development. Some promoters and some taxpayers may be recognizing the increased risk of detection and audit of tax returns claiming tax benefits from abusive tax avoidance transactions. In

any event, it is my view that this problem is significant and will be continuing, and we need to increase our diligence and effort in this area

While we may have made some progress, far more needs to be done. We must continue and amplify our efforts, and use our resources more efficiently. I believe that if we continue to focus on the areas described in this testimony, the Service will be able to limit the corrosive effects of abusive transactions and increase trust in our tax system.

I would be very pleased to answer any questions the Committee might have.

Thank you.

**WRITTEN TESTIMONY OF MICHAEL HAMERSLEY  
THE UNITED STATES SENATE FINANCE COMMITTEE  
OCTOBER 21, 2003**

**I. INTRODUCTION**

Good morning Senators. My name is Mike Hamersley. I earned my J.D. degree from Georgetown University Law Center in 1995. I also received M.B.A. and B.B.A. degrees prior to attending law school. My career at KPMG began in 1998 when I joined the Mergers and Acquisitions Group of KPMG's Washington National Tax office ("WNT"). I relocated to KPMG's downtown Los Angeles office in March 2000.

I noticed that I am listed in the program as a former employee of KPMG, LLP ("KPMG"). It seems that there are quite a few folks who are confused about my employment status. Well, let me see if I can be of some assistance. KPMG insists that I am not a former employee and that I remain employed as a Senior Manager in their Los Angeles Mergers and Acquisitions Tax Practice.<sup>1</sup> The confusion regarding my employment status is understandable. I do still receive a paycheck; however, I am not permitted to use the office, voicemail, email, computer network, or any other KPMG resources.

My performance ratings were "exceptional" throughout my tenure in Los Angeles and I was nominated for promotion to partner in 2002. However, in October 2002, after refusing to endorse or participate in what I believed to be illegal conduct and very soon after acknowledging that I had communicated with federal investigators, I was placed on

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<sup>1</sup>KPMG is a "Big 4" public accounting firm. It's principal practices are Audit and Tax. The Audit practice offers advisory and assurance services to large and midsized businesses. The Tax practice offers a variety of federal, state, and other tax services to businesses (including Audit clients) and certain high wealth individuals.

administrative leave of absence. As a result of these events and upon learning that certain KPMG partners had maliciously disseminated false statements about me in an effort to discredit me, I filed a lawsuit against KPMG and certain of its partners.<sup>2</sup>

Perhaps, most confusing of all, is the fact that after more than one year from the time I was placed on leave, KPMG still has not provided me with a clearly articulated reason as to exactly why it is that I was placed on such leave. KPMG has made vague reference to at least three possible explanations, however, each one has been less credible than the last.

In my lawsuit, I described the coercive tax shelter environment that I observed at KPMG. I also briefly described some of the most significant problems that resulted from this environment. The circumstances that gave rise to my whistleblowing and which prompted KPMG to place me on administrative leave involved my participation in the tax provision review of a KPMG audit. The events described in my lawsuit illustrate one of the most significant and harmful “collateral problems” that arise in connection with the promotion of abusive corporate tax shelters by public accounting firm, which is violations of SEC auditor independence rules.

#### I. SCOPE OF TESTIMONY

The topic of corporate tax shelters involves myriad and complex issues. In my testimony here today, I will first provide a brief overview of what I believe to be the most significant and serious problems associated with the promotion of abusive tax shelters<sup>3</sup> I will then discuss a few of the more significant “collateral problems” that can arise in

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<sup>2</sup> The complaint was filed in Los Angeles Superior Court (Case No. BC 297209) on June 23, 2003. The complaint was republished in its entirety by Tax Analysts in Tax Notes Today (Doc. 2003-14368).

<sup>3</sup> Although my testimony addresses only federal income tax strategies, similar issues exist with respect to the promotion of state tax shelters.

connection with the promotion of abusive corporate tax shelters by public accounting firms.

## II. DISCUSSION

### A. Identification of Some Concerns Associated With Abusive Tax Shelters

As a Senior Manager in KPMG's Los Angeles Mergers and Acquisitions Tax Practice, I provided transactional planning advice and review with respect to the federal income tax consequences of mergers, acquisitions, dispositions, and corporate restructurings. Although I did not promote abusive tax shelters, I was often contacted by KPMG Tax partners seeking advice on corporate tax shelters that were being promoted to their clients. I also worked in close geographic proximity to many of KPMG's most prolific tax shelter promoters. As a result, I witnessed a host of abusive tax shelter practices during my tenure in Los Angeles.

#### 1. Abusive Tax Shelters in General

Most tax shelters involve some contortion of the law. Tax shelter promoters often misrepresent even gross contortions of the law as a "loopholes" when, in fact, a reasonably thorough and intellectually honest evaluation of most such "plays" generally yields a conclusion that Congress clearly never intended the tax benefits purported to be derived from the tax shelter.

The problem of clever tax professionals twisting the law beyond its intended bounds has long existed. Congress, the courts, and the Internal Revenue Service ("IRS") are well equipped to challenge tax shelters that lack technical merit so long as the IRS can timely



identify these shelters and alert prospective tax shelter purchasers to their technical deficiencies and associated risk.

Under the circumstances, it is my opinion that the IRS has done a good job of identifying specific tax shelters and alerting the public regarding their lack of technical merit and risk. This is a good start. However, the most abusive tax shelters of recent years require more than a distortion of the law to be viable. These abusive tax shelters also require a distortion or concealment of facts. They require not only intellectual dishonesty, but also deception, secrecy, and even conspiracy. The reason for such fact distortion or concealment is simple—the promoters know that these transactions could never survive the light of day in court. Such distortion and concealment of facts often occurs both in the design and implementation of the abusive tax shelter (e.g., passthrough entities to mask transaction or facts, side agreements to report different facts for different purposes, abuse of privilege by using attorneys as conduits to facilitate fact concealment, providing false representations about business purpose, step transaction facts, etc.) and in any subsequent IRS administrative controversy actions.

Reasonable minds will differ regarding who, what, and how much should be taxed under existing tax law. However, modifications to existing substantive law made by Congress or Treasury aimed at preventing such contortions of the law will have no real or lasting impact on the incidence or severity of the current tax shelter abuses so long as unscrupulous tax shelter promoters and taxpayers are able to distort and conceal the facts of their transactions. The IRS can hardly be expected to hit what it cannot see.

Any approach to combating abusive tax shelters must strive to prevent “throwing the baby out with the bath water” by unduly punishing legitimate business transactions. The

abusive tax shelters described herein are not merely clever tax planning, nor are they creative solutions for maximizing the tax efficiency of alternative business transactions. These are transactions designed and consummated solely to obtain a tax result. The abusive tax shelters referred to herein are merely “window dressed” with a contrived façade of economic substance that is engineered into the tax shelter by the tax shelter promoters. In such cases, the tax shelter promoters are well aware that many of the facts and representations contained in the associated tax opinion letter (e.g., business purpose and step-transaction facts) are false.

A deliberate distortion of the tax law by a tax practitioner is surely unethical and unprofessional, but it rarely rises to the level of criminal behavior, and such intent is not easily proven. In contrast, a deliberate distortion of fact by a tax practitioner or taxpayer can often constitute criminal conduct. The promoters who engage in such behavior demonstrate an utter disrespect for the law, and those who make and enforce it.

Congress and the IRS must work to shift the risk/reward ratio to create a deterrent for this fact contortion and concealment behavior. Increased enforcement efforts must be focused at preventing this conduct in order to regain respect for the tax system by increasing the probability of a meaningful and proportionate punishment for those who so brazenly flout the law. This needs to happen soon, otherwise, there is a risk that this blatant noncompliance could become epidemic in scope and long-term in duration.

## 2. Specific Practices Associated With Abusive Tax Shelters

During my tenure at KPMG, I have observed several disturbing practices and workplace conditions with respect to the promotion of abusive tax shelters, including but not limited to:

- Tax professionals ignoring unfavorable facts and law, inventing facts, and subtly shifting the responsibility for these false facts to tax shelter clients via the facts and representations included in the tax opinion letters associated with tax shelters (i.e., opinion letters based on hypothetical facts).
- Tax professionals attempting to conceal from the IRS the existence of a transaction or discovery of unfavorable facts and circumstances associated with tax shelters. This conduct occurred both in the design and implementation of the tax shelters (e.g., side agreements, multi-tier “netting” structures, abuse of attorney/client privilege) and in subsequent IRS controversy matters (e.g., entering into IRS closing agreements without disclosing the existence of a listed transaction in the closed year). Tax shelters having a design or implementation intended to conceal unfavorable facts were often referred to and promoted by certain KPMG tax shelter partners as having “good optics.”
- Tax shelter promoters engaging in conduct that demonstrates a blatant disregard for tax laws and those who write and enforce these laws. Many of these tax shelter promoters openly proclaimed their disregard for the law by making statements to clients and colleagues such “It’s like stealing candy from a baby . . . “You’ll never pay tax again . . . Our clients do not pay federal income tax, paying tax is optional.” In recent years, some tax shelter promoters have trivialized the risks associated with tax promotion of abusive tax shelters making statements to the effect of (i) the IRS will never discover the tax shelter because it does not have the resources or ability to so, (ii) even if the IRS does discover the tax shelter, the law will likely only be changed and enforced prospectively thus the penalties will be minimal, and (iii) all public

accounting firms are selling these tax shelters and the government cannot shut down all of these firm.

- Tax shelter promoters misleading or otherwise inadequately informing tax shelter clients regarding the legal merits and true risks associated with these tax shelters, including the nature of the taxpayer representations provided and the limited scope of protection provided by KPMG's tax opinion letters.
- Tax professionals failing to inform tax shelter clients upon discovery of fatal flaws in tax shelters, particularly where such clients were KPMG audit clients and had already included the benefit of such tax shelters on their financial statements.
- Tax professionals promoting or enabling tax shelter clients to obtain insurance policies to cover tax liabilities associated with abusive tax shelters statements.
- Tax professionals engaging in highly questionable billing practices.

### 3. Abusive Tax Shelter Environment at KPMG

A culture existed in which intimidation and coercion were often used to foster the abusive tax shelter environment. Tax professionals who "played the game" and fully embraced the promotion of abusive tax shelters were rewarded handsomely. However, those who were vocal in raising concerns about abusive tax shelters were stifled and reprimanded and their opportunities for advancement were limited. Many of the tax professionals who expressed concerns regarding abusive tax shelters were instructed by Tax partners not to worry because they were merely following orders and had not signed-off on or approved the abusive tax shelters. These individuals were assured that they could not be held accountable under such circumstances.

My decision to “blow the whistle” was an easy one. I was placed in a position of having no other choice but to participate in the unlawful conduct and bear the associated risk. For most of my career at KPMG, I, like many other tax professionals who occasionally vocalized concerns about KPMG’s tax shelter activity, chose to avoid direct involvement in unlawful activity and refrained from blowing the whistle in fear that it would bring my career to a screeching halt.

Despite the recent adoption of a whistleblower hotline and the new whistleblower protections provided under Sarbanes-Oxley, KPMG employees who might otherwise contemplate blowing the whistle will continue to remain silent because they know such action will require them to sacrifice their career without having any adequate legal recourse. They also fear that KPMG might attempt to sue them if they disclose information about KPMG’s unlawful acts. KPMG has in place a number of measures that have been effective in preventing employees and others from disclosing unlawful conduct on the part of KPMG. Such measures include the use of confidentiality agreements, mandatory arbitration agreements, blackballing of whistleblowers, intimidation and legal maneuvers to stifle meritorious claims, sealing of court documents, and the like.

Indeed, it appears that KPMG has taken the position that the filing of my lawsuit is a breach of their confidentiality agreements. Given this view, KPMG may very well argue that my appearance before this Committee today is prohibited by KPMG’s confidentiality agreements which purport to prevent me from talking to anyone--including Congress and regulators--about anything I learned on the job, including unlawful conduct.

B. Collateral Problems and Concerns Associated with the Promotion of Corporate Tax Shelters by Public Accounting Firms

1. Identification of Some Collateral Problems

The promotion of abusive corporate tax shelters by public accounting firms can have highly detrimental ramifications beyond the obvious drain on federal tax revenues. Some of the collateral problems raised by the promotion or other involvement in corporate tax shelters by public accounting companies include:

- SEC auditor independence issues that can result from a lack of objectivity on the part of the audit firm or the Tax partners performing the tax provision review of an audit.

Generally speaking, in order for a publicly traded corporation to include in its financial statements the benefit derived from a tax shelter, it must be “probable” that the tax shelter will succeed on its merits.<sup>4</sup> There is great potential for auditor independence violations if the audit client has implemented one or more corporate tax shelters<sup>5</sup> and (1) any such corporate tax shelters were developed, promoted, or participated in by the audit firm or any of its partners, or (2) the audit firm or any of its partners promoted or otherwise participated in the same or substantially similar tax shelter.

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<sup>4</sup> This “probable” standard generally requires that the tax benefits have a greater than 50 percent chance of success on the merits (i.e., more likely than not). See FAS 109. With respect to “tax exposure items” including tax shelter transactions, a 70 percent or greater chance of success on the merits (i.e., “should” level of certainty) is required to fully benefit such item.

<sup>5</sup> This conflict is not limited to tax shelters. Similar auditor independence concerns exist for other financial statement improvement strategy or other consulting services that result in financial statement benefit for the audit client if the audit firm or any of its partners participated in the promotion of that strategy or similar strategies implemented by other corporations.

The potential for such conflicts is heightened if any of the Tax partners working on the tax provision review portion of the audit engaged in such corporate tax shelter activity

- Breach of fiduciary duty to audit clients in circumstances where there is a failure to fully disclose and take proper corrective measures when defects or implementation problems are discovered with KPMG abusive corporate tax shelters after consummation of the transaction and after the KPMG audit client has been advised by KPMG that the benefit associated with the tax shelter could be included on its financial statement benefit.<sup>6</sup>
- Conflicts of interest issues arising when a public accounting firm conducts acquisition due diligence of a target corporation that has implemented one or more tax shelters or other financial statement improvement strategies promoted by the firm conducting the due diligence.
- Unanticipated liabilities or other negative consequences resulting from implementation of tax shelter transactions without adequate diligence to determine the impact of the transaction in other jurisdictions, for other regulatory purposes, or under applicable non-tax law.
- Disparate reporting of facts for purposes other than federal income taxes or in other jurisdictions (e.g., financial statements, non-tax regulators, state and foreign

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<sup>6</sup> This can obviously lead to auditor independence and other securities law violations. Discovery and full disclosure of a "fatal flaw" in a tax shelter would almost certainly result in the client incurring a significant tax liability. If the audit client fully benefited the item on its financial statements, correction of this problem would often require a restatement. Disclosure of the true circumstances of such matters would likely result in KPMG being sued for malpractice and losing the client. Compare FAS 109 and FAS 5 standards for addressing tax benefits after already included in financial statements.

tax regulators.). This practice is often facilitated through the use of side agreements and some less sophisticated means. Such disparate reporting of facts is often mischaracterized by tax shelter promoters as being solely attributable to a difference in focus by the relevant jurisdictions or regulators with respect to the substance versus the form of the transaction.

C. Auditor independence issues described in my lawsuit

Generally Accepted Audit Standards (GAAS) and SEC auditor independence rules under Regulation S-X, Rule 2-01 require public company auditors to maintain independence and exercise professional due care and skepticism. SEC rules require that auditors of public companies maintain independence *in fact* and *in appearance*. These rules specifically state that the placing of an auditor in a position of auditing his own work or situations which place the auditor in a position of advocating for the client are both indicia of an inappropriate conflict of interest and lack of auditor independence.

The auditor independence matters described in my lawsuit illustrate the conflicts of interest that can arise when the audit client has implemented corporate tax shelters and there are tax professionals involved on the audit team who have been regularly involved in corporate tax shelter activities. As described in the lawsuit in further detail, some of the facts giving rise to such conflicts of interest included:

- KPMG audit approach was focused on looking for opportunities (to sell tax consulting services), not on finding problems. During the course of the audit, many of the KPMG Tax partners charged with auditing the tax provision regularly discussed, and were often primarily focused on, selling KPMG tax shelters and other tax services. These individuals were often wearing their tax consulting uniforms



while playing on the audit team. They were seeking to develop a relationship with management so as to enable the sale of tax shelters and other value-added tax services.

- Several of the KPMG Tax partners involved in the audit had developed, promoted, or implemented the same or substantially identical corporate tax shelters or other financial statement improvement strategies for other KPMG clients, many of which had also included financial statement benefit approved by KPMG.
- As a result of their desire to win over the audit client management, certain KPMG Tax partners involved on the audit exercised excessive advocacy, lack of objectivity, and professional due care and skepticism, and other improper conduct. These partners often relied on management representations and demonstrated an absolute unwillingness to objectively probe highly questionable transactions refusing to inquire further when client answers on significant matters did not make sense or were clearly inadequate or incomplete.
- Fearing that KPMG might be fired by the client, KPMG Tax partners rapidly reversed their position and permitted the audit client management to include a several hundred million dollar tax benefit while these partners intentionally ignored highly unfavorable facts and law directly on point and failed to conduct any significant research on the most problematic points. Certain KPMG Tax partners subsequently requested that I remove from my audit work papers any negative authority and that I draft a “persuasive brief” supporting KPMG’s favorable conclusion.

## Answers for the Record from Mr. Hamersley

Questions from Senator Baucus:

**Q1. The allegations contained in your lawsuit raise a number of troubling issues. For example, you indicate that the client was “upset” when first informed that KPMG had problems with clearing the tax shelter transaction because the client would have to restate earnings. However, the next morning things had changed and KPMG partners agreed to sign off on the deal. You indicate the partners did this without any memorandum or analysis justifying their favorable conclusion. Do you know whether a favorable report on this transaction was ever made? To what extent was the firm pressured by the client?**

**A1. *Existence of a favorable report?*** As of late September 26, 2002 (my last day in the office), which was long after KPMG reached its “should” level conclusion<sup>1</sup> and well after KPMG knowingly permitted the audit client to report to the public the rosy results of the re-audit, there existed no favorable report or other substantial written analysis on the ABC Partnership Interest transaction that was the subject of the July 31, 2002 meeting and PowerPoint presentation.

***Pressure on KPMG from audit client.*** There is significant evidence that the audit client exerted pressure on KPMG partners with respect to the ABC Partnership Interest issue and other re-audit matters. Certain members of audit client management made various statements and engaged in conduct during the course of the audit that made it clear that management was not amenable to unfavorable answers. It is my belief that such undue influence contributed significantly to the “reversal of fortunes” that took place after the Thursday evening conference call of June 27, 2002. Two significant events occurred after the KPMG Tax partner informed the audit client of the bad news regarding KPMG’s unfavorable view of the ABC Partnership Interest matter:

1. The V.P. of Tax remarked that the timing of this bad news was “awfully late” and was a “big problem.” At that point, it was not entirely clear whether the VP of Tax was confirming that the client had, in fact, already included the tax benefits on their prior period financial statements<sup>2</sup> or whether the “late date” comment was attributable to the fact that his superiors would not look kindly upon such bad news given the impending announcement of the rosy re-audit results. Beginning the following morning, certain KPMG partners stated their belief that the audit client had, in fact, included in its prior period financial statements far more of the tax benefit associated

<sup>1</sup> Note that this “should” level of certainty is required only if full financial statement benefit is to be taken.

<sup>2</sup> In the days leading up to the June 27, 2002 conference call with the client to announce the bad news, one of the KPMG Tax partners had expressed a concern that the client had already included in the prior period the entire amount of the tax benefit associated with the ABC Partnership Interest transaction. The Tax and Audit partners asserted that only \$22 million of the benefit had been taken in the prior period.

with the disposition of the ABC Partnership Interest transaction that KPMG had previously determined.<sup>3</sup>

2. Certain of the KPMG Tax partners also indicated that KPMG would be fired and lose this highly lucrative account if it did not reach a favorable conclusion on this matter.<sup>4</sup>

**Q2. Can you explain why a firm engaged to conduct a re-audit of another accounting firm's work would want to defend the other firm's tax shelter? What motivates the new firm to get comfortable with another firm's tax shelter?**

A2. I believe there were several reasons for this behavior, including the following:

1. One of the purposes of hiring the former Andersen audit partner may have been to mitigate the potential of an unfavorable recharacterization of financial statement items upon a "fresh look" at the transactions by a new auditor.
2. The principal purpose of conducting the re-audit was to improve the public perception regarding the client's financial statements. The audit client management made it clear that it would not look kindly upon any action that was detrimental to its financial statements. Certain KPMG Tax partners were desperately seeking to win over the audit client management by providing favorable financial statement treatment on tax items so as to please management and thereby create opportunities to sell tax services. These Tax partners avoided taking any action might alienate or perturb the audit client management.
3. KPMG and many of the partners involved in the re-audit had promoted or participated in many of the same or substantially similar tax shelters and other non-tax financial statement improvement strategies that were consummated by the audit client during the years subject to re-audit. The KPMG partners could hardly discredit transactions substantially identical to the transactions they had promoted.
4. The former Andersen audit partner involved on the KPMG re-audit had approved or otherwise participated in many or all of the tax shelter transactions and other financial statement improvement strategies. He was effectively auditing his own work.

**Q3. You state in your lawsuit that when Andersen collapsed, KPMG hired the former Andersen audit partner in charge of the corporation's account. This former Arthur Andersen audit partner, who had previously signed off on the financial statement**

<sup>3</sup> This revelation that the financial statement benefit had already been taken in a prior period caused two significant problems beyond the fact that KPMG would likely be fired by the audit client: (i) appropriate correction of the financial statements would require a "restatement" of prior period financials, and (ii) KPMG had contributed to the problem, and thus it would have to "call foul on itself" to properly correct its error.

<sup>4</sup> Note that immediately after the Thursday evening conference call the partners went into their "partners only" mode as they had often done with respect to other highly sensitive matters raised in connection with the re-audit. I was told by one of the Tax Partners that there were also several other high-level partner only conference calls on the morning of Saturday, June 29, 2002 pertaining to the ABC Partnership Interest transaction.

**treatment of these tax shelters in the prior year Andersen audit, was essentially put in charge of the new KPMG re-audit. Do you know whether this person was the same person who originally approved these shelters?**

A3. It is my understanding that the former Andersen Audit partner involved on KPMG re-audit is the same person who approved the inclusion of the prior year financial statement treatment associated with these tax shelters.

**Q4. You state in your lawsuit that KPMG subsequently gave the client a “clean bill of health.” To what extent did KPMG give this clean bill of health knowing that serious problems existed with the shelter transactions? Were you aware of other problems with the re-audit that might have prevented a clean bill of health?**

A4. While reviewing the federal income tax aspects of certain transactions I observed several transactions that raised significant concerns and warranted much more scrutiny on the part of KPMG. Certain KPMG partners were well aware of the serious problems that existed with respect to the tax shelters and other transactions when KPMG gave the client a “clean bill of health” on the re-audit. These partners knowingly or recklessly disregarded significant evidence of such problems.

Despite the highly aggressive and problematic tax shelters and other transactions observed during the re-audit, KPMG permitted the audit client to file a 10-K/A with the SEC that contained KPMG’s unqualified report containing no changes to the balance sheet, net income, cash flow or earnings per share.

**Q5. Can you comment to the Committee about the level of concern at your firm about auditor independence and accountability?**

A5. I was placed on leave of absence in October 2002. As such, I have limited knowledge regarding the firm’s level of concern regarding these matters during the past year. I can, however, provide information regarding my observations during my tenure. With respect to Tax practice partners and professionals, I observed that there was plenty of awareness about auditor independence rules, but very little appreciation or respect for the applicable law, and no genuine concern for the importance of implementing these rules in practice.<sup>5</sup> Although, the Tax practice had no shortage of published policies highlighting certain auditor independence issues that might arise in connection with the provision of tax services to audit client, these policies were not adequately enforced or were easily avoided by Tax partners and professionals when such policies (1) prevented the Tax practice from

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<sup>5</sup> I am aware of one significant exception to this general observation. A few years ago, the SEC became aware of and had significant concern regarding the incidence of partners and employees of Big 5 accounting firms ownership stock of their publicly traded audit clients. During this same general period, KPMG was sanctioned by the SEC for engaging in inappropriate financial relationships with its audit clients. See fn. 8. Since this time, KPMG has put in place extensive measures to help employees identify the companies for which investment or other financial relationships are prohibited. These measures include employee certifications evidencing individual compliance.

selling highly lucrative tax products/solutions,<sup>6</sup> or (2) required the firm to “call foul on itself” with respect to deficiencies in KPMG tax shelters.<sup>7</sup>

With respect to the Audit practice, I observed that there was keen awareness and some concern for independence rules related to *prohibited financial relationships*. I believe this was due to principally to the fact that KPMG had been the subject of recent SEC sanctions, censures, cease-and-desist orders associated with prohibited financial arrangements with its audit clients.<sup>8</sup> There was also a general awareness of auditor independence issues associated with KPMG Consulting activities.<sup>9</sup> However, my observation was that there was far less awareness and practically no appreciation or concern by Audit partners or professionals for the auditor independence issues that

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<sup>6</sup> The scope of potential auditor independence compromising conduct was not confined to the sale of tax shelters to audit clients. KPMG also entered into other arrangements with audit clients related to the marketing of KPMG tax shelters. The SEC has recently launched an informal inquiry regarding auditor independence issues raised by the referral of wealthy banking customer's by KPMG's audit client, Wachovia Corp. (formerly First Union Corp.) to KPMG for the purpose of engaging in tax shelter transactions designed to mitigate large capital-gains taxes.

<sup>7</sup> These situations illustrate the dangers of “auditing your own work” and why the SEC views such situations as an inherent conflict that generally gives rise to auditor independence concerns. With respect to KPMG, this inherent conflict was exacerbated by the fact that the KPMG Tax partners performing the tax provision review or providing the approval of the financial statement treatment of one or more tax shelters subject to the review had often participated in the promotion or implementation of the same or substantially similar tax shelters.

<sup>8</sup> See e.g., SEC Accounting and Auditing Enforcement Release No. 1491, Admin. Proc. File No. 3-10676, January 14, 2002 (SEC censure of KPMG for improper professional and lack of auditor independence with respect to a financial relationship with an audit client, Short-Term Investments Trust (STIT), and failure to implement adequate policies and procedures designed to detect and prevent auditor independence violations; SEC Accounting and Auditing Enforcement Release No. 1374, Admin. Proc. File No. 3-9500, March 8, 2001 (SEC cease-and-desist order related to KPMG lack of auditor independence in auditing an SEC registrant's, Porta Systems Corp.'s, financial statements and issuing an audit report while KPMG had a loan outstanding to an officer of the registrant and while it had the right to receive a fee contingent on the registrant's financial success. The SEC found that KPMG conduct resulted both in a violation of Rule 2-02(b) of Regulation S-X because its audit report stated, inaccurately, that the audit was made in accordance with Generally Accepted Auditing Standards (GAAS) and that KPMG was a cause of the registrant's violations of Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1 thereunder because the financial statements included as part of the registrant's annual report were not audited by independent accountants as represented. Pursuant to Section 21C of the Exchange Act, the SEC ordered KPMG to cease-and-desist from being a cause of violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder, or from committing violations of Rule 2-02(b), by having any transactions, interests, or relationships that would impair its independence under GAAS or under the Commission's independence standards.

<sup>9</sup> It is my understanding that awareness of KPMG audit related misconduct was heightened after my being placed on leave of absence when the SEC filed civil fraud charges against KPMG for alleged misconduct related to the Xerox audit. See SEC v. KPMG, et. al., Civil Action No. 03-CV-0671(DLC) (SEC civil fraud complaint against KPMG alleging that KPMG and its partners permitted Xerox to manipulate its accounting practices and fill a \$3 billion “gap” between actual operating results and results reported to the investing public from 1997 through 2000. The SEC alleges that this fraudulent scheme allowed Xerox to claim it met performance expectations of Wall Street analysts, to mislead investors and, consequently, to boost the company's stock price. The SEC further alleges that KPMG failed to exercise the professional care and skepticism required under Generally Accepted Auditing Standards (“GAAS”) and misrepresented to the public that audits meeting professional standards had been completed and they issued unqualified approval of Xerox's publicly reported financial accounting. KPMG and its partners engaged in fraud by falsely representing to the public that they had applied professional auditing standards to their review of Xerox's accounting that Xerox's financial reporting was consistent with Generally Accepted Accounting Principles (“GAAP”) and that Xerox's reported results fairly represented the financial condition of the company.

resulted from the “teaming” or other interaction with Tax practice professionals.<sup>10</sup> Many of the auditor independence problems I observed stemmed from the KPMG’s focus on identifying opportunities and delivering advisory services to its audit clients. The firm placed great emphasis on tapping its captive base of audit clients to sell tax shelters. This initiative involves “teaming” of KPMG Tax and Audit practice professionals through a variety of mechanisms designed to mine information from audit clients for the purpose of selling tax services and to establish relationships between tax shelter promoters and audit client management. As part of this effort, Tax practice partners often played a very active role in the tax provision review of an audit.<sup>11</sup>

**Q6. You state in your lawsuit that certain conduct you observed during the course of the re-audit of its client corporation was unlawful. Can you elaborate?**

A6. It is my belief that the following conduct witnessed during the course of the re-audit was unlawful.<sup>12</sup>

1. *Request by KPMG partners to remove information from work papers.* Some of the many concerns I raised during the course of the re-audit were contained in a 22-page Microsoft PowerPoint document presented and discussed with certain KPMG tax partners on July 31, 2002. These materials provided an analysis of certain tax issues associated with the ABC Partnership Interest. On July 31, 2002 and thereafter, certain KPMG partners requested that I remove highly negative information contained in this document which was part of my work papers.

The information that was requested to be removed from my work papers cast significant doubt on KPMG conclusions, contained material differences of opinion, and noted some of the highly questionable circumstances of KPMG’s approval of the ABC Partnership Interest transaction.

Generally Accepted Audit Standards (GAAS), including Statement on Auditing Standards No. 22 and No. 96, have long recognized the importance of retaining

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<sup>10</sup> Many of the Audit professionals have little or no understanding of tax law. As such, they rely solely upon the judgment of KPMG Tax professionals and other tax expert to determine the level of certainty associated with a particular tax position or transaction. The determination of the financial statement treatment generally relies upon the tax treatment determined by such tax professional.

<sup>11</sup> Indeed on my last day in the office, September 26, 2002, KPMG management held a local area “State of the Office meeting” in Los Angeles to discuss the impact (or lack thereof) of Sarbanes-Oxley Act, the recent California Board of Accountancy probation, and other such matters. The area managing Tax partner proclaimed that now it is more important than ever that tax professionals focus on “teaming” with the Audit practice to “penetrate” KPMG’s audit client base and “pull-through” the sale of tax services.

This “cross-pollination” effort also placed great pressure on Tax partners to sell tax shelters to Audit clients. It was my observation that many line level Tax partners participated in the promotion of these services not because they were lucrative, but because they had to generate enough revenue to keep their job. Many partners expressed a view that it was difficult or impossible to meet their revenue goals by charging hourly fees without also participating in the promotion of tax shelters rendering “value-added” fees.

<sup>12</sup> The discussion below addresses violations of federal law observed in the course of the re-audit, I believe there were also other violations of state which are not addressed herein.

records "casting doubt" on the auditor's conclusions or documenting "differences of opinion." Indeed, concerns raised in the Enron/Andersen accounting debacle regarding the destruction of such evidence led to the enactment of Section 802 of the Sarbanes-Oxley Act of 2002 and the adoption of SEC Regulation S-X, Rule 2-06.

As discussed in Question 7 below, I believe the request from KPMG partners to alter and remove information from my work papers constituted criminal conduct. This conduct also constituted one of several gross deviations from GAAS that gave rise to auditor independence and other securities law violations discussed directly below.

2. **Auditor independence violations.** The Supreme Court has made clear that an independent auditor "assumes a public responsibility transcending any employment relationship with the client [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

Sections 12 and 13(a)(2) of the Securities and Exchange Act of 1934, require that financial statements filed with the SEC be certified by independent accountants. During the relevant period of the re-audit, SEC Regulation S-X, 17 C.F.R. 210.2-01 (Rule 2-01) provided, in relevant part, that that the SEC will not recognize an accountant as independent with respect to an audit client if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.<sup>13</sup> The rule requires that an auditor must be *independent in fact and appearance*.<sup>14</sup> The Preliminary Note to Rule 2-01 specifically identified situations which place an accountant in a position of *auditing his own work* in a position of *being an advocate* for the audit client as circumstances that raise auditor independence concerns.<sup>15</sup>

The auditor independence rule further provides that it is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled

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<sup>13</sup> In assessing an auditor's independence, the SEC gives appropriate consideration to all relevant circumstances, including evidence bearing on the relationships between the auditor and the audit client.

<sup>14</sup> Moreover, the general standard adopted reflected different means of demonstrating a lack of objectivity. It provided that objectivity is a state of mind, and except in unusual circumstances, a state of mind is not subject to direct proof. Usually, it is demonstrated by reference to circumstantial evidence. Accordingly, the final rule is formulated to indicate that an auditor's independence is impaired either when there is direct evidence of subjective bias, such as through a confession or some way of recording the auditor's thoughts, or when, as in the ordinary case, the facts and circumstances as externally observed demonstrate, under an objective standard, that an auditor would not be capable of acting without bias.

<sup>15</sup> These indicia of auditor independence conflicts have since been incorporated into the final auditor independence rules of Rule 2-01(b).

professional, and that investors, therefore, can rely on them.<sup>16</sup> Consistent with SEC auditor independence rules applicable at the time of the re-audit, GAAS requires auditors to maintain strict independence from their audit clients. GAAS specifically requires auditors to avoid situations that may lead others to doubt their independence.<sup>17</sup> The SEC and GAAS view both the fact and the appearance of auditor independence as essential for investors to have confidence that an audit represents a wholly unbiased examination of management's presentation of the corporate financial picture.

SEC Regulation S-X, 17 C.F.R. 210.2-02 (Rule 2-02) provides that the accountant's report must state whether the audit was conducted in accordance with GAAS, which likewise requires that auditors be independent.

During the course of the re-audit, I witnessed a variety of conduct in which KPMG partners demonstrated excessive advocacy and a blatant lack of objectivity, professional due care, and skepticism. Such conduct was grossly inconsistent with GAAS and the auditor independence requirements of SEC Regulation S-X, Rule 2-01, 17 CFR 210.2-01. Under such circumstances, KPMG was incapable of exercising objective and impartial judgment with respect to the audit client's financial statements. No reasonable person observing the re-audit environment and the conduct of KPMG partners involved on the audit could conclude that the independence standards of Rule 2-01 and GAAS were satisfied. KPMG nonetheless knowingly and willfully permitted the audit client to misrepresent to the public on a number of occasions that the re-audit was performed by an "independent auditor" and was conducted in accordance with GAAS. These public statements and the audit reports provided by KPMG in connection with the re-audit were materially false and misleading in representing that KPMG was independent and that the re-audit accorded with GAAS. I further believe that KPMG may have violated federal securities laws by knowingly permitting the audit client to issue a 10-K/A with the SEC that included KPMG's unqualified re-audit report containing no changes to the balance sheet, net income, cash flow or earnings per share, and knowingly permitting the audit client to represent that such report was a product of a re-audit that was conducted by an independent auditor under circumstances that complied with GAAS.

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<sup>16</sup> Independence generally is understood to refer to a mental state of objectivity and lack of bias. Generally mental states can be assessed only through observation of external facts; it thus provides that an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment.

<sup>17</sup> Statement on Auditing Standards ("SAS") No.1 explains the independence requirement as follows:

It is of utmost importance to the profession that the general public maintains confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it also might be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management or its owners. . . . Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence



3. ***Improper influence on the audit.*** Section 303 of Sarbanes-Oxley Act of 2002 makes it a crime to fraudulently influence, coerce, manipulate, or mislead an accounting firm during an audit, with the intention of rendering an audit report misleading. Section 303 was not effective at the time of the re-audit. I believe that certain conduct on the part of the audit client management may have violated the “Improper Influence on the Conduct of Audits” rules enacted pursuant to Section 303 of the Sarbanes-Oxley Act of 2002 had those rules been effective at the time of such conduct.<sup>18</sup> This conduct may have violated other federal securities laws which were in existence prior to the enactment of the Sarbanes –Oxley Act of 2002.

**Q7. Did you witness any criminal conduct taking place during the re-audit period? Please elaborate.**

A7. It is my belief that the following violations of federal law constituted criminal conduct:

1. ***Request by KPMG partners to remove information from work papers.*** Even prior to the enactment of the Sarbanes-Oxley Act of 2002, Section 1512 to Chapter 73 of Title 18 of the United States Code (18 U.S.C. § 1512) provided for criminal penalties applicable to whomever corruptively persuades another person or engages in misleading conduct towards another person (or attempt or conspire to do so) with the intent to alter or conceal a document to impair its integrity or availability for use in an official proceeding. Section 1512 reaches destruction of evidence with the intent to obstruct an official proceeding that may not yet have been commenced.

At the time I was requested to alter the audit work papers as described above, it was my belief and there was significant evidence to indicate that the KPMG partners making such requests were very concerned about the discovery of the information contained in my audit work papers by federal regulators in the course of an investigation. At the time, these partners were aware of SEC inquiries regarding the ABC Partnership Interest and there was evidence that these partners were aware of the potential for an investigation by SEC or other federal officials. I believe that the request to remove negative information from my work papers was intended to prevent the discovery of such information by federal officials, and thus, this request constituted a criminal violation of federal obstruction of justice laws under 18 U.S.C. § 1512.

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<sup>18</sup> Section 303 provides:

It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

The Final SEC rules implementing rules applicable to Section 303 improper influence became effective on June 26 2003.

2. ***Destruction or alteration of audit work papers.*** Section 802 of the Sarbanes-Oxley Act of 2002,<sup>19</sup> enacted on July 30, 2002, created criminal penalties for altering documents by adding Sections 1519 and 1520 to Chapter 73 of Title 18 of the United States Code.

Section 1519 makes it a crime for a person to knowingly alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction or any department or agency of the United States or any Case filed under Title 11, or in relation to or in contemplation of such matter or case.<sup>20</sup> Section 1520 requires auditors to maintain audit work papers.

At the time I refused to comply with the request to alter my audit work papers, it was my belief that, under the circumstances, compliance with this request to alter my audit work papers and the failure to include the “negative information” casting doubt on the KPMG auditor’s conclusion would constitute criminal conduct.

3. ***Criminal Retaliatory Conduct.*** Section 1107 of the Sarbanes-Oxley Act of 2002, which became effective on July 30, 2002, provides for criminal penalties applicable to whomever knowingly with an intent to retaliate, takes any action harmful to any person, in, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense.

I was placed on leave of absence very soon after confirming for KPMG that that I had provided information to federal investigators. To the extent this or any other retaliatory conduct on the part of KPMG was or is a direct result of me providing information to a law enforcement officer, such conduct may constitute a criminal act pursuant to Sarbanes Oxley Section 1107.<sup>21</sup>

**Questions from Senator Graham:**

- Q1. Do you believe that the current penalty regimes provide a sufficient deterrent to taxpayers considering participating in abusive tax shelters?**

<sup>19</sup> Pub. L. 107-204, 116 Stat. 745. On January 23, 2003, the SEC published the Final rules implementing Section 802 by adopting Rule 2-06 of SEC Regulation S-X (Retention of Records Relevant to Audits and Reviews).

<sup>20</sup> In addition, Section 1102 of the Sarbanes-Oxley Act of 2002 amended 18 U.S.C. § 1512, which establishes penalties for witness tampering, to make it a crime to corruptly alter, destroy, mutilate, or conceal a record, document or other object, or attempt to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding or otherwise obstruct, influence, or impede an official proceeding or attempt to do so.

<sup>21</sup> I believe that certain KPMG partners have engaged in unlawful retaliatory conduct and continue to engage in such conduct by taking negative employment actions against me and otherwise retaliating against me for refusing to endorse or participate in the unlawful conduct and to diminish my effectiveness as a government witness. There are also civil law claims associated with this retaliatory conduct.

- A1. No. With respect solely to the amount of applicable penalties, I believe the current penalty regimes provide a sufficient deterrent to taxpayers considering participation in abusive tax shelters.<sup>22</sup> However, in recent years, taxpayers have often been less than fully informed with respect to the scope and responsibility for such penalties. For a variety of reasons, many tax shelter participants also perceive that the probability of the IRS detecting and successfully challenging the tax shelter transaction (i.e., actually having to pay such penalties) is minimal. As such, any altering of the taxpayer's risk/reward decision will necessarily require (i) measures to adequately inform prospective tax shelter participants of the penalties associated with tax shelters and the likely enforcement and application of such penalties to their tax shelter transaction, and (ii) fair, consistent, timely, and well publicized enforcement of the existing penalty provisions. Only under such circumstances might prospective tax shelter participants perceive that the risk of having to pay the applicable penalties outweighs the purported benefits associated with the tax shelter.
- Q2. The Senate Committee on Finance has passed legislation that would clarify the application of the economic substance doctrine and increase penalties applicable to transactions that fail this standard. Do you believe this legislation would alter the risk/reward decisions to dissuade prospective tax shelter participants from engaging in these transactions?**
- A2. *Codification of economic substance doctrine.* No. Although I believe that clarification of this doctrine is a necessary step in combating abusive tax shelters. I do not think codification of the economic substance doctrine alone will result in any meaningful reduction in the incidence of these undesirable transactions. In my opinion, efforts designed to alter the risk/reward decision must focus primarily on improved disclosure laws which (i) unambiguously require complete, accurate, and timely disclosure of tax shelter transactions, and (ii) carry penalties for intentional nondisclosure, inadequate disclosure, or untimely disclosure that are significant in relation to the purported tax benefits and the fees paid to promoters. Of course, the success of such legislation in altering the risk/reward decision requires that these improved disclosure laws enforced in a consistent and fair manner.

*Need for "truth-in-promoting" type disclosure requirements.* Improved disclosure requirements aimed at tax shelter participants (i.e., "demand-side measures") will likely result in the desired alteration of the risk/reward decision only to the extent the participant is aware of and appreciates the penalties associated with nondisclosure. The most abusive tax shelters are far too complicated for taxpayers to dream up on their own. Tax shelter participants often rely on promoters to inform them not only of the substantive law applicable to the shelter transaction, but also of the disclosure laws and associated penalties. Given such reliance on promoters for information relevant to the tax shelter, I believe that disclosure laws aimed at the "supply-side" will provide the "most bang for the buck." So long as promoters believe they can effectively shift the risk of nondisclosure to

<sup>22</sup> I do not believe this to be the case with respect to tax shelter promoters. In my opinion, this deficiency is due to both insufficient penalty levels and disclosure standards that permit manipulation by unscrupulous tax shelter promoters.

participants, there will remain an incentive for unscrupulous promoters to intentionally misinform participants regarding disclosure laws and penalties.

It is my opinion that much of the abusive tax shelter activity is fueled by a failure of the promoters to adequately and objectively inform tax shelter participants of the associated risk and obligations. There are, of course, a number of cases currently pending before the courts that allege such failures on the part of promoters in informing participants of the risks associated the tax shelter. The threat of such litigation may ultimately prove to be an adequate deterrent to this unscrupulous behavior.

In lieu of a “wait and see” approach, it may be desirable to adopt a more proactive strategy by incorporating a “truth in promoting” component into the improved disclosure rules. The current disclosure regime addresses taxpayer and promoter disclosure to the IRS. The addition of Promoter-to-Participant (“P-to-P”) disclosure requirements would not only discourage this undesirable shifting of risks from promoters to participants, but would also (i) further the IRS’s efforts aimed at educating taxpayers about the true risks associated with abusive tax shelters by providing a precision targeted means of delivering educational information, and (ii) diminish the incidence of “unreasonable reliance” on promoters by participants.<sup>23</sup>

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<sup>23</sup> Perhaps such P-to-P disclosure rules might require promoters to attach to their engagement letter a plain language IRS Form that includes items such as (i) information regarding taxpayer disclosure requirements (including information about “listed transactions” and “reportable transactions”); (ii) information regarding applicable civil and criminal penalties imposed on taxpayers for underpayment of taxes, nondisclosure, inadequate disclosure or untimely disclosure; (iii) disclosure regarding the precise scope of protection afforded by the promoter’s tax opinion letter including any limitations on such protection; (iv) confirmation that the promoter has explained the facts and representations in the tax opinion letter to the satisfaction of the participant; (v) notice that participant bears responsibility for inaccurate or incomplete facts or representations even if such information is produced by the promoter; and (vi) notice to the participant that all facts and circumstances related to the tax shelter must be made known to the IRS and that intentional concealment of such facts and circumstances is unlawful.

**UNITED STATES SENATE  
COMMITTEE ON FINANCE  
Charles E. Grassley, Chairman  
Tax Shelters: Who's Buying, Who's Selling, and What's the Government  
Doing About It?  
Tuesday, October 21, 2003**

**TESTIMONY OF  
"Mr. JANET" – A WITNESS PSEUDONYM  
REGARDING  
ABUSIVE CROSS-BORDER LEASING  
AND LEASING WITH U.S. MUNICIPALITIES**

Good morning Senators. This morning I will describe a massive scandal that has allowed major U.S. companies to receive huge tax deductions by pretending to lease the infrastructure of foreign countries, such as dams, bridges, and subways, and then pretending to lease that infrastructure back to the country or municipality that own the infrastructure. This scheme is so pervasive that much of the old and new infrastructure throughout Europe has been leased to, and leased back from, American corporations. The sole purpose of this scheme is to generate a tax shelter for U.S. corporations that invest in these schemes.

I know first-hand what I am talking about. I am a former leasing executive with between 10 and 25 years of industry experience. I was a leader in the industry, but left in large part because of my unwillingness to do the types of transactions that I will describe today. I appear before you anonymously to protect my wife and children from certain retaliation if my identity were disclosed.

The best way to explain this scheme is by the example of a car lease. Under a normal car lease, you pay a set amount each month and at the end of the lease you either buy the car or give it back to the leasing company.

In this structure, let's say you are a foreign person who owns the car. An investment banker comes to you and says "I will give you a thousand dollars if you agree to sign papers saying that you have leased the car to, and leased it back from, an American taxpayer. You will have no continuing financial responsibility or loss exposure. You will make no lease payments, you will continue to own the car as you always have – no one can take it from you, and you get to dispose of the car as you please once the lease is over. In effect you're still the owner. We are just going to pay you a fee to sign some papers that back up our deduction claim to the IRS." What would you say to such an offer?

If you are an American taxpayer, you might hesitate. But if you are an European or other foreign person, what risk do you have? Well, that is the scenario that has played

out over the past 10 years on a much larger scale. Here is the detail on how this scam works.

The deals generally involve a foreign governmental unit that is not subject to taxes, such as a municipality, a water authority, flight control agency, a subway or rail system, or similar organization that has control over large immovable infrastructure assets with long useful lives. The long lives are important so that the depreciation deductions in the U.S. can be maximized over time. In many cases, the useful life of the asset exceeds the U.S. depreciation period for the asset, so that the U.S. taxpayers will obtain deductions well in excess of the actual decline in value. Although various tax rules attempt to remove this benefit, they have been easily circumvented by the promoters of these transactions. Because they are infrastructure assets, they have a more stable value over time. Using a tax exempt governmental unit is important because the governmental unit is non-taxable and does not need their own depreciation deduction for those assets. Accordingly, they are willing to “pretend” to give up ownership of the infrastructure property to someone who can use the depreciation deduction.

The municipalities are paid a large up-front fee to enter into a long-term lease of their railways, subways, dams, water lines, or air traffic control systems to American promoters. The U.S. investors will be able to claim U.S. depreciation deductions over the life of the lease, and in some cases over a much shorter time frame.

As part of the same agreement, the American promoters will agree to simultaneously lease the assets back to the foreign municipality at a cost equal to what they are receiving from the municipality, less the municipality’s up-front payment. The foreign municipality will be responsible for operating and servicing the assets over the lease term. At the end of the lease term, the infrastructure assets revert back to the municipality. To be clear, let me again emphasize that in most cases, the municipality makes no lease payments. All of their obligations are prepaid through “phantom” debt, which is described below

There are two concerns for the foreign municipalities and the U.S. promoters. The foreign municipalities don’t want to owe rental payments to the U.S. promoters or run the risk that the infrastructure assets would actually be repossessed by the U.S. promoters from defaulting on the lease. Similarly, the U.S. promoters don’t want to take possession of the infrastructure assets in the event of default, nor do they want to actually make lease payment to the foreign country. To answer these concerns, the U.S. promoters will borrow an amount equal to the lease payments they owe to the municipality. The loan proceeds are placed on deposit in a bank account of the municipality. However, the amounts deposited can only be released to pay for lease payments owed by the municipality to the U.S. promoters, which by coincidence is the same as the payments owed to the municipality. As a result, neither the U.S. promoters nor the municipality is taking any credit or ownership risk.

The only risk in the overall transaction is whether the IRS will attack the depreciation deductions of the U.S. investors. All too often, the IRS will settle the case

rather than risk a loss at trial. Even if the settlement requires the U.S. investors to disgorge 50% of their tax deductions, they are way ahead of the game by keeping the remaining 50%.

It is important to note that these contrived transfers are structured as leases, rather than an outright purchase of the foreign infrastructure. This is because in 1984, Congress enacted the so-called "Pickle Rules" that severely limit depreciation deductions for U.S.-owned foreign assets. In order to avoid the Pickle Rules, the deals are structured as a head lease and a sublease to avoid the longer tax depreciation period required under those rules.

The IRS has initiated enforcement actions against some of these types of transactions, which are called LILOs – an abbreviation of their industry name "lease-in-lease-out" transactions. But the leasing industry is always one-step ahead of the IRS. They have now replicated these benefits through service agreement contracts, which are called SILOs - "sale in-lease out." They operate in the same manner, but with a different reason for the contrived lease payments.

The numbers involved in these deals are staggering. A minimum of \$20 to \$30 billion dollars a year of foreign infrastructure is purportedly leased or sold in this manner. As I said, most of the existing infrastructure of Europe – bridges, railroads, waterways, subways, air traffic control systems, and the like – have been leased to Americans under these deals. Investment bankers scour the countryside looking for municipalities that are interested in the easy money of the up-front payment to enter the deal. Foreign officials are routinely enticed to enter into these transactions through promoter sponsored golf outings, expense paid trips, and similar arrangements.

On the chart behind me is a picture from a July 10<sup>th</sup> New York Times article entitled "Latest German Fad: Leasing Out the Subway." It describes protests by the citizens of Frankfurt against leasing their subway system. I have included a copy of this article with my testimony.

The other chart is a recent press release from a Canadian air traffic control group proudly announcing that it has leased and leased back the Canadian air traffic control system to Bank of America for an up-front payment of \$25 million from B of A. I have no idea how much B of A is getting out of the deal.

What is even more shocking is that these transactions are arranged by some of the largest multinational financial advisors in Europe and the U.S., and include major U.S. cost center banks and Fortune 500 corporations.

I have to tell you that the leasing industry has not always been this way, nor are all leasing companies involved in this scam. As companies became increasingly profitable during the 1990s, they opted to own their assets rather than lease them. Faced with a downturn in the domestic market for real asset leases, the leasing industry was forced to find new deals and new revenues. What you have heard today is the result.

There is enormous pressure to continue these deals, which is why LILOs were quickly replaced with SILOs. In today's market, the types of deals are the only game left for the leasing industry to make the big bucks. This is because the market for leasing real assets has dried up. I'm not talking about copying machines. I'm referring to the multimillion dollar assets.

During the 1990s, leasing made a large percentage of its profits doing off-balance sheet financings, which were perfectly legal at the time. But Sarbanes-Oxley changed all of that. No one is touching those deals today. Because of the current recession, few companies are investing in new assets. If a company does need new assets, it will issue debt in lieu of leasing because of the record low interest rates and the ability of the company to take depreciation. So the only alternative left for the big ticket leasing is to do LILOs or SILOs. That's why there is so much pressure to keep doing these deals -- they are the only thing keeping the large ticket leasing industry in the money.

There is one more development you need to know about. I said earlier that U.S. municipalities have historically been hesitant to enter into these deal. That is no longer the case. Faced with local budget deficits, state and local governments are leasing off infrastructure assets at a record rate. The subway systems of Boston, Chicago, and Washington D.C. have been leased and leased back to U.S. corporations. I have reason to believe that the New York and Chicago water authorities are about to engage in a scheme to lease the waterlines under their streets.

Consider the irony of this situation. Infrastructure is built with the taxpayer dollars of working men and women and with tax exempt bond funds. They are then leased and leased back in a phony transaction to provide tax deductions for some of the most profitable companies in America. I cannot believe this is what Congress intended in writing its tax leasing laws.

As I briefly mentioned, Congress in 1984 did enact rules to limit this type of behavior. These rules are routinely evaded and have proven to be of little value in achieving the intent of Congress to stop this type of activity. I reference your recent FSC-ETI Committee bill which would add a provision to subject these types of leases to rules similar to the passive activity loss rules enacted in 1986. Those 1986 rules were effective at stopping the individual tax shelters of the 1980s, but the 1986 rules only applied to individuals and not to corporations. As a result, it left a huge gapping hole for leasing fraud. Your Committee's current proposal would greatly, if not completely, stop these abusive transactions. One suggestion for improvement would be to subject certain technological equipment to the rules enacted in 1984. This is long overdue, and it is how Bank of America can legally get U.S. tax deductions by leasing and leasing back the air traffic control system of Canada.

One final point. As I said, not all leasing companies participate in this. The leasing industry is represented primary by the Equipment Leasing Association here in Washington. Not all of their members are doing this. It is mostly the ones belonging to



the “Big-Ticket Leasing Group” within ELA. You will hear a lot of banter about how leasing lowers the cost of capital, stimulates the economy and drives economic efficiency. In fact, allowing this loophole to stay in place reduces U.S. economic stimulus, and here is why.

In doing these deals, a U.S. leasing company can shelter taxable income without the risk of having to take possession of leased equipment and without any credit risk. So why in the world would they take a risk by leasing to a capital-starved U.S. company? There is no incentive to take that kind of risk when they can get these juicy risk-free returns by doing LILOs and SILOs and shelter their income.

Moreover, I fail to see how the U.S. economy is stimulated by giving U.S. tax deductions for assets built by the French, funded by the French, and used by the French. I also don’t see how the economy is stimulated by taking subways that are built with taxpayer dollars, and allowing corporations to get a deduction for them. These transactions lack any economic substance or business purpose, and should be shut down.

Thank you for this opportunity to present my testimony. I welcome questions from the Committee.

**The New York Times**  
nytimes.com

July 10, 2003

## Latest German Fad: Leasing Out the Subway

By MARK LANDLER

**F**RANKFURT, July 9 — With smooth-running trains, bright, well-kept stations and a blissful lack of crowds, Frankfurt's subway is a pleasant surprise for people from more teeming cities.

For American visitors who cannot get enough of the U-Bahn subway system, Frankfurt is making a special, once-in-a-lifetime offer: lease the whole system for 99 years with an upfront payment of roughly \$100 million. Frankfurt will even throw in its above-ground streetcar network.

This arrangement is known as cross-border leasing, and it has become the latest fad for major German cities like Frankfurt, which are in a deep financial hole because of the economic downturn, eroding tax revenues and the high cost of maintaining their plush public facilities.

Düsseldorf, Dortmund and Essen recently raised \$60 million to \$80 million each by leasing their subway systems to American investors. About 150 municipalities in Europe — including some in the Netherlands, Switzerland, Austria and France — have offered these deals, but Germany has been the largest lessee by far.

Now, Frankfurt is angling to get into the act.

Later this summer, officials from Frankfurt's public transportation authority will embark on a road show to New York, where they will try to entice investors to lease their subway and streetcar network.

The sales pitch is simple: The tax advantages of leasing a huge fixed asset, which depreciates each year, more than offset the upfront fees paid to the city. John Hancock, Bank of America and the Wachovia Bank are among the American investors that have signed such overseas leases.

"We have to look for sources of capital outside the city," said Werner Lutz, the managing director of Stadtwerke Frankfurt am Main, a holding company that oversees the city's stakes in its airport, public transit system and utilities. "We need more capital to be ready for competition."

That sounds reasonable. But it does not mollify opponents of the plan, who have papered the city with signs that say, "Cross-border leasing? Nein!" They are trying to gather 41,000 signatures to force Frankfurt to hold a referendum on the matter.

The critics say turning over the subway system, used by 266,000 riders a day, to foreign investors poses too high a risk.

They ask a host of worrisome questions: What if Frankfurt cannot afford to buy back the lease in 30 years, the first buyback option in the contract? What if a natural disaster, such as a flood, were to befall the system? What if the American tax laws that permit these investments are changed?

"We fear future generations will have no control over the city's infrastructure," said Karola Stötzel, a teacher and union official who is helping to organize the campaign.

The protesters, Ms. Stötzel said, are steering clear of appeals to anti-foreign or anti-American sentiment. "We are internationalists," she said. "This kind of tax evasion isn't good for Germans or Americans."

But some believe the recent raw feelings between the United States and Germany are subtly bolstering the campaign. "If we had not had the Iraq conflict, this would have gotten much less attention," said Georg Vietor, a director at Macquarie Corporate Finance, an Australian bank that prepared a feasibility study for Frankfurt.

Mr. Lutz admits that Frankfurters could be alarmed by the specter of an American investor taking control of the system. "There is always the fear that the foreign investor will take over our U-Bahn and turn it into the New York City subway, which would be terrible," he said. "But of course, that's not the case."

Frankfurt would still operate the subway, repair the tracks, police the stations and collect the fares. The subway trains themselves are excluded from the lease because they become obsolete too quickly.

At heart, cross-border leases are a loophole. Because they extend over 99 years, United States tax law treats them as a sale, which gives the lease holder the benefits of depreciation. As far as German authorities are concerned, however, the ownership does not change.

"German tax authorities take a clever view," said Ulrich Eder, the managing director of Due Finance, a tax advisory firm in Düsseldorf that specializes in cross-border leases. "They say that the city is receiving a cash benefit for enabling the lease holder to gain a tax benefit."

Advocates of cross-border leasing say there is no reason German cities could not lease other pieces of infrastructure, like water systems or gas and electricity networks. For all their financial problems, German cities are still viewed as having rock-solid credit.

If Frankfurt's transportation authority attracts one or more investors, it would give a percentage of the leasing fee to the lawyers and banks that brokered the deal. It would then split the net proceeds, which could range from \$73 million to \$98 million, with the city. It would use its share to fortify the capital structure of the subway, only 8 percent of which is equity.

Finding investors should not be difficult for Frankfurt, given the recent success of Düsseldorf and other cities. The tricky part, according to people here, will be navigating the local political currents. Frankfurt's government is a balky coalition that includes all four major political parties.

And Frankfurt can draw little comfort from the Austrian city of Salzburg, which shelved plans to lease its wastewater system last spring after factions in the government objected to the plan.

Mr. Lutz said he would prefer to finance the subway system directly from municipal coffers. But with its deficit projected to rise to more than \$400 million this year, Frankfurt is in no position to do that.

"We can discuss for a long time whether it is the right thing to do," Mr. Lutz said. "But it is totally legal. When I fill out my German taxes, I take whatever deductions I am allowed to take."

As for Ms. Stötzel, she worries only that it will be tough to arouse public passions on an issue as arcane as cross-border leasing. "We're very glad we don't have to campaign to save the sewage system," she said.

October 21, 2003

Charles E. Grassley, Chairman  
United States Senate  
Committee On Finance  
Washington, DC 20510-6200

Dear Mr. Chairman:

The text of my comments for my testimony today are reproduced below. Following those comments is a more detailed discussion of the testimony. For reference, my resume follows at the end on the discussion.

**Executive Summary and Oral testimony:**

My name is Robert Lally. I am honored and pleased to be before you today to talk about a subject which has been my life's work and about which I am truly passionate, tax practice. I have practiced tax in public accounting for twenty seven years. I am a CPA and an attorney.

My comments will be brief. I hope to make three observations to your committee.

First, tax law must be the same on Farmington Ave. (our address) as it is on 5th Ave. Tax law must be perceived as the same everywhere. It is a Federal system. We all read the same cases. We all read the same Revenue Procedures. An answer in Hartford should be the same answer as in San Francisco. It is a self assessment system. It will not work if clients perceive that in New York they can get a better answer, or worse yet, a magical answer. To us in the field, standards of practice must have some uniformity.

Second, I have seen standards of practice degrade over time. As a former partner in a big four accounting firm, I remember days when we had very definite notions of what was and what was not done. We did not play an audit lottery. (Although we were certainly aware of its mathematics of chance.) We did not rely on hyper technical interpretations of Code and Regs. to reach barely tenable conclusions. (Although we were very good technicians.) We did not take contingent fees. And we never, never, in my 16 years of practice with big firms, structured a transaction around side agreements, hidden buy sell arrangements, or disguised ownership. In my more detailed text which accompanies this presentation, I have outlined some further observations on this trend and its possible causes.

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Finally, tax practice has changed by the introduction of the notion of "tax products". A tax product is an idea or a position or an integrated shelter which seeks to avoid tax with little or no business purpose. It is not a structuring of existing client matters to reduce or to defer tax, but a sojourn into a purely tax motivated realm. These products are typified by the following four common features:

- 1.) a confidentiality agreement because the idea is supposed to be proprietary;
- 2.) contingent fees based on the tax savings;
- 3.) a technical position either based on a hyper- technical reading of the tax law but which makes little common or economic sense, or in the alternative, a technical position which is based on not all of the facts being disclosed, such as hidden buy sell arrangements, etc.
- 4.) marketing to taxpayers outside of the existing client list.

**Reforms:**

1.) Regulation. The fact remains that tax practice is largely unregulated and unlicensed. One needs a license in Connecticut to cut hair but not to prepare a tax return for a fee. The signature of a CPA or a Lawyer (qualified to practice in the tax area, and not all are) should mean something about the technical quality and compliance accuracy of a return. Only by limiting practice can sanctions against unreasonable practice have meaning. Anyone with a pencil and photocopier can prepare and sign tax returns.

2.) Enforcement. The IRS audits the same issues time and again, and agents often avoid difficult technical areas ( I should, perhaps, be careful what I wish for). This lack of enforcement encourages complex hyper technical positions, secure in the knowledge that no one is going to challenge them. In 27 years, I have yet to have an agent raise a LIFO issue, an accounting method issue or an intercompany pricing issue, it is always the same: lunches and cars. Only in the most arcane specialty areas, which have dedicated IRS groups, such as industry specialty groups like insurance are substantive technical issues ever raised.

As a practitioner, the recent IRS efforts at John Doe subpoena's should be applauded. (It sounds like I am giving aid to the enemy). I am actually defending thoughtful clients and practitioners. It is helpful out in the field to be able to say to clients that some law firm in New York or Washington does not have a magic answer, and that in fact, far from playing the audit lottery, you are about to play the audit certainty. Even the limited activity so far, has had a sobering effect.

3.) Fees. Contingent fees should not be permitted in tax practice. One might think that the prohibition against contingent fees in Circular 230 is sufficient to stop the practice, but it is not.

I appreciate this opportunity to come before you today.

**DETAILED DISCUSSION:**  
**Standards of Practice:**

Circular 230 outlines basic standards of practice. For example, a tax position may be taken on a return if it is considered to have a substantial likelihood of success. A position meets this standard if it has a 1 in 3 chance of prevailing. While this wording of the standard is relatively new, it would be a fair statement to say that historically thoughtful tax practitioners used this type of guidance in their advice to clients. In my former career with Touche Ross (prior to its merger with Deloitte, Haskins and Sells), in my role as a practice unit manager, head of the Hartford office tax practice, or in my role as National Director of the firm's insurance practice or in my interactions with the National office of the firm, if a position could not stand the light of day, it was not taken. This was not an "audit lottery" standard (the position is OK because they only look at 1% of the returns). This was not a standard based on undisclosed facts or side agreements. This standard assumed that all the facts were known. The participants were honorable. The underlying books and records were accurate. The position was assumed to be examined, and we could at least explain the position in good faith and with some reasonable hope of prevailing. If lost at the audit level, one could write a thoughtful protest for appeals and have something meaningful to say.

This does not mean that before 1986 firms, my own included, did not work on tax shelter transactions. We certainly did. That was the state of the law at that time. It does not mean that we did not push the limits of creativity. One could suggest that the repeal of *General Utilities* suggested that there simply was no way to control the planning when corporations could be dissolved with one level of tax. That said, I can never recall a discussion in sixteen years where a partner said: "well they'll never find it". Or suggested that the real ownership be masked with a side deal to buy back ownership for \$1.00. This simply was not done. If we could not tell the national office about it with a straight face, it did not fly. If we could not explain the strategy in ten minutes on the phone (because it was so complex and involved so many parties and steps) it probably would not pass muster. In fact, proponents of such schemes became known as gunslingers who could not get their ideas through national review and who were to be supervised with some care.

#### **Changing Times:**

At that time, partners were considered to be tenured for life. There was gray hair, or no hair, out in the firm. Partners had been around. Partnership was revered as was experience. While partners in public accounting firms did not make rock star salaries, neither did we ever find ourselves at 50 unemployed. There was a social and professional contract which was very powerful. I sense that this has changed. I went my first sixteen years in public accounting and virtually never saw a partner leave other than from death or normal retirement. After 1990, all I saw were partner transactions. Careers, to borrow a phrase, became nasty, brutish and short.

Partner pay increased dramatically in the 90's. No longer were partners in accounting firms the honored and tenured professors of our profession. We became rock stars, with aspirations of seven figure compensation. Of course, if one does not make partner until age 35 and if careers are over by 50, it is a short time to reap the rewards. Can it be a wonder that standards fell?

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#### **The Push to Sell "Products"**

Partners, particularly tax partners, were no longer to be full service professionals, they had budgets to sell products. Without sales, especially outside their own client base, their compensation was impacted. In order to earn fees unbounded by hourly billing rates, partners had to sell tax motivated products based on commissions. Often these arrangements were typified by the use of nondisclosure arrangements (the products were purported to be proprietary). One could question how anything in the federal tax system could be proprietary. Audit partners were not immune to sales. The proliferation of special purpose entities (SPE) can probably be linked to creative audit efforts to engineer balance sheets. I suspect that for each SPE one finds on a corporate balance sheet, there was six figure consulting fee from the outside accountants to create it and to design its reporting footprint.

#### **Role of Law Firms:**

Often tax products come with an associated tax opinion letter. Under the technical tax rules, reliance on such an opinion has the potential to insulate the taxpayer from certain penalties. Often the opinion letter is simply part of the marketing package.

Law firms also have a role outside of the opinion letter. Of particular concern to our firm is the use of counsel, because of our location in Hartford, principally in New York, as a source of tax planning. In this we are hopefully not being simply defensive. On the contrary, we would be thrilled to learn of a new idea. There is a line between "planning" and counseling fraud. Care and judgment are required.

#### **Governmental Efforts:**

Recent moves to get client lists from tax advisors have been helpful. Normally, I would object on principle to such a short cut in IRS enforcement efforts. However, this chilling effect is actually helpful to tax practitioners in the field. It helps us raise the realistic specter of audit. It encourages clients who are considering these positions be more thoughtful. There has been a dramatic change in the temperature out in the hinterlands. The idea that there is some compendium of tax magic out there is diminishing. We are feeling a change in attitude. Tax work is often a game of inches, hard fought and much studied. The notion that there is a cookie cutter, magic bullet in some firm's word processor only waiting for your check and nondisclosure agreement to make your tax go away may be on the wane.

#### **Resume: Robert V. Lally**

Robert V. Lally is a partner in the accounting firm of Federman, Lally & Remis LLC in Farmington Connecticut. Prior to forming the firm in 1991 he was partner in charge of the



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Northern Connecticut tax practice for Deloitte & Touche. He had also served the firm as partner in charge of the New Jersey tax practice and had been the Firm's National Director of Insurance Tax Practice for many years. He is frequent public speaker. He and his firm present continuing education to some of the country's largest law firms in Boston, New York, Washington and San Francisco on accounting and professional issues. He has served as a Special Master in Tax Court in Connecticut. He is Member of the AICPA and the CSCP. He is a member of the federal and State of Connecticut bar. He graduated from Middlebury College and has an MBA from the University of Hartford and a JD from Western New England School of Law.

STATEMENT OF SENATOR CARL LEVIN (D-MICH)  
BEFORE  
U.S. SENATE COMMITTEE ON FINANCE  
ON  
TAX SHELTERS: WHO'S BUYING, WHO'S SELLING,  
AND WHAT'S THE GOVERNMENT DOING ABOUT IT?

October 21, 2003

Thank you inviting me here today to comment on the tax shelter promotion scandal that is corrupting too many of our U.S. tax professionals. The unethical, illegal, and, in some cases, criminal conduct involved in the peddling of abusive tax shelters needs to be exposed and stopped. We need to help honest taxpayers who are left holding the bag after tax cheats use improper tax shelters to avoid paying their fair share, and we need to help honest tax professionals who don't hawk abusive tax scams but must compete against those who do.

In some parts of the world, tax cheating is a way of life that governments do little to curb. But in this country, as taxpayers are asked to pay billions of dollars to strengthen homeland security, support our troops, care for the sick, improve our schools, rebuild Iraq, and more, the use of far-fetched and abusive schemes to avoid payment of tax needs to be exposed for what it really is -- unfair and, indeed, unpatriotic.

Last year, the Permanent Subcommittee on Investigations, of which I'm the Ranking Minority Member, opened an in-depth investigation into the development and marketing of abusive tax shelters by professional firms like accounting firms, banks, investment advisors, and law firms. I was then the Subcommittee chairman and initiated this effort in part due to our Enron investigation which, like yours, disclosed that company's use of elaborate tax dodges.

In December 2002, for example, the Subcommittee held a hearing which examined an abusive tax shelter known as Slapshot, which J.P. Morgan Chase had designed and sold to Enron for \$5 million. Enron had calculated Slapshot would produce tax benefits exceeding \$120 million. As detailed in a Subcommittee report, this tax shelter relied primarily on a sham \$1 billion loan that was arranged and financed by J.P. Morgan Chase, and concealed within a mind-boggling array of loans, stock swaps, and structured finance transactions, many of which occurred within minutes of each other. The shelter's complexity was designed in part to prevent tax authorities from finding out what really happened. We pierced the Slapshot veil only by subpoenaing hundreds of boxes of documents, reading thousands of emails, conducting numerous interviews, and spending months unraveling how that tax shelter worked.

We figured out Slapshot. But the larger issue, which we are now investigating with the support of our Subcommittee Chairman Norm Coleman, is how respected U.S. financial institutions end up hawking abusive tax shelters and enlisting the help of so many other respected U.S. professionals to make them work.

Our investigation has found, sadly, what could be called a target-rich environment – numerous respected accounting firms, investment advisors, banks, and law firms spending substantial resources, forming alliances, and developing the internal and external infrastructure necessary to aggressively design, market, and implement hundreds of complex tax shelters that U.S. taxpayers would otherwise be unable, unlikely, or unwilling to employ. And they are doing it in exchange for hundreds of millions of dollars in fees and other compensation, while denying the U.S. Treasury billions of dollars in revenues each year.

One common feature of the tax shelters we have examined during the past year is their reliance on highly skilled professionals. Many, for example, use layers of corporations, trusts, and special purpose entities that only a trained financial professional could devise and establish. Others rely on intricate financial transactions involving derivatives, warrants, and little known financial instruments that only a sophisticated investment professional could arrange. Still others utilize deceptive, multi-million-dollar loans that only our largest financial institutions could finance. And most rely on complex and novel interpretations of tax law, complete with obscure tax code references and convoluted tax opinions, that only a determined tax lawyer could construct and commit to paper.

Equally troubling is that, time and again, our investigation found that the professionals marketing highly questionable tax shelters were deliberately trading on their reputations as respected, big-name players in American business. Part of their sales pitch has been to assure potential clients that they can use complex financial transactions which those clients barely understand to eliminate their tax bills, and can rely on the firm's expertise, vast resources, and reputation to fend off IRS scrutiny and penalties. Some of the professionals peddling these tax dodges also have the audacity to claim that they are not tax shelter promoters subject to the IRS regulations requiring promoters to disclose their tax shelter activities.

Some people claim that the worst tax shelter abuses are already over, so there is no need for investigations, reforms, or stronger laws. But our investigation indicates that, while a few promoters are calling it quits, the tax shelter industry as a whole is still going strong, targeting new opportunities and market segments, hawking tax shelters like late-night cut-rate T.V. bargains, and victimizing honest taxpayers, communities, and tax professionals.

Next month, the Permanent Subcommittee on Investigations will hold the first in what we hope will be a series of hearings presenting detailed case histories demonstrating how respected U.S. tax and financial professionals develop, market, and implement abusive and highly questionable tax shelters. We plan to present an inside look at the attitudes and operations underlying these tax shelter activities, including documentary evidence illustrating the aggressive approach that some respected firms have taken in selling their tax shelters. For example, at one leading accounting firm that develops and markets tax shelters, but denies being a tax shelter promoter, a senior tax professional circulated to his team of professionals an internal email which states the following:

“I want to personally thank everyone for their efforts during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now let[‘]s SELL, SELL, SELL!!”

Our Subcommittee’s year-long investigation compliments the important work being done by the Finance Committee today. Our investigation also confirms that the tax shelter legislation already developed by this Committee is desperately needed. The Senate has twice followed this Committee’s leadership in approving tax shelter reforms which, among other measures, would strengthen the economic substance doctrine, tighten tax shelter prohibitions, and increase penalties on abusive tax shelter promoters. This Senate legislation has not yet been adopted by the House, but, hopefully, this hearing and our investigation will provide additional specific evidence and momentum for its enactment.

In addition, I am introducing today, with the cosponsorship of Senator Baucus and Senator McCain, a bill to end the conflicts of interest that now arise when an accounting firm sells an abusive tax shelter to an audit client and then audits that client’s financial statements -- in effect auditing its own work. The Auditor Independence and Tax Shelters Act would bar an accounting firm from auditing the books of any publicly traded company to which it has sold a tax shelter. The bill would also codify four auditor independence principles to guide publicly traded companies on how to avoid other auditor conflicts of interest. I ask unanimous consent to include in the hearing record a summary of our bill and a letter from five public interest organizations endorsing it. Your hearing will help show why this legislation is needed, and I hope additional Members of this Committee will join me, Senator McCain, and Senator Baucus in supporting it.

Thank you again for this opportunity.



William J. McDonough, Chairman, PCAOB  
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## TESTIMONY

Chairman Grassley, Ranking Member Baucus and Members of the Committee –

I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). I would like to begin by commending the Committee's thoughtful and deliberative review of the Enron debacle, resulting in the Joint Tax Committee's report exposing Enron's abusive tax shelters and Enron's use of executive compensation arrangements to the excessive advantage of senior managers and the devastating disadvantage of rank-and-file employees. Indeed, the evidence you and the Joint Committee on Taxation have accumulated has served as a wake-up call that we all – whether corporate leader, legislator, or regulator – must heed.

The Senate Finance Committee was quick to see the wide-ranging ramifications of the financial scandals at Enron, Adelphia, WorldCom, HealthSouth and other companies. Those corporate collapses left the impression – not just with investors, but with ordinary Americans, and even with the world community – that public company financial reporting is not to be trusted, and that professional advisors, including investment bankers, lawyers, and even a company's outside accountants, will help unscrupulous executives cook the books. When their trust was broken, the people did what they ought to – they asked their elected representatives to fix it. Congress responded by enacting the Sarbanes-Oxley Act of 2002, which, among other things, created the PCAOB. In addition, through the Senate Finance Committee's series of hearings on Enron's tax shelters – shelters that were designed to create the appearance of financial statement earnings – and on excessive executive compensation, you continue to respond to the public's concerns regarding corporate integrity and financial reporting reliability.

I am both proud and humbled to appear before you today as Chairman of the PCAOB. Among the many reasons I took on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector. It is a privilege to have the opportunity to act on those convictions by helping to build an organization, in the form envisioned by Congress, to restore the linchpin of the American financial system – trust in the integrity of financial reporting.



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### Introduction

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the "Act").<sup>1/</sup> The Act established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."<sup>2/</sup> To carry out this charge, the Act gives the Board significant powers. Specifically, the Board's powers include authority –

- to register public accounting firms that prepare audit reports for issuers;
- to conduct inspections of registered public accounting firms;
- to conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- to enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- to establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.<sup>3/</sup>

### Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of steps to position it to carry out its core programs. Starting from scratch in January 2003, the Board has grown to over 90 full-time professional staff. Earlier this year, the Board opened offices in Washington, D.C. and New York City, as well as an information technology center in Northern Virginia. The Board will be opening regional

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<sup>1/</sup> P.L. No. 107-204 (2002).

<sup>2/</sup> Sarbanes-Oxley Act, Section 101(a).

<sup>3/</sup> Sarbanes-Oxley Act, Section 101(c).



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offices in Atlanta, Dallas and San Francisco in the near future. The Board also adopted bylaws and established ethics rules and standards of conduct for Board members and staff and developed a budget of approximately \$68 million for its first fiscal year (calendar year 2003). The SEC approved that budget in April, and we have sent invoices to public companies and other issuers of securities – based on their relative equity market capitalizations, in accordance with the Act – to cover it.

### Registration

The Act and the Board's rules require that as of tomorrow, October 22nd, all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must be registered with the PCAOB.<sup>4/</sup>

Registration is critical to the Board's regulatory oversight of public accounting firms. As a legal matter, registration is the predicate for the Board's other oversight programs – compliance with auditing and related professional practice standards, inspections, investigations, and discipline. In addition, registration provides the Board with valuable information about the firms that apply for registration.

Registration of a public accounting firm is not automatic upon application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, fair and independent audit reports for public companies. To make that determination, the Board has been and remains committed to a careful and fair review of all applications. The Board received its first registration application on August 7, 2003, and, as of October 16, 2003, the Board has received 619 applications.

### Inspections

The Act requires the Board to conduct a continuing program of inspections of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

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<sup>4/</sup> Non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB next year.



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Through the Board's inspection program, we will have extensive contact with registered firms and their personnel. It is the tool we will use to assess the quality of the audits that have been conducted and, when necessary, to exert pressure to change auditor behavior. It will provide us with a view – at times through a microscope, and at other times from a bird's eye – into the registered firms to see how they are implementing applicable auditing and related professional practice standards, how they are complying with applicable laws and rules, where they are doing well, and where improvements are needed. Our inspections program will provide a unique new source of evidence relating to audit quality and to the symptoms of any weaknesses in audit quality, ranging from competence and methodology to judgment and integrity.

Our inspections will focus on a number of areas that have not been the traditional focus of the profession's own peer review process. These include –

- the "tone at the top" of registered firms – we want to know the nature of the messages that are coming from the highest levels of the firms and their frequency, and whether the messages are received and acted on;
- partner compensation and promotion – we are going to look into what behaviors are rewarded and reinforced through compensation and promotions; and
- the firms' overall communication and training practices with regard to all firm professionals.

On October 7, 2003, the Board adopted final rules relating to inspections. Under the final rules –

- regular inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies;
- other firms are subject to regular inspections every three years; and
- special inspections may be authorized by the Board at any time.

Earlier this year, we began conducting limited inspection procedures on the four largest accounting firms, which agreed to cooperate with the Board's inspectors even before they were registered. Those inspections are well underway now. Beginning in 2004, we will conduct annual regular inspections of all firms with more than 100 issuer





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audit clients, as required by the Act, and we will conduct triennial regular inspections of registered firms with 100 or fewer issuer audit clients.

Of particular importance, given the Joint Committee on Taxation's findings on the non-audit services Arthur Andersen provided to Enron, our work programs for this year's limited procedures include a focus on evaluating the independence implications of non-audit services that firms have provided to audit clients. Based on this work, we will not only assess whether the firms comply with existing independence requirements, but we will also assess whether there are any factors present that have adversely affected audit quality. Because we are inspecting the Big Four large firms, and a variety of selected audit engagements, we expect to gain an understanding of the firms' practices on an overall basis, which will help us to determine whether further action is needed.

### Investigations and Discipline

The Act authorizes the Board to conduct investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, provisions of the securities laws and the Commission's rules related to financial reporting and auditing, or professional standards. The Act further authorizes the Board to use the results of those investigations as the bases for disciplinary proceedings. If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation.

On September 29, 2003, the Board adopted an extensive set of rules relating to investigations and disciplinary hearings. The PCAOB is also in the process of staffing a Division of Enforcement and Investigations, which will have responsibility for carrying out the Board's investigative work and conducting its disciplinary proceedings.

### Professional Standards

Title I of the Act also gives the Board the authority to establish auditing and related professional practice standards to be followed by registered public accounting firms, and persons associated with such firms, when they audit and issue opinions on the financial statements of public companies.<sup>5/</sup> In addition to auditing standards, those standards include related attestation work, standards for quality controls, ethics standards, and independence standards. Early on, the Board decided to establish professional standards by creating within the PCAOB a standard-setting office, made up of highly-skilled experts, rather than by delegating the standard-setting function to a

<sup>5/</sup> See Sarbanes-Oxley Act, Section 103.



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professional organization of accountants, such as the AICPA's Auditing Standards Board.

In addition to this general standards-setting authority that Title I of the Act confers on the Board, Section 201 of the Act expressly authorizes the Board to adopt regulations specifying non-audit services – in addition to those specified in the Act – that may not be provided to audit clients.<sup>6/</sup> Section 201 also permits the Board, on a case-by-case basis, to grant exemptions from the Act's prohibitions on providing certain non-audit services to audit clients, but only to the extent necessary or appropriate in the public interest and consistent with the protection of investors.

The Act required the Board to adopt initial or transitional standards as part of the process leading up to the SEC's determination, pursuant to the Act, that the PCAOB was capable of carrying out its responsibilities under the Act.<sup>7/</sup> Accordingly, on April 16, 2003, the PCAOB announced the adoption of certain interim standards to be used by registered public accounting firms and associated persons in the issuance of public company audit reports, and the SEC approved those standards as part of its April 25, 2003 determination. The interim standards include the accounting profession's existing standards on auditing, attestation, quality control, ethics and independence. Further, where the SEC's rules on independence are more restrictive, the interim standards note that registered public accounting firms and their associated persons must comply with the SEC's more restrictive requirements.

When the Board announced these interim standards, we also announced the process we intend to use to establish permanent auditing and other professional standards. The process will include soliciting comment from the public, in addition to the views of an advisory group formed pursuant to the Act. Under the Board's rules, that advisory group will be composed of individuals with a variety of expertise, including accountants, issuers, investors, regulators and others. We also plan to use other

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<sup>6/</sup> Section 201 of the Act specifies the following non-audit services that may not be provided to an audit client: (1) bookkeeping or other services related to the accounting records or financial statements of the issuer; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker, dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.

<sup>7/</sup> Sarbanes-Oxley Act, Section 103(a)(3)(B).



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means to obtain expert advice, such as *ad hoc* task forces, roundtable discussions (which we have already held on certain issues), and other public hearings.

### **Statutorily Established Standards-Setting Priorities**

The Act itself sets forth the PCAOB's initial standards-setting agenda. First and foremost on this agenda is a standard for the auditor's attestation on management's assessment of internal control over financial reporting, as required by Section 404 of the Act. This provision required both the SEC and the PCAOB to promulgate rules. Section 404(a) required the SEC to promulgate rules requiring management to assess and report on the effectiveness of internal control. The SEC did so in June 2003, and its rules now require public companies to file such reports, with annual reports for fiscal years ending on or after June 15, 2004. Section 404(b) requires registered public accounting firms to attest to management's report on its assessment of internal control, consistent with attestation standards established by the PCAOB. In order to have a permanent standard in place in time for auditors to use in audits completed in June 2004, the PCAOB has already begun developing the standard, by holding a public roundtable discussion on internal control in July 2003 and issuing a proposed standard at a public meeting held earlier this month.

Good internal control over financial reporting is essential for a public company to function and to meet its obligations to protect its investors. Thus, the professional standards that the PCAOB is setting in this area are central to the mandate to protect investors and vital to furthering the public interest in the preparation of informative, fair, and independent audit reports.

While addressing Section 404 is the PCAOB's most pressing standards-setting assignment, it is far from the only one. The Act also mandates that we establish requirements for audit documentation, for second-partner reviews, and for quality control standards for audit firms, and we are diligently and rapidly working on those subjects.

The PCAOB has also announced plans to review systematically all of the interim professional standards and to determine whether they should be modified, repealed, or made permanent. We plan to consider and establish priorities for conducting this review once we have formed a standing advisory group, in order to obtain the benefit of the group's advice.

### **Current Rules on Auditors' Provision of Tax Services**

As directed by the Act, the SEC adopted new independence rules in order to implement Title II of the Act. These rules, which became effective in May 2003, address


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key aspects of auditor independence with special emphasis on the provision of non-audit services. Consistent with Section 201 of the Act, the rules expressly prohibit eight categories of non-audit services.<sup>8/</sup> The SEC's rules also implement the Act's requirement, in Section 202, that all auditing services, and those non-audit services that do not satisfy a *de minimis* threshold, be preapproved by the company's audit committee.

Neither the Act nor the SEC's rules prohibit tax services that are preapproved by the company's audit committee (unless, of course, those services also fall into one of the categories of expressly prohibited services). Rather, the Act expressly recognized that accountants "may engage in any non-audit services, including tax services," that do not fall into one of the prohibited categories, provided that each service is approved in advance by the audit committee.<sup>9/</sup> The SEC's adopting release on its new rules noted that there had been considerable debate regarding whether an accountant's provision of tax services for an audit client could impair the auditor's independence. The SEC determined not to prohibit tax services, however, in part because audit firms – both large and small – have long played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities. Thus, the SEC "reiterated its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence \* \* \* [and] may continue to provide tax services such as tax compliance, tax planning, and tax advice, to audit clients, subject to normal audit committee pre-approval requirements \* \* \*."<sup>10/</sup>

While the SEC made clear that it did not consider conventional tax compliance and planning to be a threat to auditor independence, it distinguished such traditional services from the marketing of novel, tax-driven, financial products, which the SEC noted raise some serious issues. The SEC's release thus cautioned that audit committees should "scrutinize carefully" the retention of the auditor in a transaction initially recommended by the auditor. Moreover, the release referred to the recommendation of the Conference Board's Commission on Public Trust and Private Enterprise that, as a "best practice," auditors not provide advice on "novel and debatable" tax strategies and products.<sup>11/</sup> Further, since the SEC's release, the AICPA has also suggested that "advice on tax strategies having no business purpose other

<sup>8/</sup> See supra note 6.

<sup>9/</sup> See Sarbanes-Oxley Act, Section 201(a).

<sup>10/</sup> Securities Act Release No. 8183 at § II.B.11 (January 28, 2003).

<sup>11/</sup> Id. at note 112.



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than tax avoidance is an appropriate dividing line for activities that should be prohibited to auditing firms registered under the Sarbanes-Oxley Act.<sup>12/</sup> Thus, there appears to be consensus that auditors ought not to be selling abusive tax shelters to audit clients.

### **The PCAOB's Tools to Evaluate and Address the Use of Abusive Tax Shelters to Manipulate Financial Statement Earnings**

The PCAOB has a variety of tools to help address problems caused by the use of complex structured transactions designed to inflate financial statement earnings. First, as part of the Board's inspections of registered firms' audits of public companies' financial statements, we will identify, and examine how firms audit, questionable, tax-oriented transactions. We will also look for auditors' involvement in structuring such transactions. The Joint Committee on Taxation found that Enron's auditor, Arthur Andersen, had promoted and provided an opinion on two of the 12 structured transactions that the Joint Committee examined and challenged. Given Arthur Andersen's involvement in the transactions, the Joint Committee also questioned the firm's ability to audit the transactions with impartiality.

Because we are only beginning to build our inspections program, we cannot today assess the current extent of promotion and use of corporate tax shelters and products. We will, however, scrutinize the accounting and presentation of transactions that we discover through our inspections program, including specifically through our reviews of selected audit engagements. In addition, by looking at compensation, promotion, and retention issues, our inspections will identify a firm's policies and practices that create incentives for firm audit personnel to promote such transactions to their clients.

Therefore, while existing laws and regulations may not ban auditors from promoting and giving tax opinions on all such transactions to their audit clients, both auditors and companies should expect heightened scrutiny of such transactions. The prospect of that scrutiny may help to influence the relevant parties – corporate managements that are attracted to the transactions, audit committees that must approve auditors' work on the transactions, and auditors that must attest to the propriety of the accounting treatment of the transactions – not to engage in questionable transactions. Indeed, some firms have already announced that they will no longer promote or give tax opinions on certain types of structured transactions to their audit clients.

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<sup>12/</sup> "SEC Proposals on Auditor Independence, Non-Audit Services Affect Tax Practitioners," 83 The CPA Letter at 1, 4 (February/March 2003).



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Second, through our authority to discipline registered firms and associated persons, we may impose stiff penalties for failing to audit such transactions adequately and impartially. These penalties include revoking a firm's registration and banning individual accountants from working on audits of public companies. We also have lesser sanctions in our arsenal, such as imposition of an independent monitor to review the firm or person's work and of tailored quality control measures.

Finally, the Board has the authority to commence a standards-setting project to address the problem, including, for example, by adopting new auditing, ethics or independence standards. The Board's authority to prohibit a registered firm from providing certain non-audit services is restricted, however, to limiting the services that a registered firm may provide to an audit client, and the Board cannot directly prohibit a registered firm from selling tax shelters to non-audit clients. Therefore, even adding to the list of prohibited services may not ensure that an auditor who has sold such a strategy to a non-audit client is any more impartial when he or she audits a similar transaction purchased by an audit client from another promoter.

The Board also has the authority, however, to develop and impose additional auditing procedures. If registered public accounting firms and their associated persons conduct audits properly and impartially, then the financial statement effects of aggressive – even if arguably legitimate – tax shelters should be transparent, which would essentially defeat the purpose of transactions whose only purpose is to make the financial statements look better. The Internal Revenue Service's list of punishable abusive tax shelter devices may, by necessity, lag practice (such that by the time a transaction joins the list, the field has already moved onto another type of transaction), but outside accountants audit the financial statements of companies who choose to engage in these transactions on a current basis. Just as Arthur Andersen had year-round offices at Enron's headquarters, the auditors of the largest companies are often "in the field" auditing much of the year. In addition, companies that engage in complex transactions typically ask their auditors to bless such transactions before completion, in order to be sure of the transaction's financial accounting treatment.

Abusive, or even very aggressive, tax strategies undertaken primarily to have an effect on a company's financial statements may be difficult for regulators and other investigators to find, but auditors are in a unique position to identify them. If the accounting profession chooses to rise to this challenge, then it will reap the benefits of renewed confidence in the integrity of its professionals. If the accounting profession shrinks from the challenge, then we will address it for them.



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### Conclusion

With the Congress's vision in establishing authority for independent standards-setting, registration, inspection, investigations and discipline, you have given the PCAOB the responsibility and the tools to build a new future for auditing public companies. I have faith that my fellow Board members and our staff will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before enactment of the Sarbanes-Oxley Act. We will scrutinize accounting records, accountants' practices, and we will adjust the rules as necessary. In the wake of Enron and Arthur Andersen, the accounting profession was weighed and found wanting, but it was given a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective – one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

What's at stake for all of us is the trust of the American people in our markets and the companies that drive our economy. We have an opportunity to reclaim that trust. As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Committee.

Thank you.

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**ANSWERS FOR THE RECORD****FROM PCAOB CHAIRMAN WILLIAM J. MCDONOUGH  
TO QUESTIONS FROM SENATOR MAX BAUCUS  
AND SENATOR BOB GRAHAM****October 21, 2003 HEARING**

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**Questions from Senator Baucus:****Question 1:**

Congress gave the Board responsibility to “establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.” Given the Joint Committee on Taxation’s findings on the non-audit services Arthur Andersen provided to Enron, the Board intends to focus on evaluating the independence implications of non-audit services that firms have provided to audit clients. In particular, based on what we know from Enron, WorldCom, Xerox, and other corporate accounting scandals, should government re-think the extent to which accounting firms are permitted to provide both audit and tax services to the same company?

**Answer:**

The Senate Finance Committee, as well as other legislators and regulators, have brought to light important issues relating to the development of tax shelters and other complex, structured transactions – including issues relating to the practice of auditors providing tax services to their audit clients – that all relevant lawmakers and regulators should be attentive to. In exercising regulatory responsibilities related to auditing, the PCAOB will necessarily approach the tax services question from the standpoint of how the provision of certain tax services to an audit client affects the auditor’s ability to perform an independent and thorough audit of all aspects of its client’s financial statements. This is a somewhat different focus from the broader regulatory policy question of whether certain types of tax services, because of their abusive nature, should not be made available by accounting firms to any type of client. Legislators and regulators ought to develop policy approaches to that broader question with attention to the full panoply of contexts in which abusive tax shelters are marketed and sold. A Board prohibition on accounting firms providing certain tax services to their public company audit clients would leave much of the larger problem of tax shelter marketing untouched.



**Question 2:**

Does the Public Company Accounting Oversight Board have the tools and independence – from the SEC and the accounting firms who pay dues to the Board – to enact tough rules to prohibit tax shelter buying and selling between accounting firms and companies?

**Answer:**

The Board is completely independent of accounting firms. The Act provides for the Board to establish its budget each year, subject only to the approval of the Commission. Once the Commission has approved the Board's budget, under the Act, the bulk of the Board's budget will be covered by mandatory fees to public companies. The Act provides for public accounting firms to pay only that portion of the Board's budget expenses that is attributable to processing and reviewing those firms' applications for registration and annual reports, and in any event those fees are mandatory, not voluntary. Thus, the Act provides the Board a strong and secure source of funding such that the Board's existence and vitality do not depend upon being in the good graces of the accounting profession. In addition, as required by the Act, the Board has adopted a strict code of ethics that bars relationships that could compromise the independence of individual Board members and staff vis-à-vis registered firms. Finally, the Act requires Board members to commit to full-time independent service.

In carrying out its mandate to establish rules and standards relating to registered public accounting firms' audits of public companies, the members of Board are committed to basing their decisions on their own best judgment, independent of any outside influences. Under Section 107 of the Act, however, any rules or standards adopted by the Board are not effective unless approved by the SEC.

Through the Act, Congress wisely insulated the Board from the types of external pressures that might otherwise lead a different type of organization – such as a private oversight entity that is organized by or otherwise answers to the profession – to be less demanding than the public interest warrants. And the Act does in fact give the Board the tools to be very tough within the sphere of responsibility given to the Board. The Board's authority to prohibit a registered firm from providing certain non-audit services is restricted, however, to limiting the services that a registered firm may provide to an audit client, and the Board cannot directly prohibit a registered firm from selling tax shelters to non-audit clients.

**Question 3:**

Please comment on S. 1767, the Auditor Independence and Tax Shelters Act. Does the Public company Accounting Oversight Board have any recommendations for improving the legislation?

**Answer:**

Consistent with the Board's mandate to oversee the auditors of public companies, the Board fully is committed to the goal of improving audit quality. The Board commends the sponsors of S. 1767 for their efforts to strengthen the independence and quality of the audits of public companies and to combat the problems of abusive tax shelters. The Board has not taken a position on S. 1767, however, because the Board is still implementing Title I of the Sarbanes-Oxley Act. The Board is charged with enforcing compliance by registered public accounting firms with the Act, the federal securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accounts with respect thereto, the Board's rules, and the rules of the Securities and Exchange Commission. To the extent that the Congress adds to the laws that the Board enforces, the Board will vigorously enforce those laws.

**Question 4:**

Please describe the level of coordination, cooperation and communication between your Board and the others represented on the panel – and – is there more that should be done to ensure a comprehensive, coordinated attack on abusive tax shelters?

**Answer:**

The Board's inspection, enforcement, and standards-setting programs remain, relatively speaking, in their early stages, and necessarily are focused on the core mission that Congress assigned to the Board: oversight of registered public accounting firms' work and conduct in auditing public companies' financial statements. Because the problem of abusive tax shelters has many aspects that go well beyond issues related to public company financial statement audits, any comprehensive approach is best formulated by those agencies that have long experience in wrestling with this specific problem – the Internal Revenue Service, the Department of the Treasury, and the Department of Justice. The Board stands ready to assist, consistent with its statutory authority, in any coordinated approach to curtailing the use of abusive tax shelters. It should be noted, however, that the Act strictly limits the list of agencies with whom the Board may share information it obtains in connection with an inspection or investigation, and that list does not include the Internal Revenue Service or the Department of Treasury.

**Question from Senator Graham:**

Do you believe that the Public Company Accounting Oversight Board has the authority to discipline registered public accounting firms that consistently peddle abusive tax shelters? If so, in what form could such discipline take?

**Answer:**

Many registered public accounting firms engage in business activities that do not necessarily relate to the work for which they are required to register with the Board – the preparation of audit reports for public companies. The Act gives the Board far-reaching authority to regulate the public company audit-related work of registered firms, but does not contemplate Board regulation or discipline with respect to other aspects of a registered firm's business. Section 105 of the Act, in describing the conduct for which the Board may impose disciplinary sanctions, refers to acts, practices, or omissions to act,

in violation of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards . . . .

In many cases, the marketing of tax shelters – even abusive tax shelters – may not, in and of itself, violate the laws, rules, and standards referenced in Section 105 of the Act.

Nevertheless, the Board may be able to address aspects of a registered firm's conduct relating to such tax shelters. For example, a firm's audit client may engage in tax-related transactions that have no business purpose other than to create the appearance of financial statement earnings. An auditor who issues an unqualified opinion on financial statements that misleadingly show enhanced earnings because of the use of an abusive tax-related transaction may have liability under the laws, rules, and standards referenced in Section 105 above. In that event, the Board would have the authority to investigate the auditor's audit work and, in appropriate cases, discipline the auditor for violation of those laws, rules, and standards.

In addition, an auditor who detects an illegal tax shelter entered into by a public company client, which may include a tax shelter designed not to create the impression of earnings but rather solely to avoid taxes, may have an obligation under Section 10A of the Exchange Act of 1934 to bring the illegal act to the attention of the audit committee of the company and others, including the SEC. If a Board inspection or investigation revealed that an auditor had failed to comply with Section 10A in that circumstance, the Board could take disciplinary action against the auditor for that failure.



# Department of Justice

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STATEMENT

OF

EILEEN J. O'CONNOR  
ASSISTANT ATTORNEY GENERAL  
TAX DIVISION

BEFORE THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE

CONCERNING

COMBATING ABUSIVE TAX SHELTERS

PRESENTED ON

OCTOBER 21, 2003

Mr. Chairman, Ranking Member, Members of this Committee: thank you for inviting me to be with you today to discuss the work of the dedicated men and women of the Tax Division of the United States Department of Justice in the ongoing battle against the abusive tax shelters that undermine the integrity of our tax system.

My overarching goal as Assistant Attorney General for the Tax Division is quite simple: to restore respect for the tax laws. People who comply with the laws and pay the bills of this great nation should have the assurance that the government is doing something about people who are not, either by simple or by sophisticated means.

My remarks today begin with a brief description of the role the Tax Division in tax enforcement in general, followed by a review of our recent activity in the tax shelter arena, ranging from what I call our information litigation to our merits litigation.

#### **THE TAX DIVISION**

Under the authority of the Attorney General, the Justice Department's Tax Division is responsible for the conduct of virtually all litigation involving the federal tax laws. The only exception is cases brought in the United States Tax Court: IRS attorneys handle those. The Tax Division of the United States Department of Justice is responsible for all other litigation involving the tax laws, affirmative or defensive, including appeals from Tax Court decisions.

Tax Division attorneys represent the United States government in federal district courts, the bankruptcy courts, the Court of Federal Claims, and the United States Courts of Appeals. We defend federal tax claims in bankruptcy, and IRS agents in suits brought against them for actions taken in the performance of their duties. We bring legal actions to collect taxes due. We bring injunction suits to stop illegal activities before they can do further harm to the Federal Treasury. The Tax Division assists the Solicitor General of the United States in Supreme Court cases involving or affecting the administration or enforcement of federal tax laws.

To promote nationwide consistency in the criminal enforcement of the tax laws, Tax Division authorization is required before the Department of Justice investigates or prosecutes a tax charge. We delegate authority to United States Attorneys to handle most grand jury investigations and criminal tax prosecutions, with Tax Division prosecutors often supervising or assisting. Tax Division prosecutors also personally litigate a small proportion of tax prosecutions.

At any given time, we have about 7,000 civil cases in progress and about 700 cases before the United States Courts of Appeal. This past fiscal year, we authorized the prosecution of more than 1,100 defendants, an increase of 17% from the prior year, which itself was an increase of 16% over the year before that. To accomplish all of this, the Tax Division employs about 550 people, of whom about 350 are attorneys.

Of all Tax Division activities, the most relevant to the subject of today's hearing are these: we help the IRS obtain information it needs to accomplish its examination function by obtaining judicial enforcement of administrative summonses or obtaining leave of court for the Internal Revenue Service to serve John Doe summonses. And we defend the United States in refund suits and in tax claims in bankruptcy. The comments that follow address these two areas of endeavor.

### **Abusive tax shelters**

Abusive tax shelter cases involve both corporations and individuals. A coordinated and effective effort is essential to prevent substantial losses to the federal fisc and to deter other taxpayers from using such shelters in the future.

The Tax Division coordinates closely with the Internal Revenue Service in all of our work. The Tax Division's summons enforcement team, comprised of senior lawyers, provides guidance to the IRS and to Tax Division attorneys in connection with the issuance and enforcement of tax shelter promoter summonses and John Doe summons issued to promoters. The Division's tax shelter coordinator maintains regular contact with IRS Tax Shelter program personnel, ensures that the IRS is consulted on major litigating decisions, provides guidance to our lawyers, and orchestrates training and planning sessions. We also have an extremely close working relationship with the IRS on the offshore credit card summons cases, and on efforts to shut down tax schemes and scams. The degree of coordination and cooperation between the IRS and the Tax Division has probably never before been this close and extensive.

### **Information Litigation: Summons Enforcement Actions**

The Tax Division plays an important role in curbing abusive tax shelters by obtaining judicial enforcement of IRS summonses. Since 1984, tax shelter organizers have been required to register certain tax shelters with the IRS before offering them to the public. In addition, organizers and sellers of potentially abusive tax shelters are required to

maintain a list of all shelter purchasers, and to make that list available to the IRS on 20-days notice. Failure to comply with these requirements can result in penalties.

The Tax Division has brought summons enforcement actions against some of the nation's largest accounting firms to obtain information for IRS examinations of compliance with the tax shelter registration and list maintenance requirements and to commence examinations of the customers. In cases against BDO Seidman and Arthur Andersen, the district courts enforced the summonses and ordered these entities to turn over the documents needed by the IRS to ensure compliance with the law. Privilege issues relating to compliance with the enforcement orders in these cases are still being litigated. Privilege issues are also being litigated in a pending case with KPMG.

These summons enforcement actions will help the IRS not only to determine the promoters' liability for penalties but also to audit their tax shelter customers, and thereby recoup taxes otherwise lost to the Federal Treasury.

Although we contend that the list-maintenance requirement Congress enacted clearly precludes any claim of identity privilege for tax shelter customers regardless of whether the promoters happen to be accountants or lawyers, the issue continues to be the subject of vigorous litigation. In two cases involving accounting firms, and one involving a bank, clients sued to intervene in an attempt to prevent the firms and the bank from divulging their names to the IRS, claiming that their identities were privileged. The Seventh Circuit rejected this claim in the *BDO Seidman* case and held that the identities of participants are not protected by privilege and must be disclosed to the IRS. The United States District Court for the Northern District of Illinois in *Arthur Andersen* subsequently issued an opinion following the decision of the Seventh Circuit. The United States District Court for the Western District of North Carolina found, in *Wachovia*, that customers of a bank that had facilitated a tax shelter transaction could not prevent the bank from disclosing their identities to the IRS. The Court in *Wachovia* also concluded there was no attorney-client relationship between the bank's customers and Jenkens & Gilchrist, the law firm that had rendered an opinion on the tax shelter transaction.

A few months ago, at the request of the IRS, the Tax Division obtained a district court order allowing the IRS to serve a "John Doe" summons on the law firm Jenkens & Gilchrist. The summons requires Jenkens & Gilchrist to disclose the identities of

persons who participated in tax shelters organized or sold by the law firm. The Division subsequently filed an action asking the court to enforce compliance with the John Doe summons and with five administrative summonses the IRS had issued as part of the its examination of Jenkens & Gilchrist's possible promotion of tax shelters.

Last week, the federal district court in Chicago entered an order authorizing the IRS to serve a John Doe summons on the law firm Sidley Austin Brown & Wood to identify participants in listed transactions and other potentially abusive transactions organized or sold by the firm's Chicago office.

As a result of the enforcement orders entered by the courts in the summons cases, the IRS has been able to obtain documents relating to potentially abusive transactions and the identities of taxpayers who may have participated in these transactions. But privilege claims concerning a substantial number of documents have yet to be resolved by the courts.

These suits are complex, difficult, and resource-intensive to prepare and file. Bringing these suits is only the first step in what has become hotly contested litigation. The resource demands continue until all aspects of a case are resolved.

The Tax Division has made it a priority to file these suits promptly and to represent the IRS effectively in the ensuing litigation. The cases must be and are prepared with great care because of their importance to the enforcement of the internal revenue laws, and the need to satisfy the courts that the requests are legally justified.

#### **Substantive Litigation: Appellate Litigation and Defense of Tax Shelter Refund Suits and Tax Claims in Bankruptcy**

The Tax Division plays an important role in the government's efforts to combat abusive tax shelters. Tax Division attorneys will handle any defense of tax shelter refund suits in the district courts and the Court of Federal Claims, as well as any defense of tax claims in bankruptcy proceedings, and also any appeal of a Tax Court decision. While each tax shelter case the Division handles involves millions of dollars of tax revenue, its impact goes far beyond the taxpayer and the years in issue. Each of these cases has the potential to set precedent that will affect other taxpayers who might still be under IRS examination or elsewhere in the administrative or judicial pipeline.



More and more cases involving large abusive tax avoidance transactions are being filed in the district courts and in the Court of Federal Claims rather than in the Tax Court. The Tax Division is now actively engaged in the litigation of 27 abusive tax shelter cases.

Compared to other tax cases, abusive tax shelter cases are especially costly to litigate. Taxpayers have been known to staff the cases with a dozen attorneys and several very-highly paid expert witnesses. The Tax Division staffs these cases at the outset with at least two attorneys, and usually three attorneys, to handle the discovery and other pretrial work in a timely and efficient manner. We must also hire our own private sector experts to testify about the purported business purpose, the values of any assets or liabilities at issue, foreign law, and other subjects.

Disputes about discovery are frequent. In many of these cases, tens of thousands of documents are relevant to transactions at issue. The sheer volume and complexity of the factual records in these cases make it essential to scan the case documents into electronic form and create computer databases that facilitate the management and sorting of the data. All in all, the cases are extremely resource intensive.

#### **Substantive Successes**

The Tax Division has had some notable successes in litigating abusive tax shelter cases.

1. In *Boca Investorings Partnership v. United States*, a case involving a contingent installment note shelter, the District of Columbia Circuit held that the taxpayer's formation of a "partnership" with a foreign entity not subject to United States tax to shelter a large capital gain lacked economic substance and would not be given effect for tax purposes. The foreign partnership purchased private placement notes (PPNs), and the PPNs were immediately exchanged for contingent payment installments. The exchange is supposed to generate large capital losses under the ratable basis recovery rule in Section 453 of the Internal Revenue Code, with the losses allocated to the United States taxpayer and gains allocated to the foreign partner. The decision aligns the District of Columbia Circuit with the Third Circuit, which in the *ACM Partnership* decision earlier denied similar benefits to a taxpayer participating in the same tax shelter scheme. Merrill Lynch marketed this scheme to many of its corporate clients. (This shelter is described in Notice 2001-51, 2001-2 C.B. 190.)

2. In *Nicole Rose Corp. v. Commissioner*, the Second Circuit rejected a corporation's use of an abusive tax shelter to avoid tax on gain realized on the sale of a manufacturing business, and upheld the assessed negligence penalty. The court found that the corporation engaged in a sham computer leasing transaction designed to generate an apparent tax loss at a small economic cost to itself.

3. The district court held in *CM Holdings* (D. Del.) that interest on loans to fund corporate owned life insurance (COLI) policies was not deductible and the Third Circuit affirmed. The COLI cases involve taxpayer claims of large interest deductions on purported policy loans against life insurance policies taken out on all of the corporation's employees. In the 1980's and early 1990's, many Fortune 500 companies purchased COLI policies covering thousands of employees, used purported loans to pay the premiums, and deducted interest on the policy loans. Congress phased out the interest deduction on broad-based COLI policies beginning in 1996. The government's position is that such loans lack economic substance and thus do not give rise to interest deductions under § 163. In another COLI case, *American Electric Power Co.* (S.D. Ohio), the district court agreed with the government's position and the Sixth Circuit affirmed. The district court in *Dow Chemical* (E.D. Mich.) recently issued an adverse decision in another COLI case, but any government appeal would be heard by the Sixth Circuit, the same court that decided *American Electric Power Co.*

#### **Pending Cases**

The Tax Division's inventory of pending cases involve a variety of abusive tax shelter techniques:

Lease stripping shelters. In a lease stripping shelter, the taxpayer claims large deductions from a multi-party transaction intended to allow the income from a lease to be allocated to a tax-neutral entity such as a foreign corporation or Indian tribe, and allow the related deductions to be claimed by the taxpayer. (This shelter is described in Notice 2003-55, 2003-34 I.R.B. 395, modifying and superceding Notice 95-53, 1995-2 C.B. 334.)

Basis shifting shelters. Basis shifting shelters involve a taxpayer's attempt to use §§ 302 and 318 (relating respectively to corporate stock redemptions and the constructive ownership rules) to shelter large capital gains. (This shelter is described in Notice 2001-45, 2001-2 C.B. 129.)

Contingent liability shelters. A contingent liability shelter scheme is comprised of a series of transactions in which a taxpayer claims a loss from the sale of a minority interest in one of its subsidiaries through the use of a complex set of intra-corporate actions that is intended to accelerate a deduction of what otherwise would be a contingent loss. (This shelter is described in Notice 2001-17, 2001-1 C.B. 730)

Basis pump shelter (a.k.a. Short Sale Strategy). A basis pump shelter involves a taxpayer's attempt to create a loss to offset against anticipated gain on the sale of an asset. It contributes the asset to a partnership. It also contributes the rights and obligations associated with a "short sale." The taxpayer then causes a technical termination of the partnership, pursuant to section 708(a)(2)(B) of the Code, by substituting one subsidiary-partner for another. The taxpayer argues that as a result of the termination, the partners' bases in their partnership interests are allocated to the partnership assets in accordance with section 732 of the Code. By not treating the obligation to close the short-sale as a liability for purposes of section 752 of the Code, the taxpayer is able to "pump up the basis" in the partnership interests. When a partnership interest is sold, the carefully scripted events create an artificial loss.

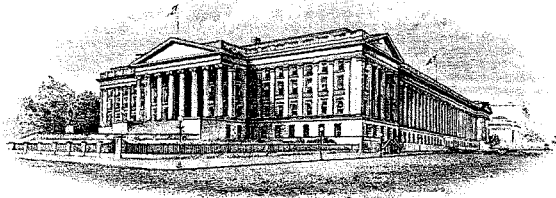
"Son of BOSS". In one typical form of a Son of BOSS shelter, a taxpayer purchases and writes economically offsetting options and then purports to create substantial positive basis by transferring those option positions to a partnership. On the disposition of the partnership interest, the liquidation of the partnership, or the taxpayer's sale or depreciation of distributed partnership assets, the taxpayer claims a tax loss, even though the taxpayer has not incurred a corresponding economic loss. (This shelter is described in Notice 2000-44, 2000-2 C.B. 255 and is now addressed in Temporary Regulations section 1.752-6.)

## **CONCLUSION**

The Tax Division is fully committed to restoring and maintaining the integrity of the federal tax system. This means succeeding in our summons enforcement litigation, and in our tax shelter litigation. We have made progress, but considerable challenges remain.

The IRS has made shutting down abusive tax shelters one of its major strategic initiatives. The IRS cannot do it alone. And the Tax Division cannot initiate the necessary actions on its own. Through legal necessity and shared commitment, the Tax Division and the IRS are partners in these efforts.

I will be pleased to respond to any questions Members of the Committee might have.



**DEPARTMENT OF THE TREASURY  
OFFICE OF PUBLIC AFFAIRS**

Embargoed Until Delivery  
October 21, 2003

Contact: Tara Bradshaw  
(202) 622-2014

**Statement of  
Pamela F. Olson  
Assistant Secretary of the Treasury for Tax Policy  
Committee on Finance  
United States Senate**

Mr. Chairman, Mr. Baucus and other members of the Committee, thank you for inviting the Treasury Department to testify today on abusive tax avoidance transactions. This Committee has taken a leading role in the public discussions about how to best address this important issue. Over the past year and a half, the Committee has passed a number of bills with provisions that would strengthen the Government's ability to combat these transactions. We appreciate the opportunities that we have had to work with the Committee on these matters. The Committee's support of the Treasury Department and the IRS' efforts sends a clear message to the American public that the Government is committed to ensuring that all taxpayers pay their fair share.

My testimony today is summarized by the following points:

- The complexity of the Internal Revenue Code has created opportunities for abuse; abusive transactions are but the symptom of a larger problem.
- Treasury and the IRS have taken appropriate and aggressive actions to address the abusive transaction problem, more than in any period in recent memory.
- Treasury has made a number of legislative proposals, including new broader disclosure requirements and enhanced penalties, and since worked with the Committee on additional proposals.

In March 2002, this Committee heard from the Treasury Department and IRS on plans to combat abusive transactions. The IRS spoke of the actions that already were underway. Looking forward, the Treasury Department described the need for transparency and certainty – that is, a web of rules, backed by meaningful penalties, that would reinforce each other by

requiring information reporting to the IRS about potentially questionable transactions both by the taxpayers participating in the transactions and by promoters.

The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions, issued in March 2002, described the legislative proposals and administrative actions needed to create this web. The Treasury Department and the IRS didn't wait for the enactment of the legislative proposals, but moved forward with all of the administrative actions described in the Enforcement Proposals, and almost all have been completed. These actions have been important steps in creating the transparency and certainty needed to combat abusive transactions. The legislative proposals would complete and reinforce the web by simplifying the disclosure rules and imposing meaningful penalties on taxpayers and promoters who fail to provide the IRS with requested information. We commend the Committee for including these important proposals in pending legislation, and we look forward to continuing to work with you and Congress to enact these proposals into law.

The right tools are needed to effectively address abusive tax avoidance transactions, but tools alone are not enough. The sophistication of the transactions, combined with the cultural laxity engendered among some taxpayers and promoters in the '90s made them possible. The combination has posed challenges to our efforts to bring taxpayers back into compliance. There is no silver bullet – legislative or administrative – that will rid the system of abusive transactions. We must continue to identify abusive transactions and discourage taxpayers from entering into these transactions in the future. The better we can become at rapid, upfront identification of transactions, the easier the task will be. Even so, the past eighteen months have taught us that persistence, creativity, and a willingness to try new approaches to problems is required.

Commissioner Mark W. Everson will describe the IRS' ongoing efforts to apply the right IRS resources and expertise to the problem as well as the steps being taken to resolve controversies concerning past transactions. These are significant and important steps towards bringing taxpayers back into compliance. I want to commend the IRS for its commitment to develop new processes and strategies for dealing with the challenges presented by abusive tax avoidance transactions. The effort has been marked by a high level of coordination and consultation among many of the organizations within the IRS, and with the Treasury Department, and this to continuing under the strong team of executives assembled by Commissioner Everson. The Treasury Department and the IRS also are working together to identify and evaluate potentially abusive transactions more quickly. In addition, the IRS is continuing its coordination with the Justice Department on promoter audits and cases in litigation involving abusive transactions. Over the past eighteen months, the IRS and the Justice Department have been vigorously pursuing promoters of abusive transactions, and the IRS has reached two significant settlements in this area. This progress is attributable to the joint efforts of these two agencies.

Our ability to better understand the scope of the problem facing us, and the progress of our efforts, depends on the information that will be provided under our new disclosure rules. For the most part, taxpayer disclosures under these rules will not be filed until 2004 when 2003 tax returns are filed. If our legislative proposal to conform the registration rules to the disclosure rules had already been enacted, however, we would have had an earlier indication of how the

rules are working. Nonetheless, the anecdotal information we have suggests that taxpayers and promoters are hearing the message that the Government is committed to identifying and addressing abusive tax avoidance transactions. We have seen some evidence, that taxpayers are taking their disclosure obligations seriously, even before non-disclosure penalties are enacted. None of this means that our job is done, but we are making progress. As a result, in large part, of the Committee's continued focus on this issue and support for our efforts, we believe that we now have a strong foundation for combating abusive transactions.

Our testimony today will highlight the actions we have taken since March 2002 to combat abusive tax avoidance transactions and the importance of the legislative proposals that have been passed by this Committee but not yet enacted into law. It also will emphasize that we must find ways of addressing the complexity of our tax laws. Complexity provides an opportunity and an excuse for engaging in abusive transactions. At the same time, we believe that sunshine on abusive transactions will reduce taxpayers' willingness to take a risk and positively affect attitudes towards tax compliance. We are looking for opportunities to replace a perceived headlong rush to the bottom by some tax advisors with a return to the best practices that should mark the tax profession. Failing at these tasks means the tax system will face in the future the same problems it faces today.

#### **2002 Treasury Department Enforcement Proposals: A Status Report**

In March 2002, the Treasury Department released its Enforcement Proposals for Abusive Tax Avoidance Transactions. The proposals, which include both legislative proposals and administrative actions, are designed to give the Treasury Department and the IRS the information needed to identify, evaluate and address abusive transactions before they proliferate. Since March 2002, we have become even more convinced of the importance of these proposals, and we look forward to working with the Committee to ensure that they all are implemented.

##### ***Legislative Proposals***

This Committee has taken the lead in the effort to enact the legislative proposals set out in the Treasury Department's Enforcement Proposals. We are grateful for the priority that the Committee has given to these proposals. Our efforts to combat abusive tax avoidance transactions can be fully effective only if they are backed by legislation that creates fully consistent disclosure rules and imposes meaningful penalties for non-compliance.

Our goal is a single set of consistent rules for the disclosure of potentially questionable transactions by taxpayers and promoters. A single set of rules, without subjective exceptions, for all types of disclosure will make the law easier for taxpayers to apply and easier for the IRS to administer. More importantly, consistent rules will give the IRS multiple sources of information on potentially questionable transactions. Hiding a transaction with the hope that the IRS will not see it will become a risky course of action.

I will discuss shortly the actions that the Treasury Department and the IRS have taken to align the taxpayer disclosure and promoter list-maintenance rules. The rules for promoter registration, however, cannot be made consistent with these rules until legislation changing the

underlying statute is enacted. Once that legislation is enacted, potentially questionable transactions will have to be disclosed by taxpayers on returns and registered by promoters with the IRS. Based on the disclosure by either the taxpayer or the promoter, the IRS will have the ability to go to a promoter and obtain a list of all taxpayers who engaged in that type of transaction.

We continue to believe that the disclosure regime for potentially abusive transactions must be backed by meaningful penalties. For instance, as the Committee is aware, there is no penalty currently for a taxpayer's failure to disclose a reportable transaction. The Treasury Department has proposed penalties of up to \$200,000 for such failures, regardless of whether the tax benefits of the transaction are ultimately sustained on the merits. If a listed transaction results in an underpayment of tax, the Treasury Department has proposed increases in the penalties that will apply to these underpayments if the transaction is not disclosed. In addition, the Treasury Department has proposed requiring the disclosure of these penalties in SEC filings in the case of corporate taxpayers.

Similarly, the existing penalties on promoters for the failure to register a transaction or the failure to maintain lists of participating taxpayers should be increased to meaningful levels. The Treasury Department has recommended legislation to increase the existing penalties for the failure to register a transaction and to impose an escalating time-based penalty for promoters who fail to turn over a list of participants requested by the IRS within a reasonable time period.

The Treasury Department also has proposed a number of other needed legislative changes. Some are administrative or procedural in nature and confirm the Government's ability to seek injunctions against promoters who disregard the disclosure rules and impose new penalties for taxpayers who fail to report foreign bank and other financial accounts. Other Treasury Department legislative proposals are substantive changes to the law that address abusive stripping transactions and the trading in foreign tax credits. Separately, the Administration's FY 2004 budget proposes to eliminate a non-corporate taxpayer's ability to use the federal practitioner privilege as a defense against providing the IRS with requested information about potentially abusive transactions.

The Treasury Department's legislative proposals primarily are intended to give the IRS the information needed to evaluate and, if appropriate, act upon potentially questionable transactions. If the Treasury Department and the IRS conclude that a transaction does not work under the existing technical tax rules, then we believe that it is our obligation to make sure that it is clear to taxpayers. In some cases, transactions may work under existing rules, but produce results that do not represent sound tax policy. In these situations, we will work with this Committee and Congress to make necessary changes to the statute.

We recognize that the Committee is concerned that the doctrine of economic substance may have been misapplied in the case of one type of abusive transaction. We share the Committee's concern that certain taxpayers and promoters may try to read too much into this caselaw to support positions that are without merit. We do not believe, however, that codifying this judicial doctrine will bring more certainty to the law, that it will deter those who are inclined to find economic substance and business purpose in virtually any transaction, or that it will



insure that the doctrine is considered in every situation where it should be considered. Moreover, a statutory rule will bring uncertainty for careful practitioners and taxpayers. The proposed codification is complicated. We believe it is likely, on balance to increase administrative burdens on the IRS. We believe that the judicial doctrines work best when they remain appropriately flexible doctrines and are applied to facts properly developed and presented. The IRS and Justice Department are working together to ensure that the Government's position in litigation, including on these judicial doctrines, reflects a coordinated approach that appropriately and effectively applies the doctrines.

#### *Administrative Actions*

The legislative proposals I have described will significantly enhance the Government's ability to combat abusive tax avoidance transactions. While we await those changes, we have been implementing the administrative actions set out in the Treasury Department's March 2002 proposals. These administrative actions focus on broadening and simplifying the rules for taxpayer disclosure and promoter list-maintenance, and we will apply these rules to promoter registration once necessary legislation is enacted.

Proposed disclosure and list-maintenance rules were issued in October 2002 and reissued as final rules in February 2003. Return disclosures under these new rules generally will not be filed until tax returns for 2003 are filed in 2004. These rules provide a single, integrated set of definitions for transactions subject to taxpayer disclosure and promoter list-maintenance and apply to individuals, partnerships, and trusts in addition to corporations. These rules will allow the IRS to move quickly from a taxpayer's disclosure to a promoter's list of investors to other taxpayers who engaged in the reportable transaction. They will create a more effective web that deters abusive tax avoidance transactions by increasing the certainty of IRS detection.

We have targeted for disclosure those categories of transactions with the potential for abuse. These include transactions that we have specifically identified as tax avoidance transactions (known as listed transactions), transactions that generate large tax losses, transactions that generate significant book-tax differences (such as a large tax benefit without a corresponding financial accounting cost), transactions with contractual protection, transactions marketed on a confidential basis, and transactions that result in tax credits even though the underlying assets are held for a brief period of time. These categories are based on indicia of potential abuse to avoid definitions that are so finely tailored that they are easy to avoid. We recognize that, as a consequence, these rules will result in the disclosure of legitimate transactions, and we continue to work with taxpayers and practitioners to ensure that these rules appropriately target potentially questionable transactions. For instance, we expect to issue shortly guidance that will refine the definition of a confidential transaction that must be disclosed. This guidance will reduce the number of disclosures that taxpayers will have to make solely on account of the confidentiality of some part of the subject matter. As we make these and perhaps other changes, simplicity and clarity will remain our guiding principles.

Our new disclosure and list-maintenance rules deliberately cast a broader net than the previous rules. The old rules were being parsed in a way such that many taxpayers and tax advisors convinced themselves that they were not required to make disclosures. Moreover,

abusive transactions clearly have moved beyond corporate taxpayers. In June 2002, we partially extended the disclosure requirements to partnerships, S corporations, trusts, and individuals. When our final disclosure and list-maintenance rules were issued in February 2003, they fully covered these types of taxpayers. In addition, the final list-maintenance rules provide clear rules for identifying persons who are required to maintain customer-lists. Persons who provide tax advice and receive significant fees from a potentially abusive transaction should and will be expected to maintain a list of participants in that transaction. The accounting, legal, and financial services industries are now aware that they have these obligations, and that the IRS is entitled to this information if requested.

The Treasury Department and the IRS are currently working to complete two important administrative actions from the March 2002 Enforcement Proposals. We are working to finalize proposed regulations issued in December 2002 that will preclude a taxpayer from relying on a favorable tax opinion as a defense to the imposition of the accuracy-related penalties if the taxpayer does not disclose a reportable transaction or does not disclose a return position based on the invalidity of a regulation. We also are in the process of preparing further guidance under Circular 230 on standards for tax opinions. Taxpayers rely on opinions for assurance that transactions are proper and will not be subject to penalties, and Treasury and the IRS believe that tax opinions used for this purpose should satisfy standards that represent best practices.

In addition to completing the administrative actions set out in the March 2002 Enforcement Proposals, we are evaluating a number of other possible actions that may bring potentially significant benefits to tax administration. We are working, for instance, on possible revisions to Schedule M-1 of the corporate income tax return to increase the schedule's usefulness to the IRS. Schedule M-1 requires taxpayers to identify book-tax differences. It has not been updated for almost 40 years. We are concerned that the current version of this schedule simply fails to provide the IRS with the information on book-tax differences that highlight issues to which the IRS should devote resources. We are examining ways that the Schedule M-1 might be revised to highlight those book-tax differences that matter the most in an examination of a taxpayer, such as permanent book-tax differences that are more likely to arise from aggressive tax planning. As we move forward, we will work with affected taxpayers to ensure that any changes are manageable for them while meeting our objectives. More broadly, we are exploring ways in which specific areas of tax accounting and financial accounting could be more closely aligned without compromising the policy objectives behind these systems. We are early in the process and look forward to working with the Committee and the Securities and Exchange Commission in this effort.

We also are working with the IRS to explore ways in which its forms can better convey needed information and computer systems can better process data. While the IRS has a tremendous amount of information available to it, existing systems limitations prevent the IRS from fully utilizing this data. Some abusive transactions, for instance, are designed specifically to take advantage of the IRS' current inability to readily access, match, and evaluate all of the information it collects. As a related matter, the Treasury Department and the IRS are continuing efforts to increase the use of electronic filing by corporations and other business entities.

#### **Measuring Compliance**

We share the Committee's longstanding interest in better understanding the extent of the problem created by abusive tax avoidance transactions and the ways in which we can measure our progress. In response to questions from the Committee following its March 2002 hearing, we stated that without fuller disclosure, it is difficult for the Treasury Department and the IRS to assess the number of corporations that are engaging in potentially abusive transactions. Rules that will give us that information went into effect in January 2003. Return disclosures under these new regulations, however, will not be filed until next year. While it is too early to assess the scope of the problem, there clearly is much to do in the meantime.

The Treasury Department is committed to supporting a robust compliance research agenda. With the support of this Committee, the first phase of the National Research Program (NRP), a study of individual income tax returns, is well underway. As you know, the NRP is the first broad-based compliance study conducted by the IRS in well over a decade. This study will cover individual taxpayers of all types and from all income levels and will provide valuable information about the extent of voluntary compliance and the nature of compliance problems. The Treasury Department and IRS are now working on plans for the next phases of the NRP, which will cover the business sector. In addition, the IRS is pursuing other research directed at shedding light on particular compliance problems and appropriate solutions.

#### **Looking Forward: Simplification and Compliance**

There is a temptation, in discussing the problem of abusive tax avoidance transactions, to focus on the immediate tasks of identifying and addressing abusive transactions that already have occurred and discouraging taxpayers from entering into these transactions in the future. Those are, without question, important and necessary tasks. The Government's answer to abusive transactions, however, cannot be solely an ongoing struggle with the promoters of abusive transactions and the taxpayers who decide to enter into them. If we are to put the problem of abusive transactions behind us, we must address the pervasive complexity of the tax code. Many abusive tax avoidance transactions are designed to take advantage of this incredible complexity to obtain benefits that Congress never intended. The tax code's complexity effectively aids and abets those who seek to improperly reduce their taxes. We are increasing the stakes for taxpayers who enter into abusive transactions and their promoters through the actions we have taken. So long as the complexity remains, however, the risk we face is that the problem we eliminate in one area will simply reemerge somewhere else. We may expect that promoters will continue to mine this complexity to develop and market abusive transactions.

The problem created by complexity is not limited to perceived opportunities for abusive transactions. Complexity imposes costs on both taxpayers and the Government not directly related to abusive transactions. For taxpayers, the cost is the enormous effort required to comply with the law. Many taxpayers must seek professional tax assistance just to understand the law. For the Government, complexity makes it more costly for the IRS to administer the tax system. The Treasury Department and the IRS must write rules to administer complex tax laws, and the IRS must expend resources to administer these laws, including everything from taxpayer assistance to audits of returns. Ultimately, these are resources that the IRS cannot use for other priorities such as efforts to stem abusive transactions.

This Administration has made tax simplification an important priority. Achieving tax simplification is difficult because existing complexity often is a result of well-intended efforts to achieve important policy goals without impacting other policy objectives. In some cases, simplification can be achieved in a manner that can serve all existing policy objectives equally well or even better. In many cases, however, simplification will result in some compromise of other policy objectives. For example, a simpler rule that is easier for taxpayers to apply and easier for the IRS to administer may result in a less precise targeting of a tax benefit. Finding the right balance will not be easy.

The Administration has developed objectives to guide its development of simplification proposals. We focus on reducing the burden of the tax laws on the IRS and on taxpayers, with the intended results of increased voluntary compliance, reduced controversy and reduced distortions caused by the tax laws on business and economic decisions. We believe that simplification proposals meeting these objectives will be good for our tax system and our economy, and we look forward to working with the Committee on what we know is a mutual interest.

Similarly, taxpayers and practitioners must be willing to re-evaluate how they view the tax system and their willingness to abide by the highest standards. Our tax laws are replete with prohibitions, sanctions, and rules of conduct, and these apply both to taxpayers and practitioners. We are examining these rules, particularly with respect to practitioners, to see whether they are fully serving their purpose. Where they are not, we will propose changes. In doing so, we must be mindful of the tendency of rules to establish minimally acceptable conduct and to result in a focus on what practitioners can get away with. We believe the nation and our tax system would be better served by practitioners who aspire to do what is right and adhere to best practices. We have begun discussions with professional associations to see how we might work together to reinforce our mutual interest in protecting society's confidence in the tax system. We are optimistic that we can help tax professionals understand the importance of doing more than satisfying a minimum code of conduct.

### **Conclusion**

In conclusion, our ability to address abusive tax avoidance transactions is part of the larger struggle to preserve the integrity of our self-assessment tax system. Success will require both short-term and long-term efforts. In the short-term, we must put into place the rules and systems necessary to identify and respond to abusive transactions as they occur, and not years after the fact. The administrative actions we have taken are important steps, and the Treasury Department's legislative proposals will allow us to complete the web of information that will bring these abusive transactions out of the shadows. The Treasury Department, the IRS and the Justice Department have been and will continue to work together to address this problem.

In the long-term, a continual battle to root out abusive tax avoidance transactions, without more, will impose significant costs on both taxpayers and the Government. We must begin addressing underlying causes. We should close loopholes as we identify them, ensure statutory provisions produce tax results consistent with the underlying economics, and simplify the rules

wherever possible. We must support the adoption of best practices. These prescriptions are not easy; we believe, however, that they will bring about the increased respect for our tax system that is essential to our self-assessment system.

Thank you again, Mr. Chairman, for the opportunity to speak today. The Treasury Department looks forward to working with this Committee on the important task before us. I would be happy to answer any questions the Committee may have.



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON

November 17, 2003

The Honorable Charles Grassley  
Chairman, Committee on Finance  
United States Senate  
219 Dirksen Senate Office Building  
Washington, D.C. 20510-6200

Re: October 21, 2003, Hearing on Tax Shelters

Dear Senator Grassley:

On behalf of the Treasury Department and Commissioner Everson, I am pleased to submit the attached responses to the Committee's written questions following the Committee's October 21 hearing.

Please contact me if you have any questions, or if you desire any further information.

Very truly yours,

Pamela F. Olson  
Assistant Secretary for Tax Policy

Attachment

cc: Mark W. Everson

Questions from Senator Baucus to Assistant Secretary Olson:

1. **You have a great deal of experience with the IRS, in private practice and as Assistant Secretary for Tax Policy. The IRS has 28 “listed transactions” which are transactions that it has designated as being heavily tax-motivated. One of the first listed transactions involved the ACM case and now this case is frequently cited by the courts in other tax shelter cases. Your former firm, Skadden Arps, was involved with the litigation in this case and I’m certainly not asking you to comment on that. But what I’d like to ask you to do is inform the committee about who thought up the idea, who marketed the transaction, and who gave the opinion on this transaction? In other words, in a transaction that some say contributed substantially to the whole tax shelter craze, what were the relative roles of the various parties?**

**Response:**

As the Committee staff is aware, the first involvement of my former firm, Skadden Arps, with the transaction at issue in the case of ACM P’Ship v. Commissioner, 71 T.C.M. (CCH) 2189, aff’d in part and rev’d in part, 157 F.3d 231 (3d Cir. 1998), dates to approximately two months before the case was scheduled for trial in the Tax Court.

The evidence presented by the taxpayer regarding the origin of the transaction at issue in ACM is detailed by the Tax Court in its findings of fact. The court’s findings address the roles of the parties to the transaction in detail, including its development. For instance, the court’s initial finding of fact describes the role of the Swap Group at Merrill Lynch & Co., Inc. in developing the transaction, which eventually involved 11 partnerships formed over a 1-year period from 1989 to 1990, as follows:

The design of the CINS transaction appears to have originated in discussions in early 1989 between Macauley Taylor (Taylor), a managing director of Merrill’s Swap Group, and James Fields (Fields), a member of his staff. From the spring of 1989 through the summer of 1990, the Swap Group and Merrill’s investment bankers promoted the idea among Merrill’s clients.

ACM, 73 T.C.M. at 2190. The court’s opinion also discusses the role of Algemene Bank Nederland, N.V. in each of the 11 transactions. See id. at 2193-94. The roles of the parties to the specific ACM partnership similarly are discussed throughout the court’s opinion.

2. **The IRS has 28 “listed transactions” which are transactions that it has designated as being heavily tax-motivated. How long did it take for Treasury to identify and then “list” these shelter transactions? Can you describe the time line? Also, by the time Treasury lists these transactions, is there any evidence that the promoters have moved on to other deals? Lastly, with regard to the COBRA transaction, does Treasury have any information evidencing sales after the transaction became listed?**

**Response:**

Currently, 27 different transactions have been identified as tax-avoidance (i.e., listed transactions) by the IRS. The designation of a transaction as a listed transaction typically, but not always, represents the determination by the Treasury Department and the IRS that the claimed tax benefits from the transaction are impermissible under the law. In some cases, it represents the determination that under the facts in almost all cases that the Treasury Department and IRS have seen, the claimed tax benefits from the transactions are not proper. In all cases, the designation reflects a very high degree of concern about the propriety of the transaction. For this reason, the Treasury Department has proposed legislation that will treat the failure to disclose a listed transaction (including any underpayment from an undisclosed listed transaction) as subject to higher penalties than other reportable transactions.

The Treasury Department believes that the ability to “list” a transaction has been one of the most important tools in the fight against abusive tax avoidance transactions. Designation sends a clear message that the Treasury Department and the IRS are aware of and are committed to addressing these transactions, including identifying and taking appropriate action against the promoters of these transactions and the taxpayers who have entered into them. This response acts as a strong deterrent to taxpayers who may be considering these transactions. At the same time, the Treasury Department and the IRS have an obligation to understand fully and carefully evaluate a transaction before it is designated as a listed transaction. The failure to do this would erode the credibility of the message being sent by the designation of a transaction as a listed transaction. As a result, it is impossible to generalize as to how much time it took to identify and list the various designated transactions.

Fuller disclosure of potentially abusive transactions is needed to determine whether promoters have “moved on” to other transactions by the time a transaction is designated as a listed transaction. Nevertheless, the anecdotal information we received indicates that in a number of cases, some promoters either have continued to market a transaction after it has been designated or have modified a transaction in an effort to claim that it is not a listed transaction. It is our understanding that the COBRA transaction is the transaction described in Notice 2000-44 (Son of Boss). The IRS has indicated that some promoters continued to market this type of transaction after it was designated as a listed transaction. The IRS continues to monitor disclosures submitted pursuant to the disclosure,



registration and list maintenance rules to identify areas of potential continued noncompliance.

There are a wide variety of potentially abusive transactions and each transaction presents unique challenges in determining whether, as a factual and legal matter, the transaction is one that merits designation as a listed transaction. In general, once the Treasury Department and the IRS become aware of a potentially abusive transaction, the first step in the process is to gather the information necessary to evaluate the transaction fully. Initial information may come from a variety of sources, including disclosures (from special programs such as the IRS' disclosure initiative that was completed in April 2002), taxpayer audits, promoter audits, and the "hotline" maintained by the Office of Tax Shelter Analysis (OTSA). Although the Treasury Department and IRS' objective is to provide guidance as early as possible to taxpayers and promoters, the source of the information may dictate how quickly additional information necessary to evaluate a transaction can be obtained.

After a transaction is identified as a candidate for designation as a listed transaction, the Treasury Department and the IRS coordinate the evaluation of the transaction. This effort involves personnel from the IRS' operating divisions (including OTSA as part of LMSB), Chief Counsel, and the Treasury Department. Within Chief Counsel, a Senior Counsel position was created to assist in coordinating the analysis of potentially abusive transactions. All involved recognize that the expeditious, but full, evaluation of a potentially abusive transaction can be accomplished only if the review is coordinated. Although improving that process is an ongoing effort, in the case of recently listed transactions, the time between detection and listing was a matter of a few months.

Ultimately, the value of designating a listed transaction will be greatest when the Treasury Department and the IRS are able to learn about a potentially abusive transaction before it has spread through the marketplace. The legislative proposals proposed by the Treasury Department in March, 2002, and passed by the Committee will help significantly in achieving this goal. The Treasury Department continues to look forward to working with the Committee to see these legislative proposals enacted into law.

3. **Last year, former IRS Commissioner Rossotti publicly stated that "the IRS is simply outnumbered when it comes to dealing with compliance risks. . . Even after we focus on the most egregious noncompliance cases, we can only handle a small fraction of them." The IRS estimates that it is leaving \$30 billion on the table each year simply from cases it knows about but hasn't the resources to pursue. That doesn't include the ones it doesn't know about but might discover if it were able to do more investigating. Please comment on Mr. Rossotti's assessment of IRS's ability to pursue tax noncompliance.**

**Response:**

Noncompliance, including noncompliance through the use of abusive tax avoidance transactions, poses a very significant challenge for the IRS. Unfortunately, our ability to assess the level of noncompliance in our tax system – and the steps needed to most effectively address noncompliance – are hampered by the lack of current information regarding noncompliance.

As the Committee is aware, the IRS, with Treasury Department support, has initiated the National Research Program (NRP). The NRP is the first broad-based compliance study conducted by the IRS in over a decade. This study will cover individual taxpayers of all types and from all income levels and will provide valuable information about the extent and nature of noncompliance. The Treasury Department and IRS now are working on plans for the next phases of the NRP, which will cover the business sector. In addition, the IRS is pursuing other research directed at shedding light on particular compliance problems and appropriate solutions.

The Treasury Department and IRS have moved aggressively to mandate the disclosure of potentially abusive transactions by taxpayers and promoters, which will address some of the information deficit we face. Final regulations issued in February 2003 are based on clear, objective rules and eliminated subjective exceptions. These rules apply to all types of taxpayers, not just corporations. Disclosures under these new rules, which generally will be filed starting in 2004, will give the IRS and the Treasury Department a much clearer picture of the nature and extent of potentially abusive transactions in our tax system. We are pleased that the Committee has passed legislation that will make the statutory changes we believe are necessary to coordinate fully all of the disclosure rules for potentially abusive transactions and back those rules with meaningful penalties.

We obviously cannot wait for research and disclosures to give us a truer picture of noncompliance before we act. The actions taken by the Treasury Department with respect to abusive tax avoidance transactions are discussed further in response to Question for the Record No. 5 (Senator Baucus). In addition, please see Commissioner Everson's responses to the Committee's questions for the record for a discussion of the steps being taken by the IRS to address noncompliance.

4. **GAO reports that IRS is reallocating resources from one area to bolster efforts in another. While some shifting of resources may be appropriate, shifting resources means that activities from which the resources are being shifted must be de-emphasized. Please explain where the shifted resources have and will come from and the rationale for de-emphasizing the activities that are losing the resources.**

**Response:**

Please see Commissioner Everson's Responses to Questions for the Record Nos. 6 and 7.

5. **In August 2002, you advised the Committee that "the IRS is devoting additional resources to these issues, but more may be needed." To what extent is the Administration's response to tax noncompliance commensurate with the nature of scope of the problem identified by the IRS? What steps is the Administration taking to ensure that the IRS has adequate resources to effectively tackle the abusive tax shelter problem? In your judgment, can the IRS continue to do more with less?**

**Response:**

Addressing abusive tax avoidance transactions has been, and continues to be, one of the Treasury Department's highest priorities. Our approach is intended to address the immediate problem created by these transactions and significantly diminish the likelihood that these transactions will proliferate again in the future. Although there is much to be done, we have taken many steps that we believe will help to address abusive transactions effectively, such as revising the rules requiring the disclosure of potentially abusive transactions by taxpayers and the maintenance of lists of participants in these transactions by promoters. In addition, we believe that the IRS, with the right tools and through the careful use of its resources, can significantly improve its ability to address abusive transactions.

Commissioner Everson's responses to the Committee's questions for the record discuss the steps being taken by the IRS to combat abusive transactions. For instance, the IRS is shifting resources from lower income individual and small corporate returns to higher income individual returns, abusive transactions, and abusive schemes. In addition, as described in the Response to Question for the Record No. 3 (Senator Baucus), the Treasury Department and the IRS are carefully studying existing noncompliance so that we can have a better understanding of its nature and scope. We strongly support the IRS' efforts and will continue to work closely with the Commissioner. In addition, the Administration's FY 2004 Budget includes a \$133 million initiative for 1,700 staff to bolster immediately the IRS' resources for addressing abusive transactions and other high risk areas of noncompliance.

An effective response, however, cannot focus solely on transactions that already have taken place. The Treasury Department's response includes a number of important actions that will make the IRS better equipped to address, and hopefully deter, future abusive transactions:

- Revised Disclosure Rules to Ensure Early Disclosure of Questionable Transactions – Revised disclosure rules will make our response to abusive transactions far more proactive. (As the Committee is aware, the Treasury Department’s March 2002 Enforcement Proposals for Abusive Tax Avoidance Transactions contain legislative proposals that will make the various disclosure regimes for taxpayers and promoters consistent and will back them up with meaningful penalties.) The IRS must devote a tremendous amount of resources to address an abusive transaction after it has spread in the market. The early registration and disclosure of potentially abusive transactions will allow the Treasury Department and the IRS to identify and address abusive transactions before they proliferate.
- Better Information from Taxpayers – Although fuller disclosure of potentially questionable transactions under the disclosure rules is a critical step for addressing abusive transactions, the Treasury Department is exploring other ways of making potential noncompliance more transparent on a return. An important part of this effort is increased filing of electronic returns. We share Congress’ goal of having most returns filed electronically. Electronically-filed returns allow the IRS to use all the information on the return. In addition, we are working with the IRS to revise forms so that they clearly convey the information needed by the IRS. For instance, we are exploring potential revisions to Schedule M-1 of the corporate income tax return, which has not been updated for almost 40 years. Our goal is to revise Schedule M-1 to increase the schedule’s usefulness to the IRS, and we will work with affected taxpayers to minimize any burden that these changes may cause.
- Increased Cooperation with the States – The IRS has significantly expanded its agreements with the States to share information on potentially abusive transactions.
- Effective Use of Information by the IRS – Better information gathered from taxpayers must be used effectively by the IRS. We are working with the IRS to enhance its ability to do so. Some abusive transactions, for example, are designed specifically to take advantage of the IRS’ current inadequate ability to readily access, match, and evaluate all of the information filed. The K-1 matching program and similar initiatives related to electronic filing by corporations and other business entities are responses to this problem.
- Prompt Guidance on Abusive Transactions – Learning about abusive transactions early on is not enough. As described in the Response to Question for the Record No. 2 (Senator Baucus), the Treasury Department and the IRS are working closely together to expedite guidance on abusive transactions so that taxpayers and promoters are made aware that we have identified the transaction and are committed to addressing it. The Treasury Department also is committed to

working with the Committee and Congress if legislative changes are needed to address specific abusive transactions. The Treasury Department's March 2002 Enforcement Proposals, for instance, contain legislative proposals targeting specific abuses, such as trading in foreign tax credits.

- The Right Tools for the IRS – The Treasury Department's March 2002 Enforcement Proposals include legislative proposals that will provide important tools for the IRS. These proposals include confirmation of the Government's ability to seek injunctions against promoters who disregard the disclosure rules and the imposition of new penalties for taxpayers who fail to report foreign bank and other financial accounts. The Treasury Department also has proposed legislation that will increase the penalty for frivolous returns and permit the IRS to disregard other submissions, such as requests for collection due process (CDP) hearings that are based on frivolous arguments. The Treasury Department currently is working with the IRS to complete important administrative actions that will enhance the IRS' ability to combat abusive transactions. These initiatives include: (i) guidance that will permit the IRS to quickly initiate focused exams of disclosed abusive transactions; (ii) guidance prohibiting taxpayers from relying on a favorable tax opinion as a defense to penalties for undisclosed transactions; and (iii) revisions to the opinion standards under Circular 230. All of these actions will allow the IRS to work more effectively and efficiently.
- Reduced Controversy through Published Guidance – Too much of the IRS' resources are being consumed addressing issues that can be clarified through additional published guidance. The Treasury Department and the IRS have drafted published guidance for issues, such as capitalization, cash-method accounting, and the research credit, that historically have resulted in considerable controversy between taxpayers and the IRS. These guidance projects are continuing, and the Treasury Department will continue working on guidance that establishes clear rules that can be applied readily in those areas where historically there has been uncertainty and controversy. In sum, we have devoted considerable effort to resolving issues so that the IRS can spend less time examining "lunch and cars" and more time tackling priorities such as abusive transactions.
- Improved Compliance through Improved Practitioner Practices – Although the Treasury Department and the IRS have the authority to set standards for practitioners who practice before the IRS, tax practitioners also must police themselves. Specifically, the practitioner community must establish and improve practice standards in order to change the culture that allowed abusive transactions to flourish. The Treasury Department is working with practitioner organizations to explore ways in which the Treasury Department, the IRS, and tax practitioners can work together to improve compliance with our tax laws.

- **Reduced Burden through Simplification** – The complexity of our tax laws both creates the perceived opportunities for many abusive transactions and hinders the IRS' ability to address abusive transactions. For taxpayers, complexity means that enormous effort is required to comply with the law. For the Government, complexity makes it more costly for the IRS to administer the tax system. The Treasury Department and the IRS must write rules to administer complex tax laws, and the IRS must expend resources to administer these laws, including everything from taxpayer assistance to audits of returns. Ultimately, these are resources that the IRS cannot use for other priorities such as combating abusive transactions. The Treasury Department is working to identify areas of the tax law that can be reformed through simplification, and we look forward to working with the Committee as we further develop these proposals.

The problem of noncompliance, whether in the form of abusive transactions or otherwise, requires a comprehensive approach if the IRS is to have the information, tools, and resources necessary to address noncompliance. The Treasury Department believes that the actions outlined above are important steps towards that goal, and we look forward to working with the Committee as our efforts continue.

6. **The IRS Commissioner has stated that the sharp drop in prosecutions, especially high profile prosecutions, had emboldened many tax cheats. Specifically, what does the IRS need in terms of resources to get a handle on the enforcement issue?**

**Response:**

Please see the Response to Question for the Record No. 5 (Senator Baucus).

7. **Please describe the level of coordination, cooperation and communication between your agency and the others represented on the panel – and – is there more that should be done to ensure a comprehensive, coordinated attack on abusive tax shelters?**

The level of cooperation and coordination between the Treasury Department, the IRS, and the Justice Department – the agencies charged with the administration and enforcement of the tax laws – in addressing abusive tax avoidance transactions has been considerable, necessary, and effective. The Treasury Department coordinated with the IRS in developing the Treasury Department's March 2002 Enforcement Proposals. The Treasury Department and the IRS also work together on all of administrative actions, including published guidance, relating to abusive transactions. These administrative actions are described in more detail elsewhere in these responses to the Committee's questions for the record. Specific taxpayer matters, however, are handled solely by the IRS. In addition, the Treasury Department has discussed with the Securities and Exchange Commission ways in which specific areas of tax accounting and financial

accounting could be more closely aligned without compromising the policy objectives behind these systems. As PCAOB begins to fulfill its recent mandate, we also will be seeking opportunities to work with that organization.

The IRS also is continuing its coordination with the Justice Department on promoter audits and cases in litigation involving abusive transactions. Over the past eighteen months, the IRS and the Justice Department have been pursuing promoters of abusive transactions vigorously, including court approval to serve John Doe summonses on five promoters. In addition, the IRS has reached two significant settlements in this area. This progress is attributable to the joint efforts of these two agencies.

Questions from Senator Graham to Assistant Secretary Olson:

1. **The courts apply the economic substance doctrine unevenly, yet you testified that efforts by this Committee to clarify its application “will bring uncertainty.” Why?**

**Response:**

The IRS and Justice Department are working together to ensure that the Government’s position in litigation, including arguments with respect to judicial doctrines like economic substance, reflects a coordinated approach that appropriately and effectively applies the doctrines. The economic substance doctrine is a facts and circumstances test that is applied most effectively when those facts are fully developed and presented for consideration. The Treasury Department does not believe that codifying this judicial doctrine will bring more certainty to the law. Courts will and should continue to apply the doctrine based on the factual record, tailoring it as necessary to reach an appropriate result. For that reason, codification of the economic substance doctrine will increase uncertainty for careful practitioners and taxpayers. The proposed codification is complicated and suggests certain rigid rules that may be inappropriate for a particular case.

The proposed codification does not indicate when the codified rule should, or should not, apply. The Committee’s goal, which we share, is to deter inappropriate transactions. Without a target, however, codification will land wide of that goal. Moreover, the complexity and uncertainty of the codified rule likely will increase administrative burdens on the IRS and have an adverse impact on the IRS’ compliance efforts.

2. **The Committee's efforts to clarify the application of the economic substance doctrine are designed to alter the risk/reward decisions made by taxpayers. Why does the administration believe that this change will not deter those who are inclined to engage in transactions that lack economic substance?**

**Response:**

Based on our observations, as well as the testimony presented to the Committee, we believe, unfortunately, that the promoters of abusive transactions will convince themselves and their clients that their transactions meet whatever standard for economic substance exists, whether judicial or statutory. Moreover, because the proposed codified rule does not indicate when the doctrine applies, in many cases, promoters will conclude that the doctrine does not apply to a particular transaction for a variety of reasons, including, for instance, that the transaction is consistent with the purpose or intent of the statute or that courts have not applied the doctrine to a particular transaction or type of transaction. The Treasury Department, therefore, believes that the deterrent value of a codified rule is very limited and easily outweighed by the uncertainty that such a rule would create for the majority of taxpayers who do their best to comply with the rules.

The Treasury Department shares the Committee's concern with promoters who seek to flout the tax laws to obtain unwarranted tax benefits for their clients. In our experience, potentially abusive transactions often fail to satisfy the technical statutory or regulatory requirements necessary to achieve the claimed results or run afoul of other articulated judicial doctrines. As noted above, the Government is working to ensure that the economic substance doctrine is used effectively. At the same time, the Treasury Department and the IRS are focusing on subjecting questionable transactions to careful technical analysis. These steps, combined with the early disclosure of questionable transactions and the other actions described in these responses, will greatly enhance the Treasury Department and the IRS' ability to address effectively abusive tax avoidance transactions.

**Questions from Senator Kerry to Assistant Secretary Olson:**

1. **A growing number of companies are seeking to reincorporate from the United States to tax haven countries like Bermuda, Luxembourg, or Barbados in order to avoid paying taxes on U.S. and foreign-source income. The actions of these companies have the effect of increasing taxes on individual Americans and small businesses who play by the rules, because tax rates must be higher on them to raise a given level of revenue. These "inverting" companies reduce the legal protections given to shareholders and reduce the shareholders' ability to hold companies, their officers, and directors accountable in the event of wrongdoing. I strongly believe we must do everything possible to stop these companies from using sham parent companies to avoid paying their fair share of taxes. Does the Bush Administration support legislation which will force corporations that set**



**up paper headquarters in tax havens to continue to pay U.S. income tax, if more than 80 percent of their owners are exactly the same as before the foreign reincorporation?**

**Response**

The corporate inversion activity of late 2001 and early 2002 is certainly a cause for concern. In May 2002, the Treasury Department issued a report on the issues arising in connection with these corporate inversion transactions and the implications of these transactions for the U.S. tax system and the U.S. economy. The report identifies two distinct classes of tax reduction that are available to foreign-based companies and that can be achieved through an inversion transaction. First, an inversion transaction may be used to achieve a reduction in the U.S. corporate-level tax on income from U.S. operations. In addition, an inversion transaction may be used to reduce substantially or to eliminate the U.S. corporate-level tax on income from foreign operations.

Legislative action is needed to address the income minimization strategies associated with inversion transactions – strategies that can be employed to reduce the inverted company's U.S. tax on its income from its U.S. operations. These strategies unfairly advantage inverted or other foreign-based companies over U.S.-based companies. These strategies have a corrosive effect on the public's confidence in the U.S. tax system. We cannot focus this action solely on inverted companies, however, since an inversion is only one route to accomplishing the same type of reduction in taxes.

The Treasury Department made specific legislative proposals and is taking action to address the income minimization strategies. The Treasury Department's legislative proposals would tighten the rules of Code section 163(j) to prevent the inappropriate use of related-party debt to generate deductions against income from U.S. operations that otherwise would be subject to U.S. tax. We are reviewing and revising the transfer pricing rules, with a focus on ensuring that cross-border transfers and other related party transactions, particularly transfers of intangible assets, cannot be used to shift income out of the United States. In this regard, earlier this year we issued a comprehensive set of proposed transfer pricing regulations on the treatment of services transactions, including services transactions related to intangible property. We are constantly reviewing the network of U.S. income tax treaties to ensure that they do not provide inappropriate opportunities to reduce U.S. taxes or to shift income from the United States. It is important to ensure that none of our treaties operate inappropriately to grant benefits that are intended for the mitigation of double taxation in situations where there is no real risk of double taxation. Where necessary, we are renegotiating or will renegotiate. In addition, we issued regulations last year that require reporting to shareholders and to the IRS to ensure that inverted company shareholders pay the tax they owe on gain recognized in the inversion transaction.

In addition to addressing these opportunities, through inversions or otherwise, to inappropriately reduce U.S. tax on income earned in the United States, we must address the tax disadvantages that can be imposed by our international tax rules on U.S.-based

companies with foreign operations. Our overarching goal is maintaining the U.S. position as the most desirable location in the world for incorporation, headquartering, foreign investment, and business operations.

- 2. The federal government should not reward those companies that renounce their corporate citizenship just to lower their taxes with government contracts. According to an Associated Press study, the Federal government has awarded approximately \$1 billion in contracts each year to companies that have reincorporated overseas. It is outrageous for companies that have avoided their taxpaying responsibilities to receive Federal contracts over those companies that play by the rules. Does the Bush Administration agree that companies that reduce their U.S. tax bill by incorporating overseas should no longer be allowed to obtain federal government contracts?**

**Response**

The recent activity involving corporate inversion activity is a cause for concern. Pending legislation to address corporate inversion transactions, including bills passed by the Finance Committee, as well as the administrative actions taken by the Treasury Department have served effectively to stem the flow of these transactions. Of course, we must continue to work together to address the income minimization strategies associated with both inversion transactions and other forms of transaction in order to ensure that we have a permanent solution.

Some have proposed addressing corporate inversion transactions by banning inverted companies from the federal contracting process. We believe the most effective course of action is to address corporate inversion activity directly, through needed changes to our tax law. To the extent that our tax law provides opportunities, through inversions or otherwise, to reduce inappropriately U.S. tax on income earned in the United States, we must eliminate those opportunities. By addressing through the tax law the income minimization opportunities conferred by an inversion, we will eliminate the immediate benefits of, and therefore the impetus for, the corporate inversion transactions.

- 3. When American companies reincorporate abroad, the ability to seek appropriate remedies to ensure workers receive their pensions are limited. What actions has the Bush Administration taken on behalf of workers to ensure that corporations which reincorporate in other countries maintain their pension funds at levels that match current U.S. pension laws?**

**Response**

When companies reincorporate abroad but continue to operate a business in the U.S. that provides a pension benefit to employees, the companies remain subject to the Employee Retirement Income Security Act (ERISA). See Section 4(a) of ERISA. In addition, if the

plan is funded and the employer wants to have contributions made to the plan currently deductible and benefits earned by employees not currently taxable, it must comply with the qualification rules under the Internal Revenue Code. The place of incorporation of a plan sponsor is not a factor in determining what protections apply. Therefore, the employees have the same protections under ERISA and the Internal Revenue Code as employees covered by pension plans sponsored by a company that is incorporated in the U.S. This would include compliance with the funding rules for pension benefits.

It should also be noted that ERISA provides that any assets of a pension plan must be subject to the jurisdiction of the district courts of the U.S. Section 404(b) of ERISA. We are not aware of instances where the pensions of workers in a company that reincorporated abroad were given less protection than employees of companies incorporated in the U.S.

4. **During a recent Finance Committee markup on FSC/ETI repeal, one proposal that received some discussion was the so-called “repatriation” proposal, which would allow U.S. companies with foreign subsidiaries to temporarily bring back dividends to the United States at a 5.25 percent tax rate. This proposal was included in a modified Chairman’s Mark. I have opposed this proposal from the beginning because I believe it is just another corporate tax boondoggle, and that the repatriated funds would not create jobs or new investment. I understand that the Administration is opposed to the repatriation proposal. Would you please elaborate on why you think it is bad tax policy?**

**Response**

As I stated during the Finance Committee markup on October 1<sup>st</sup>, the Administration has concerns about proposals to provide a temporary tax holiday for repatriation of foreign earnings.

We are skeptical of the asserted economic benefits. Temporary repatriation relief would be unlikely to stimulate the economy because it would neither change companies’ investment opportunities in the United States nor reduce significantly companies’ cost of financing those investments.

As a matter of tax policy, the proposal represents a fundamental change to our rules regarding the treatment of foreign-source income, made on a temporary basis. The proposal would operate to the disadvantage of companies that have repatriated foreign income as it was earned and paid the U.S. tax due thereon. This raises concerns about fairness. Moreover, tax holidays such as this raise expectations that they will be renewed or repeated and serve to undermine the IRS’ ability to enforce the tax law.

Questions from Senator Baucus to Commissioner Everson:

**1. Everyday there are reports of the government taking criminal action against corporate executives and their advisors for violations of the securities laws. These criminal actions often involve charges of obstruction of justice, false statements, conspiracy, lying to government authorities, destruction of documents, etc. There is an absence of criminal prosecutions in the area of corporate tax shelters. Why? Is it fair to assume that if a corporation endeavors to conceal its unlawful activities with regard to the securities laws that similar conduct might be taking place with regard to taxes?**

**Response:**

The IRS is focused on investigating criminal activity and our examination agents are alert to both the badges of criminal tax fraud and actions taken to obstruct justice, such as the making of false statements and the destruction of documents. Our revenue agents are trained to refer cases involving tax evasion, tax fraud, obstruction of justice, and other tax crimes to the IRS' Criminal Investigation Division ("CI"). CI has been working with revenue agents in all operating divisions to increase fraud awareness in connection with examinations of abusive tax schemes. For example, during a recent Office of Tax Shelter Analysis ("OTSA") national meeting, CI officials reinforced the importance of working together on abusive tax schemes. In addition, LMSB employees have received fraud awareness training and additional training is planned.

Currently, we are conducting parallel civil examinations and criminal investigations of promoters and participants in a number of abusive tax schemes. In the course of their examinations, our agents have encountered evidence of tax evasion and a violation of the securities laws. In addition, CI has participated in Department of Justice task forces established to address important national law enforcement priorities, including most recently, the Department of Justice's Corporate Fraud Task Force. Although the Securities and Exchange Commission (SEC) and FBI have leading roles, CI's involvement has been sought because of the investigative skill of its agents.

It is important to note, however, that taking an aggressive position as to the tax treatment of an item, without more, does not constitute a criminal violation under our tax laws. The tax laws can produce surprising and unintended results, some of which increase and some of which decrease taxpayers' tax liabilities. Abusive corporate tax avoidance transactions are sophisticated transactions that involve the application of technical rules and legal judgments often supported by opinions from lawyers or accountants. These transactions typically do not rise to the level of criminal conduct because a criminal conviction requires proof beyond a reasonable doubt of a knowing and intentional violation of the law.

Many abusive corporate tax transactions are intentionally structured to appear similar to legitimate transactions that are permitted under the Internal Revenue Code (the Code). In light of this, we appreciate the Committee's efforts to provide disclosure rules that will help the IRS identify these aggressive positions. We look forward to the enactment of these

provisions and other amendments to the Code identified by the Treasury Department that will enable the IRS to more effectively address abusive transactions.

**2. Have IRS field agents recommended criminal action be taken with respect to illegal conduct by corporate taxpayers regarding abusive tax shelters? What has been the National Office's position with regard to referring these matters to Justice?**

**Response:**

The IRS has devoted significant resources to combating abusive corporate tax transactions. As noted above in the Response to Question for the Record No. 1, these transactions often involve an aggressive position regarding the tax treatment of a particular transaction, but such conduct typically does not rise to the level of a criminal violation.

CI special agents, however, routinely refer criminal tax cases to the Department of Justice recommending that corporate officials be prosecuted for tax crimes, tax evasion, and money laundering. The focus of these CI investigations typically is the misconduct of individual corporate officers, which typically involves participation in an abusive tax scheme. This misconduct includes the use of offshore entities or foreign financial arrangements for illegal purposes, fictitious payments to related parties, fraudulent loan transactions, and inflated earnings.

The National Office has delegated the authority to recommend prosecution in criminal tax cases, including abusive tax scheme investigations, to the Special Agent in Charge of each field office. The Special Agent in Charge has the authority to sign a transmittal letter to the Department of Justice recommending prosecution for violations of the Code and related financial crimes. The IRS' policy is that the Special Agent in Charge should refer criminal matters to the Justice Department in all instances where there is sufficient evidence of criminal wrongdoing.

**3. Has the IRS made any criminal referrals to the Justice Department involving abusive corporate tax shelters? If so, please describe the nature of the offense, how many and the outcome?**

**Response:**

As noted in the Responses to Questions for the Record Nos. 1 and 2, a referral to the Justice Department requires evidence of criminal behavior. In recent years CI has investigated potential criminal conduct by corporate officials of major corporations and made referrals to the Justice Department where appropriate.

**4. A Federal court recently ruled that KPMG did not have to produce documents to the IRS that the firm said were protected by attorney-client privilege. The government argued that documents used by professionals in conducting and marketing illegal tax shelters are not privileged. The ruling could affect efforts to subpoena documents from other accounting firms as well as law firms. To what extent are**

**professional firms cooperating with the government's effort to learn the names of shelter investors? How will the Federal court's decision in the KPMG matter affect the government's ability to identify tax shelter participants?**

**Response:**

In response to requests for investor lists, the IRS has received a range of responses from professional firms. Some professional firms have provided the names of investors and other requested information in response to IRS information requests and summonses, while other firms have provided little or no information. In each case, our goal is to obtain the requested information as expeditiously as possible. Notably, we recently reached agreement in connection with one major professional firm that will require that firm to ensure that all required disclosures are made to the IRS and that will require that firm to adhere to the highest standards of tax practice. We hope that this settlement will serve as a model for future agreements with professional firms and tax advisers.

In many cases where the IRS has requested investor lists from professional firms, tax advisers have asserted the attorney-client and section 7525 tax-practitioner privileges with respect to investor identities and documents. As a general matter, the IRS believes that the attorney-client and tax-practitioner privileges do not apply to investor names and many documents created in connection with the promotion of abusive transactions. While we acknowledge that tax advisers have the obligation and responsibility to assert valid claims of privilege, we believe that in many cases the assertion of these privileges is inappropriate. We have challenged and will continue to challenge claims of privilege that we believe are improper.

We do not believe that the outcome in the KPMG case will affect the Government's ability to identify taxpayers who have participated in abusive transactions. The KPMG case does not involve investor identities. The dispute in that case arose from the IRS' administrative summons to KPMG for documents relating to a listed transaction. KPMG asserted, in a privilege log, the attorney-client and tax-practitioner privileges and the work product doctrine with respect to a number of documents. The Department of Justice brought a summons enforcement proceeding against KPMG to challenge KPMG's assertions of privilege on the basis, among others, that the privilege log did not contain adequate information for the IRS to determine whether these privileges should apply. A special master was appointed by the district court to review the documents. The special master determined that some of the documents were privileged. This determination is pending review by the district court. In any event, the findings of the special master will not affect the IRS' ability to identify investors in abusive transactions because the findings are limited to claims of privilege relating to specific documents.

It is worth noting, however, that the section 7525 tax-practitioner privilege excludes communications relating to corporate tax shelters, but does apply to partnerships and high net-worth individuals that participate in abusive transactions. We share the Committee's concern that, without a statutory modification, taxpayers and their advisers will continue to assert the section 7525 privilege in such cases.

**5. Last year, former IRS Commissioner Rossotti publicly stated that “the IRS is simply outnumbered when it comes to dealing with compliance risks. . . Even after we focus on the most egregious noncompliance cases, we can only handle a small fraction of them.” The IRS estimates that it is leaving \$30 billion on the table each year simply from cases it knows about but lacks the resources to pursue. That doesn’t include the ones it doesn’t know about but might discover if it were able to do more investigating. Please comment on Mr. Rossotti’s assessment of IRS’s ability to pursue tax noncompliance.**

**Response:**

In order to address the serious problem of noncompliance, we must make sure that the right resources and tools are being applied to the right problems. This requires the careful identification of priorities and the efficient allocation of resources to meet those priorities.

Identification of compliance priorities requires, first and foremost, current and reliable information. The IRS and the Treasury Department have begun a number of initiatives to obtain and analyze such information. These initiatives include the revised rules mandating the disclosure of potentially abusive transactions by taxpayers and promoters and the National Research Program (NRP). We also are exploring ways in which we can obtain more reliable information from taxpayers through electronic filing and revisions to our tax forms, and from the States through increased cooperation and sharing of information. These actions and others are discussed further in Assistant Secretary Olson’s responses to the Committee’s Questions for the Record.

**6. Combating abusive tax shelters often requires IRS employees to unearth, understand, and take action against sophisticated, cleverly disguised tax schemes. These are often among the most difficult cases for IRS to pursue and therefore often require significant staff day investments by IRS’s most skilled employees. Thus, the overall number of enforcement cases IRS is likely to handle with existing resources may decline as these reallocated staff work complex cases for longer periods of time than may have been necessary for previous cases. Please comment on how IRS intends to combat abusive shelters without abandoning other compliance areas.**

**Response:**

In order to respond to the challenges presented by abusive transactions, we must understand the nature and extent of noncompliance in our tax system so that can target our resources to compliance priorities, while at the same time making sure that historical compliance priorities are being addressed. Early identification of noncompliance permits the IRS to gather information and respond appropriately. We believe that increased disclosure of potentially abusive transactions will permit the IRS to respond proactively and more efficiently.

We also recognize, however, that noncompliance involves more than just abusive transactions. The IRS is prioritizing its examination focus and applying proportionately greater resources to areas where we believe there are, or where we expect to find, compliance issues.

We have initiated new programs to make traditional examinations more efficient, thereby freeing resources for high-risk areas. For example, pre-filing agreements and the limited issue focused examination (LIFE) program allow agents to address areas of potential noncompliance more effectively. In addition, we have instituted programs, such as Fast-Track Mediation and Fast-Track Settlement, which are designed to resolve contested issues more quickly. Faster resolution of examinations permits agents to keep pace with emerging issues and developments. Advances already have been made in this regard, and these efforts must continue and expand.

As we work to focus our resources on important compliance priorities, one of our concerns is that significant resources are being spent on issues that could be clarified through additional published guidance. We are addressing these historically contentious and resource-intensive examination issues through published guidance rather than through protracted examinations and litigation. With an increased emphasis on published guidance and on new ways of conducting examinations, we believe we can continue to direct additional resources to other compliance priorities such as abusive transactions. The responses to Questions for the Record Nos. 5 and 7, and Assistant Secretary Olson's responses to the Committee's Questions for the Record, discuss other actions being taken by the IRS and the Department of the Treasury to provide the IRS tools it needs to address compliance.

**7. GAO reports that IRS is reallocating resources from one area to bolster efforts in another. While some shifting of resources may be appropriate, shifting resources means that activities from which the resources are being shifted must be de-emphasized. Please explain where the shifted resources have and will come from and the rationale for de-emphasizing the activities that are losing the resources.**

**Response:**

As described in detail in the GAO's written testimony to the Committee, we have developed and are following a broad-based, multifaceted strategy to combat abusive transactions. This strategy involves identifying priorities and applying resources appropriately. Although we are continuing to gather data regarding noncompliance, we have made initial decisions regarding the application of shifted examination staff resources to support the IRS' efforts against abusive transactions. We are making increased efforts to complete a risk assessment of noncompliance areas and to audit accordingly. For example, LMSB's compliance plan will apply up to 20 percent of its compliance resources to abusive transaction enforcement activities in fiscal year 2004. We will continue to measure the effect of these steps and will reevaluate these decisions as we develop better information regarding the size of the abusive transaction problem and the amount of time it takes to examine abusive transaction cases.

At the same time we are devoting more resources to compliance priorities, we also are exploring ways to mitigate the impact of resource reallocations to abusive transactions. In



this regard, we are initiating a variety of measures, such as the pre-filing and LIFE programs outlined above, that will require less staff time to close cases and permit this freed-up capacity to be used in other areas. We will continue to analyze and evaluate ways to curtail the inefficient use of resources in low-priority areas. The responses to Questions for the Record Nos. 5 and 6, and Assistant Secretary Olson's responses to the Committee's Questions for the Record, discuss other actions being taken by the IRS and the Department of the Treasury to provide the IRS tools it needs to address compliance.

**8. With the emphasis on disclosure, and the anticipated large volume of filings, how will the IRS work with the Chief Counsel's Office to identify tax positions on returns that its agents should pursue on examination?**

**Response:**

We recognize that the IRS will be receiving more disclosures and registrations of reportable transactions, especially if legislation passed by the Committee imposing stiff penalties for the failure to disclose is enacted. We are committed to responding quickly to the information we receive from the disclosures of questionable transactions.

Taxpayer disclosures and promoter registrations, as well as tips from its tax shelter hotline, are channeled through OTSA. In addition to identifying known abusive transactions, OTSA analysts review this information to identify new or potentially abusive transaction for further scrutiny by the Office of Chief Counsel. OTSA is preparing for a sharp increase in the number of disclosures and is training analysts and exploring ways to reduce the time it takes to process taxpayer disclosures.

One key to preventing the proliferation of abusive transactions is early identification and the early publication of the Government's position. By designating an abusive transaction as a listed transaction, the IRS imposes disclosure obligations on taxpayers that engaged in the transaction, and certain record retention requirements on promoters and tax advisors. The "listing" of a transaction chills significantly, or even stops, the continued promotion of the transaction. The listing of a transaction, for instance, notifies IRS agents in the field of these abusive transactions. Listing a transaction also provides strong support to those tax advisors who advise clients to avoid engaging in abusive transactions. The listing of a transaction thus fosters respect for the tax system and conserves IRS examination and Chief Counsel resources that otherwise would be needed to examine and litigate these transactions.

We have decreased significantly the time between identification of a potentially abusive transaction and the issuance of guidance relating to such transactions through coordination between OTSA, technical advisers, the Office of Chief Counsel, and the Treasury Department. Continued coordination between the IRS operating divisions and the Office of Chief Counsel will be required to evaluate the disclosures and determine which reportable transactions warrant follow up through examinations, published guidance, or both. We will continue to explore ways of reducing lead time in evaluating and understanding abusive transactions so that we can respond rapidly to the disclosures we receive.

**9. What steps is the Administration taking to ensure that the IRS has adequate resources to effectively tackle the abusive tax shelter problem? In your judgment, can the IRS continue to do more with less?**

**Response:**

We are working very closely with the Treasury Department to ensure that the right resources and tools are being applied to the right problems. Our objective is to continue the careful identification of our priorities and the effective and efficient allocation of resources to meet those priorities. As discussed in response to Questions for the Record Nos. 6 and 7, the LIFE and Fast-Track programs are examples of valuable tools we have implemented to make better use of the IRS' resources, and we are continuing this effort. Additional tools include simplified and revised disclosure rules to ensure the early disclosure of questionable transactions, the NRP, prompt guidance for abusive transactions, and revised tax forms requiring taxpayers to provide relevant tax information in a form that can be more easily evaluated by the IRS. These initiatives are discussed in more detail in Assistant Secretary Olson's Response to Question for the Record No. 5 (Senator Baucus).

**10. You testified that the sharp drop in prosecutions, especially high profile prosecutions, had emboldened many tax cheats. Specifically, what does the IRS need in terms of resources to get a handle on the enforcement issue?**

**Response:**

I am concerned that noncompliance, if not addressed, threatens our system of self-assessment. I am confident, however, that the steps that have been taken over the past three years to address abusive transactions are making a difference and will be effective. In addition, the Administration's FY2004 Budget proposed to provide the IRS additional resources to fight noncompliance, including over \$130 million of increased funding to be used by the IRS to combat abusive transactions and schemes and to address other compliance issues. I appreciate the Committee's continued support of the IRS in these efforts. Please also see Assistant Secretary Olson's Responses to Questions for the Record No. 5 (Senator Baucus) for a more detailed discussion of these actions.

**11. You testified that the IRS intends to shorten audit cycles. How does the 18-month goal for audit cycle time affect resolution of material issues? To what extent will this goal require that all material issues be known by the IRS at the beginning of the examination? Is this a realistic expectation? To what extent are IRS agents abandoning significant adjustments because they lack the time to make them within the reduced audit cycle time?**

**Response:**

We believe that examinations should start sooner after a tax year has ended and that once started, an examination should be completed more quickly. A reduction in the time needed for an examination cycle should enhance, and not diminish, the effectiveness of

examinations. Examination issues, including those related to abusive transactions, typically do not become clearer with age; rather, they become less clear as memories fade and records become more difficult to locate and maintain. To achieve the objective of shorter examination cycle times, the IRS has studied and developed several tools for working more effectively with taxpayers to reduce examination cycles. These tools include the increased disclosure of questionable transactions, the limited issue focused examination (LIFE) program, and the reexamination and reengineering of the examination process (e.g., reducing delays in the processing returns before they are delivered to an agent for examination). We also are involving specialists, technical advisers, and Chief Counsel attorneys earlier in the examination process to ensure that complex issues are developed appropriately and consistently. In addition, reductions in examination cycle time can be achieved through the more effective use of technology, such as increased electronic filing and the exchange of information through electronic formats during the examination process.

We fully recognize, however, that some complex issues require more time to develop. In those cases, we will invest the time necessary to develop the facts and legal arguments in a manner that best supports the Government's position. Although these issues may require more examination time, we still have a responsibility to work with taxpayers to resolve these issues as quickly as possible.

We share the Committee's concern that reduced examination cycle times should not lead to agents abandoning significant adjustments. Our focus is to get all significant issues on the table at the start of an examination. We will not sacrifice compliance in our efforts to reduce cycle times. We will deal appropriately with taxpayers that are unwilling to work with the IRS to develop issues and do not cooperate by providing requested information. We are prepared, if necessary, to use existing available tools, such as summonses, in dealing with such taxpayers.

**12. Please describe the level of coordination, cooperation and communication between your agency and the others represented on the panel – and – is there more that should be done to ensure a comprehensive, coordinated attack on abusive tax shelters?**

**Response:**

There has been significant cooperation and coordination between the Treasury Department, the IRS, and the Justice Department in addressing abusive tax avoidance transactions. In particular, the IRS, the Office of Chief Counsel, and the Department of Treasury have a historic and longstanding close relationship on all aspects of tax administration. This close working relationships extends to efforts to identify and address in published guidance various tax compliance issues, such as abusive tax avoidance transactions. This coordination and cooperation between the IRS and the Treasury Department has been reinforced in response to the proliferation of abusive transactions.

The IRS and the IRS Office of Chief Counsel currently have a strong working relationship with the Department of Justice. A strong relationship historically has existed between the agencies with regard to tax litigation and criminal tax prosecution matters. This relationship

has broadened during the past few years to include more frequent injunction actions against promoters of tax schemes, summons enforcement actions against promoters, and John Doe summons actions related to credit card companies and promoters of abusive transactions.

In addition, the IRS' CI has a longstanding relationship with the Department of Justice, including the Department of Justice's Tax Division, the Federal Bureau of Investigations ("FBI"), and the United States Attorneys' offices. This cooperation is exemplified by the IRS' participation in the Department of Justice's task forces established to address important national law enforcement priorities. These task forces include the National Health Care Task Forces, the FBI's Joint Terrorism Task Forces, and, most recently, the Department of Justice's Corporate Fraud Task Force.

LMSB has consulted with the SEC on the SEC's risk assessment methodologies that may be adaptable for tax administration purposes. LMSB also has access to SEC data that can be utilized to enhance the risk assessment process used to determine material issues in IRS examinations. We will continue to look for ways that we can share ideas and information in furtherance of our respective missions of providing taxpayer service and ensuring tax compliance, and ensuring accurate financial reporting to the public. Finally, as PCAOB builds its organization, we will seek opportunities to work with this important new organization.

**13. The IRS and 40 states recently announced an agreement to share investigative leads on promoters of fraudulent tax schemes and to coordinate efforts to shut down and prosecute some cases and warn the public about these schemes. Please explain how this program will work. Does the IRS intend to permit the states to share in tax collections?**

**Response:**

The memorandum of understanding ("MOU") between the IRS Small Business/Self-Employed Division (SB/SE) and participating states is an agreement to facilitate information sharing for tax administration purposes in connection with abusive tax avoidance transactions and abusive tax schemes (referred to collectively as "abusive tax avoidance transactions"). The key aspects of the agreement with each state include:

- The exchange of information regarding abusive tax avoidance transactions with participating States.
- The sharing of results from examinations involving abusive tax avoidance transactions.
- Collaboration with respect to outreach and education to combat the marketing of and participation in abusive tax avoidance transactions.

Implementation teams comprised of IRS and State tax administrators will coordinate the implementation of the MOU. Upon full implementation of the MOU, each participating

State and the IRS will exchange information to identify and, as appropriate, take action to bring participants in abusive tax avoidance transactions in compliance with Federal and state tax laws. As outlined in the MOU, the IRS will begin forwarding taxpayer leads to the States beginning in late January 2004.

The IRS also will provide participating States with examination results from abusive tax avoidance transaction examinations conducted by the IRS. The States will provide similar information regarding state tax examinations to the IRS. This sharing of information will assist the IRS and states in increasing compliance and enable the state and federal governments to use their resources more effectively.

In addition, the MOU contemplates the sharing of information and experience regarding effective examination strategies and procedures to better deter, uncover and combat abusive tax avoidance transactions.

With regard to collection activities, existing procedures remain in place and are not impacted by the MOU. The IRS and the States do not share in tax collections. The IRS will assess and collect any federal taxes determined to be due. Based on examination reports and other information received under the program, the States similarly will take independent action to assess and collect any state taxes from these same taxpayers.

**STATEMENT OF ROB SCHMIDT**

Mr. Chairman, as with my colleague Tom Walsh, I was a Director of International Tax at Levi Strauss & Company (LS&Co.) prior to my termination in December 2002.

Among my responsibilities were project lead and issue manager for the factual and technical review of a partnership named LSLA entered into between LS&Co. U.S. subsidiaries corporations. The LSLA partnership was an issue of great interest to the IRS during its audit of LS&Co.'s 17 open tax years. The IRS took issue with a number of LS&Co.'s contentions with regard to this transaction. Beginning in 2001 and extending through September of 2002, I devoted a considerable amount of time and energy to understanding how the partnership was formed, what the justification claimed for the partnership was, and what events had transpired from formation through to the present. As part of that review I traveled to Brazil on two separate occasions and reviewed approximately 50 boxes of materials generated in connection with this partnership. Prior to and during this same period of time the IRS issued a number of Information Document Requests (IDR's) seeking specific information about this partnership. Following my first visit to Brazil I returned with a number of documents directly relevant to the partnership formation, to the IRS's ongoing audit, and directly responsive to the IRS IDR's.

Specifically, I located a number of non privileged documents responsive to the outstanding requests from the IRS. On July 25, 2002, I contacted my superiors at LS&Co. and advised them that I had located critical information pertaining to the Brazil transaction, that this information was directly responsive to IRS requests, and that it must be turned over to the IRS. My supervisors, Vince Fong and Laura Liang, instructed me not to turn the information over to the IRS. I was told at that meeting by Vince Fong that he would "go to higher-ups in the IRS and have the IDR's withdrawn." I advised him that I would expect to see notice that the request had been withdrawn. The next day I was removed as the primary IRS contact on the LSLA Brazilian Partnership transaction and was told not to have further contact with the IRS on that issue. My replacement was Jim Fuller of the Fenwick & West law firm. I never received notice that the IRS request was withdrawn and to my knowledge, the IRS has never received the documents that I located and identified.

Subsequently, I returned to Brazil for a period of three weeks. On this occasion, I brought four boxes of materials back with me to the United States. Shortly after my return, these materials were removed from my office at LS&Co. and taken to the offices of Fenwick & West. In September 2002, I receive a proposed response to an IDR that had been drafted by the Fenwick & West firm in response to a very broad IDR from the IRS. That request sought any and all documents related to the Brazilian transaction. Appended to this response were seven letters – all benign – with the explanation that this correspondence constituted a fair and accurate representation of the available documents. I knew this representation to be false as I had recently returned with four boxes of materials which essentially laid out in detail the complete history of the Brazilian transaction and which clearly articulated the history of the transaction, the bases for

the transaction, and the benefits obtained from the transaction. I refused to sign this response. My supervisor, Vice President Laura Liang, was furious at my refusal and signed off the IDR in her name. This occurrence is under litigation, pending civil litigation, Sarbanes Oxley Federal investigation and continuing IRS review. It is my belief that the response given to the IRS was materially false, misleading, and obstructive.

In August 2003, I met with an Investigator working for the LS&Co. Board of Directors. I informed him of the fact that I had been instructed to withhold documents from the IRS. In spite of my experiences LS&Co. announced in a recent press release that they found no evidence of fraud in their internal investigation.

At the beginning of December 2002, I was fired by LS&Co. for, among other things, allegedly providing documents to the IRS without approval of my supervisors.

Thank you.

Rob Schmidt

## Statement of Thom Walsh

My name is Thom Walsh. I am a Canadian Chartered Accountant. From September 1999 to December 2002, I was employed in the global tax department of Levi Strauss & Co. (LS&Co.). First as a manager, then as a senior manager, and from February 2001 to my termination in December 2003, as a Director of International Tax. As one of 5 Directors, I reported to Vice Presidents Laura Liang and Vince Fong. My responsibilities as Tax Director included calculating LS&Co's worldwide tax provision for 2001 and 2002. That process required the calculation of historical data including the history of tax accounting reserves established and released, the availability and prior use of foreign tax credits, and the application of valuation allowances against credits.

My efforts began in an unusual context as LS&Co. had at the time, 16 open tax years, meaning the company's consolidated tax returns had not been completely audited by the IRS for 16 years. With respect to reserves I discovered that from 1995 forward large amounts of tax reserves had been systematically released into earnings. From 1995 to 2001, LS&Co. released approximately 200 million of tax reserve into earnings. Because I was aware that the timed release of reserves violates GAAP and FASB rules, I looked for documentation that would tie the reserve release to the termination of a specific tax liability. I found no such documentation. I was equally unable to find any lawful justification for the release of the tax reserves. I concluded that LS&Co. was engaged in the systematic timed release of tax reserves to lower its effective tax rate. That is, it was releasing "cookie jar" reserves to lower its effective tax rate and boost income. Any doubts I had were removed when I was told by Vice Presidents Fong and Liang that the company sets its target tax rate and that it attains those rates through the release of tax reserves.

In addition to releasing unsubstantiated reserves, LS&Co. failed to set meaningful tax reserves against potential exposure for a number of extremely aggressive tax schemes. Setting reserves has the effect of reducing income and increasing the effective tax rate. Approximately 3 million dollars was set as a reserve against exposure that I and others in the Global tax department including Mr. Schmidt, calculated to be at least 100 million dollars.

A similar scenario existed with respect to foreign tax credits. From 1995 to 2002 LS&Co. claimed the benefit of foreign tax credits and "tax on unremitted foreign earnings" on its balance sheet in the aggregate amount of approximately \$200 million. Unless LS&Co. can show that it is more likely than not that it will be able to use these deferred assets it must set a valuation allowance against them. LS&Co's own internal models demonstrated that it would not be able to utilize these tax credits before they expired. Even so, LS&Co. failed to book any valuation allowance. Therefore, overstating assets by up to \$200 mil.

These issues troubled me deeply as I believed LS&Co's conduct to be unlawful. I raised my



concerns with Laura Liang, CFO Bill Chiasson, and HR Manager Nancy Handa among others. I also raised my concern that VP Fong had instructed the tax leadership team to show the new auditor KPMG “only what we want them to see”. The response by the company was to issue me with a written warning threatening me with termination. A threat ultimately carried out approximately one week prior to the arrival of KPMG to perform its first year end F/S audit. With respect to KPMG it is also noteworthy that the original partners assigned to LS&Co. were removed at the request of VP Fong and replaced with two other partners.

## Addendum

## Levi Strauss Income Manipulation

## Reserves

Between the years 1995 and 2001 Levi Strauss released into income \$200 million or reserves and previously unrecognized loss carry forward. The result of the releases was to lower to its effective tax rate while increasing net income by over \$200 million for the period. In a recent article published by the Wall Street Journal Levi Strauss was reported to have admitted that these reserves were not supported by sufficient contemporaneous documentation that related the reserves to specified tax exposures. Although Levi Strauss did not register its debt under the Securities Act of 1933 until February 2001 the S-4 and 10K filings include financial statements which report the financial results for the period back to the financial year ending November 24, 1996.

For the years commencing 2000 I was involved in meetings with the senior management (referred to as the "Tax Leadership Team") of the tax department where the discussion centered around determining the amount of reserves that were required to be released in order to achieve the desired effective tax rate. The amounts in these later years were not as large as during the period from 1995 through 1999 due to the fact that the net income before was smaller and therefore less reserves were required to be released to achieve the lower effective tax rate.

Levi Strauss' open audit years goes back to 1986. I became responsible for the worldwide effective tax provision in 2001 which includes tracking the reserves. I was uncomfortable with the way the tax reserves were determined and had attempted to set up a new analysis whereby we would identify the specific tax exposures in the open audit years and determine the amount of reserve which would be required to cover these potential exposures. Ms. Laura Liang VP Tax at Levi Strauss assigned Mr. Vince Fong (former VP of Tax at Levi Strauss) the responsibility of determining the tax exposures and their potential related costs. Mr. Fong had determined that amount to be approximately \$3 million. I did not feel that this was a reasonable estimate in light of the fact that Levi Strauss had received a Revenue Agents Report ("IRS") for the 1990 through 1994 audit period which showed a tax liability of approximately \$90 million and an additional \$90 million of interest owing. Had Levi Strauss drawn down its tax reserves for the \$180 million related the IRS RAR it would have left the company with tax reserves of approximately \$25 million for the remaining tax exposures in the open audit years back to 1986 as well as various State tax exposures.

### Valuation Allowances

In its 10K filed with the SEC for the year ended November 24, 2002 Levi Strauss reported a deferred tax asset related to its foreign tax credit carryforwards of approximately \$200 million. Of this amount approximately \$129 million relates to tax on unremitted foreign earnings in excess of 35%, this represents taxes paid to foreign jurisdiction in excess of 35% on foreign earnings which have not been repatriated to the US by way of dividends. The remaining \$71 million relates to taxes paid to foreign jurisdiction which have been repatriated to the US but were unable to be used to offset US taxes.

I was responsible for the tracking of the foreign tax credits ("FTC"), for which I prepared a model which showed the utilization of these FTCs'. The results produced by various versions of the FTC model showed that a large percentage of these FTCs on repatriated earnings would expire unutilized. Therefore, it was more likely than not that the deferred tax asset related to these FTCs' reported would not be realized which is the criteria to determine whether a valuation allowance would be required to reduce the value of this asset, as defined in Financial Accounting Statement No. 109 (FAS 109). The result of this action was to overstate the net income and assets.

With respect to the \$129 million of foreign taxes on unremitted earnings the triggering of the carry over period had not occurred. However, Levi's used a company in Belgium ("Finserv") as its cash management center whereby Levi Strauss' foreign subsidiaries would lend excess cash to Finserv and Finserv would then lend these funds back to Levi Strauss in the US, thereby effectively repatriating the foreign profits without triggering the FTCs'. The Internal Revenue Code contains provisions which provide that any amount of loans from foreign controlled corporations to its US parent, either directly or indirectly, would be deemed to be a dividend to the extent of the foreign subsidiaries' earnings and profits and trigger the foreign taxes paid. If the IRS was to successfully argue that the Finserv loans were made indirectly from Levi Strauss' other foreign subsidiaries or that Finserv was a conduit financing entity, that \$129 million of foreign tax paid would be triggered commencing the 5 year carryforward period. The triggering of these foreign taxes paid on unremitted earnings would result in those FTCs expiring unutilized, therefore requiring a valuation allowance of \$129 million to reduce the carrying value of this asset.

### New Auditors KPMG

Levi Strauss was audited by Arthur Andersen prior to its collapse, in May of 2002 Levi Strauss appointed KPMG as their new auditors for the 2002 year. In the course of an internal Levi Strauss tax department auditor transition meeting Mr. Fong had stated that "we are only going to tell the auditors what we want them to know." I interpreted this statement to mean Levi Strauss intended on withholding information from its financial statement auditors, and vigorously refused to be involved in an "Enron-like" situation. KPMG had assigned a number of tax partners to be responsible for the audit of the tax provision. Two of these tax partners questioned the appropriateness of the tax reserves with respect to the large number of open IRS audit years and the valuation allowances related to the deferred tax assets related to the FTCs'. The management

of the tax department requested that these two partners be removed from the account and replaced with other partners. KPMG complied with the request and these partners were replaced. Mr. Schmidt and myself were terminated on December 10, 2002 one week before KPMG was to commence its audit fieldwork thereby denying the auditors access to us.

**SENATE FINANCE COMMITTEE  
Testimony of B. John Williams, Jr.  
Shearman & Sterling LLP,  
and former Chief Counsel for  
the Internal Revenue Service**

**October 22, 2003**

Mr. Chairman, Senator Baucus, Members of the Finance Committee, thank you for inviting me to testify today on the subject of the government's efforts to curtail abusive tax avoidance transactions. This is the third occasion on which I have had the privilege of testifying before this Committee on this important topic.

**INTRODUCTION**

This Committee has wrestled with abusive tax avoidance transactions for years, and I applaud your efforts to focus on the central solution: disclosure. I also applaud the Committee for enabling Commissioner Rossotti to redesign the administrative apparatus of the Service in a way that permits it to act on a national basis. The organization of the Service by taxpayer type and industry has permitted efforts to address the proliferation of abusive tax avoidance transactions and the technical issues presented by them in a way that the old organizational structure never could have. The new structure not only permits the issues to be addressed on a national basis to assure more consistency in tax administration, but also permits the Service to focus on compliance levels more quickly and efficiently by particular taxpayer groups thus permitting use of resources where most urgently needed.

**IDENTIFICATION OF THE PROBLEM**

At the hearing on whether to confirm my nomination to be Chief Counsel for the Internal Revenue Service on November 15, 2001, Sen. Baucus asked me how, as Chief Counsel, I would address the problem of proliferating tax shelters. In response, I identified two institutional issues that I believed were recurring obstacles to successful interdiction. These issues were (1) improving the use of existing tools available to IRS, including more effective gathering of information that was needed to analyze transactions and more timely publication of the IRS' view of the proper tax treatment of those transactions; and (2) encouraging the appropriate use of existing enforcement tools to promote "an ideal that the IRS is in the business to help people comply with the law...so that the attitude is not, 'we're looking for a fight,' but 'we're looking to help you pay the right amount of taxes' which this Congress has said the taxpayers owe." Sen. Baucus urged me to pursue these issues.

My testimony before this Committee on March 22, 2002, identified more specific hurdles to interdicting abusive tax avoidance transactions, which the Service refers to as

"technical tax shelters". To summarize, the Service's reliance on old audit processes to identify technical tax shelters left it unknowledgeable and incapacitated to interdict the promotion of those transactions. Further, this lack of knowledge was impeding analysis and publication of guidance on which transactions were regarded as abusive. This impediment was occurring at a time when published guidance in general was languishing terribly, despite the obvious fact that effective tax administration assumes that the public knows the positions that the Service believes are correct. The Service was not using its information gathering tools as effectively as it could, and the disclosure, registration and list maintenance requirements had produced limited information.

The Committee on May 31, 2003, received my Report on Abusive Tax Avoidance Transactions which the Committee had requested at my confirmation hearing (the "Report"). By then, with the active support of Pam Olson, Charles Rossotti, and Larry Langdon, I had already begun to implement strategic changes that I shared with the Committee in that Report. The changes involved streamlining the relationship between Counsel's field operations, its national office technical functions and the Large and Mid-Size Business Division of the Service ("LMSB"), which was charged with responsibility for examining technical tax shelters. In general, these changes included: (1) improving early detection of questionable transactions; (2) improving prompt analysis of questionable transactions; (3) accelerating public notification and guidance on questionable transactions; and (4) vigorously enforcing tax rules to ensure the system works fairly for all taxpayers, including vigorously pursuing information relating to these transactions.

#### **PURSUIING PROMOTERS OF ABUSIVE TAX AVOIDANCE TRANSACTIONS – THE SUPPLY SIDE**

The supply of tax avoidance transactions cannot be quantified. Nevertheless, the creators of such transactions frequently have legal obligations to register them (Code section 6111) and to maintain a list of investors in them (Code section 6112). Accordingly, the Service has a public duty to examine compliance with these legal obligations. To help the Service discharge this duty, I made clear within days of my appointment that I would support enforcement of summonses for information from promoters. The Service had already requested, 18 months earlier in some cases, information on compliance with registration and list maintenance requirements from promoters and was being largely ignored. Further, I committed whatever resources were needed from Counsel to support this audit activity.

Promoter audits are led by the LMSB Industry Director for Financial Services, at that time Dave Robison and now Paul DeNard. LMSB was well served in this effort by the Industry Counsel, Roland Barzal, who received for leading field counsel's support of the promoter audits the Chief Counsel's Award, the highest award the Chief Counsel can give. The close working relationship between Counsel, both in the field and the national office, and LMSB is, I believe, a model for future examinations in not only promoter audits (which must continue if the supply side is to be monitored) but also regular income tax audits. Strategic use of audit resources is the most effective way of maximizing them, and I believe

more resources can be justified only after adequate strategic analysis of audit issues is done and implemented.

Although it was impossible to quantify the supply of abusive tax avoidance transactions, it was much more critical that the Service did not know the nature of the transactions being marketed. In general, the Service's analysis of transactions had been undertaken without the benefit of having reviewed the deal documents. There had been few registrations, and even as to those, the Service had not actively pursued examinations. There were even fewer disclosures, so there was no capacity to cross-check investors with promotions. The normal audit process would never give the Service that knowledge. Examining compliance with the registration and list maintenance requirements, however, enabled the Service to gain access to knowledge of the technical tax shelters, past and present, that had been or were then being marketed.

LMSB had published an initiative to encourage disclosure by waiving penalties that otherwise might be imposed on taxpayers who voluntarily participated in the program. See Announcement 2002-2, 2002-2 I.R.B. 304. The disclosure initiative was designed to provide the IRS with information about questionable transactions provided by taxpayers who had participated in a tax avoidance transaction.

Complementing the disclosure initiative, LMSB provided guidelines to IRS examiners regarding the consideration of the accuracy-related penalty under section 6662 in examinations involving listed transactions and other potentially abusive tax avoidance transactions. Together with the disclosure initiative, the penalty guidelines were intended to create a compliance incentive by ensuring that in appropriate circumstances the IRS will consider and apply penalties consistently, impartially, and fairly among all taxpayers.

In my view, the success of the disclosure initiative depended in large part on intensifying the promoter audits. Unless individuals realistically thought that the Service was going to knock on their door, they had little incentive to participate. Promoter audits should produce the list of investors required to be maintained under Code section 6112, and this effect should cause investors to believe that they were at risk for an examination. Of course, that perception could be sustained only if the Service followed-up and examined the investors whose names we received from such audits, a use of resources that could not be assumed.

Information revealing both the investors' identities and the nature of the transactions being marketed should have been kept by the promoter. Accordingly, promoter audits would give us the information we needed about the transactions being marketed and the technical analysis used to justify the tax benefits being claimed. Most importantly, these audits examined current as well as past activities so the audits enabled the Service to bridge the knowledge gap that otherwise would develop during the time between the marketing of the transaction and the review of it in a standard income tax examination years later.

The Service has wide-ranging authority to examine books and records and to conduct interviews of taxpayers. The Service can summons this information under Code section 7602, but if the taxpayer fails to comply, the summons can be enforced only if the Justice Department petitions a federal district court for an enforcement order. Accordingly, to promote the most efficient use of the Service's summons power, I asked that the promoter summonses be pre-cleared with the Justice Department. My objective was to provide the Service with assurance that Justice would file an enforcement petition, if needed. For example, I wanted to be sure that Justice would agree that the scope of the summons was proper and not over-broad. I also wanted to reduce the time necessary for review prior to filing the enforcement petition. Examination teams predictably become discouraged with significant delays in seeking enforcement, and of course, the progress of the audit is impaired.

#### **PURSuing THE INVESTOR – THE DEMAND SIDE**

Focusing on investors rather than solely on the promoters is also a key part of interdicting abusive tax avoidance transactions. If the demand for the shelter product is reduced, the supply diminishes. For individuals and smaller businesses, I believe the most critical factor in reducing demand is whether the investor believes the Service will discover the investment and audit their return. This effect on taxpayer behavior makes a follow-up audit imperative. It also places critical importance on the Service using its audit resources strategically, that is, using its audit resources based on informed judgment about the transaction and who has invested in it. For corporations, I believe the most critical factor is the availability of sound technical analysis to the Examination team. Large corporations assume they will be audited, but the question is whether the Service will pursue the right issues with the right arguments, and frequently it does not.

The Service has a tool, independent of list maintenance, for identifying individual investors, but it is awkward and clumsy to use. The Service has the authority under Code section 7609 to ask that Justice petition a district court for permission to serve a "John Doe" summons where it appears that there is reasonable likelihood that the investors have understated their tax liabilities. The benefit from using a John Doe summons is that, if the recipient does not comply within 6 months, the statute of limitations on the investors' underlying tax obligations is suspended. In the first instance, this requires that the Service have analyzed the transaction and concluded that the tax benefits claimed are not meritorious. Then, the Service must show that other reasonable means of identifying the investors have been exhausted. Whether the Service must fruitlessly pursue enforcement of a 7602 summons for the investor list prior to filing a request for service of a John Doe summons was extensively debated between the Chief Counsel's office and Justice.

The value to good tax administration of producing the investors' names is most tellingly revealed in the battles fought over "identity privilege". I have spoken on several occasions about the frivolous nature of the claim that the investors' identities are protected from disclosure to the Service by either the attorney-client privilege or the "tax practitioner's



privilege" of Code section 7525. See, e.g., Speech of June 6, 2002, before the Texas Federal Tax Institute (the "Alamo Speech") quoted in *John Doe #1 v. Wachovia Bank* (WDNC June 24, 2003). One effect of these battles was to delay audits to the point of losing one or more tax years to the statute of limitations.

#### **THE COMMON THREAD OF THE SOLUTION – ADEQUATE DISCLOSURE**

I testified in March, 2002, in support of Treasury's proposals to expand registration requirements and to adopt a penalty regime for taxpayers' failure to disclose reportable transactions. Those proposals, as modified by the Chairman's Mark on the JOBS Act, give the Service all the tools that are needed to interdict abusive tax avoidance transactions, and I am as firmly convinced today as I was then that these proposals are essential to long term management and control of the "shelter problem". The web of information that would permit cross-checking of promoter information with taxpayer disclosures is a tool that the Service needs for effective tax administration. Access to this information would provide the Service with an early opportunity to analyze the merits of a transaction and to publish guidance on whether the transaction works under current law. Treasury is then in an early position to announce whether policy considerations dictate a review of the current law to consider changes in regulations or the Code. If a transaction is regarded as abusive, Treasury and the Service could list the transaction.

Perhaps the most effective impact of the disclosure regime would be in those instances where the transaction is listed. The web of information reporting and disclosure would permit the Service to connect either the disclosure to the promoter (and thus to all the other investors) or the transaction to the investor. This web of information should enable the Service to regain credibility that the Service will "knock on the door" of the taxpayer. I believe that LMSB is capable and supportive of this effort, and if executed properly, available resources are sufficient to the task. This strategic use of audit resources, however, requires (1) a new flexibility at the Service, and (2) a willingness to reassure taxpayers that the Service is not engaged in chest-thumping.

#### **FLEXIBILITY IS NEEDED**

Additional flexibility is needed in the Service's audits, whether in promoter examinations or in the follow-up ordinary income tax audits, in three important aspects of the process. The first is organizing agents to pursue an audit; the second is encouraging examination teams to rely earlier and more frequently on Counsel's advice; the third is permitting the examination team the room needed to develop the issues.

There have always been institutional obstacles to effective audits. When the Service was organized geographically, examining a taxpayer with significant operations across districts presented jurisdictional problems. This jurisdictional issue now appears as a problem coordinating the efforts of the different operating divisions. For example, a transaction that is a technical tax shelter may be sold by a taxpayer audited by LMSB. If that transaction is bought by individuals, the examining agents on the income tax audit will

be from the SBSE (Small Business Self-Employed) division not from LMSB. The Service needs to be able to organize and deploy revenue agents and audit specialists in teams that can function across divisions. This reallocation is not "robbing Peter to pay Paul;" rather it is sensibly using resources strategically.

Second, the Service needs to rely more closely on Counsel's technical expertise. Ultimately, what is at issue is the application of the law, and Counsel as legal adviser should be an integral part of such teams. These teams would be steeped in the technical and factual issues presented by a particular transaction with Counsel with them to advise on the spot. LMSB has started in this direction by working with Counsel to have specific lawyers identified as advisers to each large case examination.

Finally, and most importantly, these teams need the room to develop and pursue the issues identified for audit. Placing artificial demands on shortening the "cycle time" for completing an audit will adversely impact compliance. First, the audit will not uncover important issues because the team will simply not have the time needed to find them. Second, the examination team will not develop issues it finds because the administrative goal of reduced cycle time will determine performance. Extensions of time that have to be justified will simply by default not be made. Some of the field counsel in my office were alerting me to this problem before I left office. Lastly, a shortened cycle time will place new emphasis on routinely issuing summonses because the examination team will not be able to assure completion within the allotted time by pursuing informal requests for information. Routine reliance on summonses will impede the progress of the audit because the formalization of the information request will tend to impair the working relationship between taxpayers and the Service.

#### **THE DANGER OF INDIGNATION**

One of the foundation stones of the credibility of the Service with the American public is that the Service proceed analytically rather than emotively. "Abusive" reflects the indignation that the Service feels about a transaction, but the Service's feelings about a transaction do not state a legal basis for disallowing the tax benefits from a transaction. "Abusive" is not an analytical term, it is an emotive term, and the mission of the Service is to apply the law fairly and impartially, not to apply the law in a manner that is biased toward a result the government wants. In this connection, the institution does not need to be reminded that it is an enforcement agency. Instead, the Service needs to be encouraged to use its enforcement tools in a way that helps taxpayers comply with the law. This was the point of my colloquy with Sen. Baucus at my confirmation hearing, when I stated that the Service does not need an attitude that "we're looking for a fight", it needs an attitude that "we're interested in determining and collecting the right amount of tax" and "we accept your disagreement with us as legitimate." Taxpayer service is far more than processing returns quickly or answering phone calls pleasantly and accurately; it is the bedrock attitude that the Service should bring to its dealings with taxpayers. It was this insight that Commissioner Rossotti brought to the rehabilitation of the Service after this Committee's 1997 hearings. In this respect, there should be no pendulum swing between taxpayer

service and enforcement. Compliance with the tax law, by both taxpayers and the Service, should be the overriding objective of tax administration.

Recently, I have seen reports that the Service is being urged to approach the taxpaying public as if it were divided into three categories: (1) those who pay; (2) those who can't pay; and (3) those who don't pay. Further, it is said, the first group deserves "service", the second deserves "help" and the third deserves "enforcement". This truncated view of the American taxpaying public is not only short-sighted but also misguided. Taxpayers "who don't pay" the tax that the government says they owe are not always wrong. Indeed, on occasion the Service has had legal fees imposed on it for taking unreasonable positions. More to the point, however, is that the complexity and intricacy of the tax law is often murky or uncertain, and even if not unreasonable, the government's position may not be right. The Service does not always determine a correct deficiency, and the deficiencies as determined by examining agents may be used to measure compliance, but they are not a fair yardstick. To say that taxpayers "who don't pay" deserve enforcement evidences an emotive sense of indignation that has very little place in the administration of a fair tax system. In this connection, I would urge the Committee to remember the hearings it held little more than 5 years ago.

I would caution the Committee against proceeding with strict liability penalties. First, with regard to disclosure, the size and complexity of many businesses and the returns they file will inevitably result in missed items. In my view, the disclosure regime needs some tolerance for inadvertent mistakes. Second, strict liability penalties tend to suffer one of two extremes in tax administration: either they are employed too sparingly because they are viewed as too draconian or they are used as threats to force resolutions that are not appropriate. Neither should be acceptable to sound tax administration. In particular, the special penalty for engaging in a transaction that lacks economic substance is fraught with potential arbitrariness.

The proposed changes in penalties, both regarding disclosure and the Code section 6662 penalties, require personal involvement of the Commissioner in those limited circumstances in which a penalty can be rescinded. I think is a mistake to require involvement of the Commissioner personally in any case.

#### **CONCLUSION**

While the Service still has much work to do, the "shelter problem" is manageable with strategic use of resources and a disclosure regime in place. The Service must, however, demonstrate a continued respect for taxpayers who disagree with it or place at risk its credibility with the American public as a fair and impartial tax collector.

A disclosure regime like that proposed by the Chairman's Mark of the JOBS Act is essential to managing the shelter problem. The Committee's proposed legislation substituting an information reporting requirement for the tax shelter registration requirements of Code section 6111, adding significant penalties for failure to disclose

under Code section 6011 and for failure to maintain lists of investors under section 6112, and limiting the applicability of Code section 7525 should all be enacted as soon as possible.

Thank you again, Mr. Chairman, for the invitation to speak today. I will gladly answer any questions the Committee may have.

## COMMUNICATIONS

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November 5, 2003

### **VIA HAND DELIVERY**

Honorable Charles Grassley  
Chairman  
Committee on Finance  
United States Senate  
Washington, D.C. 20510-6200

Re: October 21, 2003 Hearing: "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?"

Dear Chairman Grassley:

This letter is submitted on behalf of KPMG LLP (KPMG) with regard to testimony and statements made at the above-referenced hearing. KPMG requests that this letter be entered into the hearing record. We are concerned that characterizations of the firm's work on tax matters paint an inaccurate picture with respect to prior events but, even more importantly, that the record fails to reflect KPMG's public commitment to leading our profession in the restoration of professional credibility and to the highest standards of professional integrity.

In his testimony before the Committee, Mr. Michael Hammersley misleadingly described a single engagement in which he was directly involved and made more general allegations regarding KPMG services about which he had no knowledge. KPMG strongly disagrees with Mr. Hammersley's assertions. The concerns he raised in connection with one re-audit engagement were taken very seriously by our firm. They were investigated and reviewed thoroughly by more experienced tax and audit personnel at KPMG. In each and every case, Mr. Hammersley's concerns were found to be without merit and his analysis flawed. Moreover, this situation did not involve tax advice provided by KPMG nor, to our knowledge, did it involve any transaction listed by the IRS. In short, KPMG stands fully behind the work it performed in this engagement.

It is unfortunate that Mr. Hammersley has clouded the record in this hearing with unsubstantiated allegations and subjective personal opinions. Contrary to his claims, Mr. Hammersley was never asked to engage in any illegal action in connection with the engagement, and his claims in that regard are completely wrong.

Tax advice and assistance offered to KPMG's clients is and always has been thoroughly reviewed and analyzed by the firm to assure consistency with the law and regulations in effect at the time. We fully and carefully advise our clients, and they are encouraged to seek independent assistance in implementing that advice. KPMG has always strived to make certain that our clients understand the



Honorable Charles Grassley  
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risks associated with tax strategies on which we have advised them. As the law and policy in this area evolve, KPMG continues this careful approach, and we have a wide range of internal policies and procedures in place to ensure compliance with laws and regulations, including enhanced training and quality control measures.

KPMG believes that the most effective means of further enhancing compliance with the tax laws is the IRS's continued dissemination of clear, timely, and explicit guidance regarding what types of transactions are permissible and impermissible. Unambiguous guidance is extremely helpful to taxpayers and advisors. For example, the "listing" of transactions clearly articulates the IRS's position on specifically described transactions.

KPMG appreciates the opportunity to provide these comments for the record. We believe that the debate over these questions should recognize the changes that have taken place both in the marketplace and in the conduct of taxpayers and their advisors, as well as the need to preserve those aspects of the tax system that work well. We are committed to being a positive force in that debate and to working cooperatively with the government to improve clarity, transparency, efficiency and fairness in the tax laws.

Sincerely,

A handwritten signature in dark ink, appearing to read 'John J. Chopack', written over a light-colored background.

John J. Chopack  
Partner in Charge of Tax Risk and Regulatory Affairs